STATEMENT OF OWNERSHIP

Franchise Law Journal (ISSN: 8756-7962) is published quarterly, by season, by the American Bar Association Forum on Franchising, 321 North Clark Street, Chicago, Illinois 60654-7598. Franchise Law Journal seeks to inform and educate members of the bar by publishing articles, columns, and reviews concerning legal developments relevant to franchising as a method of distributing products and services. Franchise Law Journal is indexed in the Current Law Index under the citation FRANCHISING.

Requests for permission to reproduce or republish any material from the Franchise Law Journal should be sent to copyright@americanbar.org. Address corrections should be sent to coa@americanbar.org. The opinions expressed in the articles presented in Franchise Law Journal are those of the authors and shall not be construed to represent the policies of the American Bar Association and the Forum on Franchising. Copyright © 2015 American Bar Association. Produced by ABA Publishing.
# Table of Contents

## Editorial & News

**Article Hounds**

_Bethany L. Appleby_  

Deadline for the Rising Scholar Award Is Quickly Approaching  

Experience _The Soul of Franchising_ in the Big Easy!  

_Andrew P. Loewinger and Natalma M. McKnew_

## Articles

A Franchisor Is Not the Employer of Its Franchisees or Their Employees  

_David J. Kaufmann, Felicia N. Soler, Breton H. Permesly, and Dale A. Cohen_  

Your Store Is Gross! How Recent Cases, the FTC, and State Consumer Protection Laws Can Impact a Franchise System’s Response to Negative, Defamatory, or Fake Online Reviews  

_Eleanor Vaida Gerhards_  

Developing Domain Name Enforcement Options  

_Jonathan S. Jennings_  

Material Changes and the FDD: Amending and Going Dark  

_Terrence M. Dunn_  

Franchisor Political Speech: The Disclosure Question  

_Daniel J. Oates_  

The Legal Relevance of Bargaining Power in U.S. and Canadian Franchise Litigation: A Comparative Perspective North and South of the Border  

_Adam Ship and Danny McMullen_  

Immigration Issues: A Basic Guide for Franchise Counsel  

_Laura Hayes_
FEATURES

From the Franchising Bookshelf

*Mergers and Acquisitions of Franchise Companies*: Superb Scholarship and Practical Insights 599

*Review by Natalma M. McKnew*

Franchising (& Distribution) Currents 603

*C. Griffith Towlie, Trishanda L. Treadwell, and Jason B. Binford*
One of the benefits of the long, snow-filled (and some-
times homebound) winter we had in many parts of the
country is that it has given our membership time to refl ect
and write. I do not think that we have ever before had this
many articles, features, or pages in any single issue. Don’t
think that this is going to shut me up about encourag-
ing the rest of you to write, though. I will continue to do
that through the end of my term and beyond. In fact, one
of my many “article hounds” is former Editor-in-Chief
(and current Governing Committee member) Chris Bussert, who regularly
“volunteers” his friends, colleagues, and clients to write articles. Work it,
baby! In any event, it will probably take you until the summer issue comes out
to make your way through the end of this issue, but it will be a worthwhile
endeavor if you do.

The issues starts off with a bang—a 60+ page article by David J. Kaufmann,
Felicia N. Soler, Breton H. Permesly, and Dale A. Cohen about the topic on
everyone’s minds these days: *A Franchisor Is Not the Employer of Its Franchisees
or Their Employees*. It then rolls into Elle Gerhards’s wonderfully titled and
interesting *Your Store Is Gross! Recent Cases, the FTC, and State Consumer
Protection Laws Can Impact a Franchise System’s Response to Negative, Defamatory, or
Fake Online Reviews*. Jonathan S. Jennings then treats us to a very useful article
on a topic that many of us have had to confront at some point in our careers,
*Developing Domain Name Enforcement Options*. Terrence M. Dunn answers
some questions that many in-house and outside counsel have had but may
have been afraid to ask in *Material Changes and the FDD: Amending and Going
Dark*. Dan Oates next addresses *Franchisor Political Speech: The Disclosure Ques-
tion*. Adam Ship and Danny McMullen give us *The Legal Relevance of Bargain-
ing Power in U.S. and Canadian Franchise Litigation: A Comparative Perspective*

Bethany Appleby (bappleby@wiggin.com) is a partner in Wiggin and Dana LLP’s Litiga-
tion Department and co-chair of the firm’s Franchise and Distribution Practice Group. She
practices in the firm’s New Haven, Connecticut, office, where she focuses on franchise, com-
mercial, and utility litigation. She welcomes comments from readers.
North and South of the Border. Laura Hayes provides a helpful primer on immigration issues relevant to franchisors (and franchisees) in *Immigration Issues: A Basic Guide for Franchise Counsel*. Tami McKnew reviews the new Forum publication *Mergers and Acquisitions of Franchise Companies* for our feature *Franchising Bookshelf*. Last but not least, Griff Towle, Trish Treadwell, and Jason Binford review recent case law in *Currents in Franchising (& Distribution) Law*.

Some of these authors are seasoned Forum members and leadership, and others are junior associates just getting started. We need you all!

To keep the momentum going, please don’t forget to encourage submissions for the 2015 Rising Scholar Award. See details on the adjoining page.

Happy reading!
Bethany L. Appleby
Editor-in-Chief
Deadline for the Rising Scholar Award Is Quickly Approaching

The deadline for the 2015 Rising Scholar Award is July 13, 2015. To be eligible, entrants must be members of the ABA Forum on Franchising and zero to four 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 Bethany L. Appleby, the current editor-in-chief of the Franchise Law Journal, no later than Monday, July 13, 2015, to be considered in this year’s competition. All inquiries should be directed to: bappleby@wiggin.com.

We look forward to receiving the submissions!
Experience *The Soul of Franchising* in the Big Easy!

Andrew P. Loewinger and Natalma M. McKnew

Welcome to *The Soul of Franchising*! The ABA Forum on Franchising’s 38th Annual Forum on Franchising graces New Orleans this year on October 14–16. As usual, the opportunities for socializing and networking, CLE credits, ethics credits, and the highest quality franchise programs are unsurpassed.

Our plenary offerings this year include what promises to be THE topic of the year—what will be the effect of the NLRB Office of General Counsel’s position on franchisors as co-employers of a franchisee’s employees? We have as our speakers:

- Richard F. Griffin, Jr., General Counsel of the U.S. National Labor Relations Board, and
- Dr. David Weil, Wage and Hour Administrator of the U.S. Department of Labor, and author of *The Fissured Workplace*.

It may be standing room only for this one!

We also feature our signature *Judicial Update*, a lively and informative overview of the most important franchise and distribution cases in the past year, headlined by two of our colleagues, Ric Cohen and Peter Lagarias.

Our line-up of twenty-four high quality workshops will offer the best in franchise education. Topics include what to do after a data breach, strategic trial techniques, best practices for franchisors on avoiding employment risks, global dispute resolution, electronic and mobile pay systems, ownership of franchise goodwill, recent changes in franchise regulations, dealing with financially challenged franchisees, ethical risks in cyberspace, international master franchising, potential franchise investor liability, and many more.

And, as usual, the Wednesday before the workshops, we offer the Forum’s classic intensive *Fundamentals of Franchising* course. In addition, we have two excellent intensive programs, *International Franchising 201* (an advanced...
fundamentals of international franchising program) and Corporate Counsel Summit: Managing the Franchise System.

The Forum offers the best in legal education, and the setting couldn’t be more inviting. Our Thursday and Friday venues are trademark New Orleans—NOMA (the New Orleans Art Museum) and the Presbytère. Both will feature equally trademark New Orleans musical entertainment. Come to New Orleans for the 38th Annual Forum on Franchising, October 14–16, and experience The Soul of Franchising!!
A Franchisor is Not the Employer of Its Franchisees or Their Employees

David J. Kaufmann, Felicia N. Soler, Breton H. Permesly, and Dale A. Cohen

The politics of economic disparity—manifested recently by cries to eliminate income inequality, calls for an increase in the minimum wage, and strikes by fast food workers—have now invaded the franchise arena. And they threaten to cripple or even eradicate franchising, one of the most dynamic and fertile engines of economic growth and opportunity in the United States during the past half century.

The approach? Seek to have franchisors declared the employers or joint employers of their franchisees or their franchisees’ employees, a tactic designed to make large franchisors the economic “bargaining unit” with which unions may negotiate on behalf of the franchisees’ employees.

On December 19, 2014, NLRB General Counsel, Richard Griffin, Jr. issued complaints (Complaints) against McDonald’s Corp. and certain McDonald’s franchisees, alleging that those franchisees violated the rights of employees working at their franchised restaurants at various locations around the country—and asserting that McDonald’s, as a “joint employer” of those franchisees’ employees, was equally liable with its franchisees for any violations of the National Labor Relations Act (NLRA)\(^1\) that may have transpired.

---

Specifically, the NLRB General Counsel informed McDonald’s and its subject franchisees that 86 of the 291 charges filed since November 2012 were found meritorious. The McDonald’s franchisees in question are located in Manhattan, Philadelphia, Detroit, Atlanta, Chicago, St. Louis, Kansas City, New Orleans, Minneapolis, San Francisco, Indianapolis, Phoenix, and Los Angeles. The allegations of unlawful conduct advanced against McDonald’s and its franchisees include discriminatory discipline; reductions in hours; discharges; and allegedly coercive conduct directed at employees in response to union activity, including allegedly overbroad restrictions on employees communicating with union representatives and other employees about unions. Consolidated hearings began in March 2015.

The Complaints against McDonald’s come against the background of labor unions pressuring fast food restaurants to adopt a $15 per hour wage floor (and against the larger political backdrop of claims of income inequality in America). Over the past year, unions organized various one-day strikes by fast food workers, some of which resulted in the arrests of strikers. Ninety percent of McDonald’s restaurants in the United States are franchised, and McDonald’s responded that, like other franchisors, it does not set employee wages, its franchisees do. But, if adopted by the NLRB, the position of the NLRB General Counsel could give rise to McDonald’s being the joint employer of its franchisees’ employees and, as a consequence, would enable unions to collectively bargain with McDonald’s itself (as opposed to thousands of individual franchisees).

Of course, as a joint employer, McDonald’s may also find itself jointly liable under the doctrine of respondeat superior for all of its franchisees’ employees’ acts, errors, and omissions; its franchisees’ workers compensation, unemployment, and Affordable Care Act health insurance obligations; wage-and-hour violations; sick leave obligations; and all of the other duties, obligations, and liabilities which inure to employers.

The authors have been unable to identify any published effort by the NLRB to learn about franchising, its structures, and its legal foundations—not a single study, hearing, or investigation. The NLRB does not even appear


to have tapped into the deep fund of knowledge possessed by its fellow federal agency, the Federal Trade Commission (FTC), whose FTC Franchise Rule,\textsuperscript{4} FTC Franchise Rule Compliance Guide,\textsuperscript{5} and FTC Franchise Rule Statement of Basis and Purpose\textsuperscript{6} evidence a deep and comprehensive knowledge of the franchise arena.

But the law and the economic realities of franchising have appeared, thus far, to matter little to the analysis of the NLRB Complaints. It seems that the mission is to aid labor unions and fight “income inequality.” Unfortunately, it appears that the NLRB is paying little attention to the potential negative impact that this joint employer position may have on such a vital segment of the American economy as the franchise sector.

And also never mind the significant consequences that this position, if adopted by the NLRB, may have not just on franchisors but on franchisees. After all, should it be adopted, the economics of the franchise relationship would be so fundamentally altered that one can almost predict an end to franchising as we know it. One way or another, franchisors will increase the payments due from their franchisees to make up for massive employment-related liabilities that would be thrust upon them. Or they may cease franchising altogether (and perhaps, under the judicial doctrine of “frustration of contractual purpose,” seek to terminate all existing franchise agreements and purchase their franchisees’ assets, resulting in pure company-owned networks). Either way, the investments of franchisees and their ability to reap the profits of their independent businesses could either be vastly diminished or disappear altogether. Quite an irony, given that the focus of all federal and state franchise laws, rules, and regulations enacted over the past forty-plus years has been the protection of these small, independent businesspersons/franchisees.

Given this background, the question must arise: Will the NLRB General Counsel’s position survive judicial scrutiny, or will many decades of case law, FTC action, and economic realities overwhelm the theory?

This article addresses the forces and philosophies that gave rise to the “franchisor as joint employer” theory; how that theory will be deployed against McDonald’s; the basic structures of the franchise model of distribution; and the integral importance of the Lanham Act and its requirement that franchisors exert the very types of controls on their franchisees which the NLRB General Counsel Complaints wrongly characterize as indicia of an employment relationship. The article also will address federal and state laws defining the term “franchise” as requiring such controls; survey the varying definitions of “employer” and “employee” afforded by federal and state law; identify the “tests” of employment invoked by the judiciary; review

those many cases addressing the issue of whether a franchisor is the employer or joint employer of its franchisees or those franchisees’ employees (the vast majority of which answer that question in the negative); cite extensive judicial precedent almost universally holding that franchisors and franchisees possess an independent contractor relationship; and, in the process, demonstrate how the view that McDonald’s may be deemed the joint employer of its franchisees’ employees not only has no support from these bodies of statutory and case law but, instead, directly contravenes them.

Rationale for the “Franchisor as Joint Employer” Theory

Academic proponents of economic change were quick to applaud the NLRB General Counsel’s August 2014 initial determination that McDonald’s could be deemed to be the employer or joint employer of its franchisees’ employees. “Companies like McDonald’s insert an intermediary between themselves and workers, even though they’re manifestly in control of the franchisees’ employment decisions,” asserted Mark Barenberg, a professor of law at Columbia Law School.7 “Like other fast-food franchisors, McDonald’s is trying to have it both ways when it comes to its relationship with employees working in stores bearing its name . . . [I]n order to circumvent the rights of its employees under the National Labor Relations Act, it proclaims that it is ‘shocked, shocked’ that anyone would think it actually exerts such extensive control over its franchised stores,” asserted Michael Fischl, a professor of law at the University of Connecticut School of Law.8 Similarly, Julius Getman, a professor of law at the University of Texas at Austin School of Law, contended: “Employers like McDonald’s seek to avoid recognizing the rights of their employees by claiming that they are not really their employer, despite exercising control over crucial aspects of the employment relationship.”9

The principal union seeking to unionize fast food restaurant workers—the Service Employees International Union (SEIU)—stands to benefit a great deal from a joint employer finding. According to one report, turnover of employees at McDonald’s restaurants is 157 percent annually, with most workers leaving within three or four months.10 Initiation fees to join a union can range from $50 to $100.11 Thus, unions would receive not only a stream of dues, about 2 percent of paychecks, but also a stream of initiation fees.12

---

8. Id.
9. Id.
11. Id.
12. Id.
calculates that unions stand to gain about $155 million, $45 million of which from initiation fees alone, from unionizing half of McDonald’s work force.\(^\text{13}\)

The philosophical support for the “franchisor as joint employer” theory reflects the economic resentment and political schisms that the United States has increasingly experienced over the past decade (and especially so since the Great Recession of 2008–2010).

Although many reference works may be cited reflective of the philosophy at issue, four are particularly important: Thomas Piketty’s *Capital in the Twenty-First Century*;\(^\text{14}\) David Weil’s *The Fissured Workplace*;\(^\text{15}\) Weil’s *Improving Workplace Conditions Through Strategic Enforcement: A Report to the Wage and Hour Division*;\(^\text{16}\) and the National Employment Law Project’s *Who’s the Boss: Restoring Accountability for Labor Standards in Outsourced Work*.\(^\text{17}\)

Piketty’s *Capital in the Twenty-First Century*, which does not specifically address franchising, devotes much of its attention to the purported sources and causes of income inequality and proposes a solution to shrink the income gap. Piketty, a professor of economics at the Paris School of Economics, examines the history and development of capital and income allocations from their beginnings through the transition from Old Europe to the New World and then turns his attention to today’s economics.

Piketty addresses the minimum wage issue head on, asserting:

Inequalities at the bottom of the U.S. wage distribution have closely followed the evolution of the minimum wage: the gap between the bottom 10 percent of the wage distribution and the overall average wage widened significantly in the 1980s, then narrowed in the 1990s, and finally increased again in the 2000s. Nevertheless, inequalities at the top of the distribution—for example, the share of total wages going to the top 10 percent—increased steadily throughout this period. Clearly, the minimum wage has an impact at the bottom of the distribution but much less influence at the top, where other forces are at work.\(^\text{18}\)

Interestingly, Piketty does not argue that continually raising the minimum wage is the answer to what he views as rampant income inequality. Instead, he posits that “the best way to increase wages and reduce wage inequalities in the long run is to invest in education and skills. Over the long run, minimum wages and wage schedules cannot multiply wages by factors of five or ten: to achieve that level of progress, education and technology are the decisive forces.”\(^\text{19}\)

\(^{13}\) Id.
\(^{15}\) DAVID WEIL, THE FISSURED WORKPLACE (2014).
\(^{18}\) PIKETTY, supra note 14, at 309.
\(^{19}\) Id. at 313.
In addition to investing in education and skills, Piketty’s proposed solution to what he calls an “income inequality” problem is higher marginal income tax rates imposed on those earning $200,000 or more:

The evidence suggests that a (marginal income tax) rate on the order of 80 percent on incomes over $500,000 or $1 million a year not only would not reduce the growth of the U.S. economy but would in fact distribute the fruits of growth more widely while imposing reasonable limits on economically useless (or even harmful) behavior. . . . The idea that all U.S. executives would immediately flee to Canada and Mexico and no one with the competence or motivation to run the economy would remain is not only contradicted by historical experience . . . it is also devoid of common sense. . . . In order for the government to obtain the revenues it sorely needs to develop the meager U.S. social state and invest more in health and education (while reducing the federal deficit), taxes would also have to be raised on incomes lower in the distribution (for example, by imposing rates of 50 or 60 percent on incomes above $200,000).20

Piketty posits that it is entirely unlikely that any such policy will be adopted by the United States any time soon; he also presents as an income inequality “solution” a global tax on capital, which, in the authors’ view, is even a far more remote possibility than increased marginal tax rates.

Other discussions of “income inequality” specifically address franchising, comparing it to outsourcing and characterizing it as an effort to shield large corporations from responsibilities toward employees.

In Report to the Wage and Hour Division of the U.S. Department of Labor (the Report),21 David Weil, now the Department of Labor’s Wage and Hour Administrator, posits a “fissuring” of the employment relationship:

The relationship between worker and employer has become more and more complex as employers have contracted out, outsourced, subcontracted, and devolved many functions that once were done in house. Like rocks weakened and split apart by the passage of time, employment relationships have become deeply “fissured” in many sectors that employ large numbers of vulnerable workers. Multiple motivations underlie this change. The use of subcontracting, long used in construction, has become widespread in sectors ranging from building services to the hotel and motel industry. . . . In [some] cases, it arises from a desire to shift labor costs and liabilities to smaller business entities or to third-party labor intermediaries, such as temporary employment agencies or labor brokers . . . Regardless of motivation, fissuring in employment relations dramatically complicates the regulation of workplace conditions. . . . [T]he task of bringing regulatory pressure on the “employer” has become elusive.22

The Report targets for U.S. Department of Labor enforcement activity “priority industries” such as the heavily franchised hotel/motel, janitorial services, landscaping, and home health care sectors as well as what it characterizes as “fast food eating places.”23

20. Id. at 513.
21. Weil, supra note 16.
22. Id. at 9.
23. Id. at 39.
With respect to the hotel/motel industry, the Report cites an alleged high incidence and high severity of Fair Labor Standards Act violations (especially overtime violations). It again raises the notion of “employment fissuring” in the hotel/motel sector but suggests that it allegedly takes a different form:

Employment fissuring has taken a unique form in the hotel/motel sector, particularly on the side of the industry made up of well-known, branded enterprises. As in the fast food sector, hotel brands have been split off from ownership of properties via franchising and related arrangements so that, in most cases, a hotel property bearing the name of a well-known national or international brand is owned not by the brand company itself but by a franchisee, group of investors, or real estate development group. In addition, management of the property is increasingly undertaken by another company. . . . The fact that many properties bear the brand of one entity, are owned by another, and managed by a third means responsibility for many operational policies, including those related to FLSA compliance, are blurred.24

According to the Report, employment “fissuring,” in particular among guest lodging facilities in the United States, which are 80 percent franchised, results in outsized numbers of labor law violations. It does concede, however, that branded hotels and motels have a greater labor law compliance record than independent hotels.

The Report proposes several solutions to the alleged widespread labor law noncompliance in the quick-serve restaurant and hotel/motel sectors:

The WHD [Wage and Hour Division of the U.S. Department of Labor], in consultation with the Office of the Solicitor, should seek to clarify joint employment in the many industries and sectors where the locus of employment has blurred. . . .

The WHT and Solicitor could also pursue litigation, based on evidence of systemic violations across different owners linked by a common brand or other higher-level entity, to establish joint employer responsibility. For example, franchisees are commonly viewed as the direct and sole employer of workers in their outlets or hotels. But . . . franchisees operate under specific, extensive, and demanding operational requirements. . . . The nature of franchisor/franchisee relationships may imply under state law a joint venture relationship, which, in turn, implies more interdependence in the employment relationships between the parties.

The Solicitor’s Office (of the Department of Labor) should actively review cases involving legal issues revolving around franchising. . . . And consider filing amicus curiae (“friend of the court”) briefs as part of its efforts to clarify the law involving employment responsibilities in fissured industries.25

These themes are more expansively repeated and addressed in The Fissured Workplace,26 in which Mr. Weil contends that “[l]ike a rock with a fracture that deepens and spreads with time, the workplace over the past three decades has fissured,” again citing the franchised hotel, fast food, and janitorial

24. Id. at 58.
25. Id. at 79–80 (emphasis added).
sectors as prime examples. Indeed, franchising is characterized as “an often unrecognized form of fissured employment,” and Mr. Weil comments that:

[The fundamental dilemma of the fissured workplace . . . allowing lead companies [in this case franchisors] to have it both ways: creating, monitoring, and enforcing standards central to business strategy while at the same time ducking responsibility for the social consequences of those policies when it comes to the workplace. Any effort to improve labor standards compliance in franchised industries must recognize that organizational form’s role in creating fissured workplaces.]

*The Fissured Workplace* characterizes franchisors as “lead companies,” each of which creates a business organization model replicated by others “but controlled by [the] lead company.” It repeatedly cites the provisions of various franchise agreements that allow franchisors to impose standards and controls upon their franchisees—the very standards and controls which, this article demonstrates below, are required by the Lanham Act and form the basis of the very legal definition of the term “franchise.”

*The Fissured Workplace* does not acknowledge that franchisors franchise their businesses to expand them rapidly but, instead, argues that they do so to lower their labor costs:

Franchising is an organizational form used to connect the lead company with subsidiary organizations that provide the required glue to keep the pieces of the fissured strategy together. . . . Franchising potentially provides a lead business with a method of preserving the benefits of a strong brand while controlling labor costs.

Note again the language change—franchisors are not franchisors; they are “lead companies,” and franchisees are “subsidiary organizations.” *The Fissured Workplace* also casts a harsh light on franchisees:

[Although the franchisee has a stake in brand reputation, its stake is not as great as that of the franchisor. A franchisee has incentives to “free ride” on the established brand and may be willing to cut corners to reduce costs or improve its individual bottom line. . . . This means that franchisees may be more willing to violate consumer, workplace, or environmental regulations in order to reduce labor costs than would be the case for company-controlled units.]

Subsequent to the publication of *The Fissured Workplace*, Mr. Weil was appointed the U.S. Department of Labor Wage and Hour Division Administrator.

The fourth seminal work supporting the NLRB General Counsel’s “franchisor as joint employer” approach is the May 2014 National Employment Law Project (NELP) report entitled *Who’s The Boss: Restoring Accountability for Labor Standards in Outsourced Work*.
The NELP report targets franchising as a means through which companies dodge employment responsibilities, akin to corporations outsourcing work overseas. It cites franchising as among “. . . [t]he simplest outsourcing models.”33 It calls for robust and strategic enforcement of existing broadly defined labor laws, “including holding more entities and individuals responsible as ‘joint employers.’”34 The NELP report characterizes franchisees as mere “contractors” of their franchisors, a characterization that it suggests again is a deliberate misclassification designed to evade labor law responsibility. According to the NELP report:

Publicly traded fast-food companies including McDonald’s, YUM! Brands, Subway, Burger King, Wendy’s, Dunkin’ Donuts, Dairy Queen, Little Caesars, Sonic, and Domino’s are highly profitable. . . . By contrast, fast-food franchisees themselves are in many cases unprofitable. . . . Like other contractors, franchisees can easily be replaced if their business fails.

Franchise brands typically dictate the terms of agreements with their franchisees, including charging exorbitant fees for the right to operate their businesses. Lead companies can exert significant control over the day-to-day operations of their franchisees. The franchisors can dictate how many workers are employed at an establishment, the hours they work, how they are trained, and how they answer the telephone. While the brands claim that they have no influence over wages paid to workers, they control wages by controlling every other variable in the businesses except wages.35

We note, again, the language shift—franchisors are not franchisors, they are “lead companies.” And in one sentence, the NELP report states that franchisors control franchised unit employees’ wages by controlling other “business variables”—the very standards that, by law, franchisors are required to impose both to comply with the mandates of the Lanham Act (as elucidated below) and to ensure brand uniformity (the very foundation of franchising).

Turning to McDonald’s, the NELP report asserts that “McDonald’s computers keep track of data on sales, inventory, and labor costs, calculate the labor needs of the franchisees, set and police their work schedules, track franchisee wage reviews, and track how long it takes for employees to fill every customer order.”36 We note, however, that these are measures every large and reputable franchisor undertakes to assist franchisees in maximizing productivity and profitability and to ensure adherence to system standards. Note that the NELP report does not suggest that McDonald’s controls the day-to-day operations of its franchisees, as opposed to setting standards they must adhere to and furnishing assistance to help them maximize productivity and profitability. Nevertheless, the NELP report’s observations are cited as support for declaring McDonald’s eligibility as a “joint employer” of its franchisees’ employees.

33. Id. at 7.
34. Id. at 5.
35. Id. at 11 (emphasis added).
36. Id. at 11.
Janitorial, home health care, and staffing industries—all heavily franchised—come under similar criticism in the NELP report, which characterizes these franchise models as engaging in “outsourcing . . . now a deeply entrenched business model.”

The NELP report’s proposed solution is to declare franchisors to be the “joint employer” of their franchisees’ employees:

Any “joint employer” will generally be held jointly and severally liable for all labor and employment violations. Extending liability up and across supply chains and other structures may preclude outsourcing firms from insisting on rock-bottom pricing arrangements and require them to consider the ability of the lower-level entities to comply with and pay for any violations of basic labor-standards laws.

The authors cite the above works and academic voices not because they take into consideration various laws that govern the franchise relationship, but to demonstrate that these works are representative of the literature upon which the push for declaring franchisors the “joint employers” of their franchisees rests. But what these reports do not say perhaps is more important than the little of franchising substance they do say. This article will reveal that the philosophies underlying the “franchisor as employer” theory are contradicted by the established structures and norms of franchising; the federal and state laws governing franchising; the Lanham Act; judicial precedent almost universally holding that franchisors and franchisees possess an independent contractor relationship; and the vast majority of judicial decisions addressing whether a franchisor should be deemed the “joint employer” of its franchisees’ employees. In the face of these precedents, one must question whether the NLRB General Counsel’s position will survive judicial scrutiny.

McDonald’s and Browning-Ferris

The NLRB General Counsel’s December 19, 2014, announcement of the issuance of complaints alleging that McDonald’s is the joint employer of its franchisees’ employees was not accompanied by any decision, memorandum, memorialization, or report illuminating the rationale or logic behind it.

However, the NLRB General Counsel’s amicus brief in *Browning-Ferris Industries of California, Inc.* serves as a useful guide to what will likely be the NLRB General Counsel’s rationale deployed against McDonald’s.

In *Browning-Ferris*, the NLRB, on April 30, 2014, granted the petition for hearing of the International Brotherhood of Teamsters, which contended

37. Id. at 27.
38. Id. at 33.
that Browning-Ferris Industries of California, Inc. was the joint employer of FPR II, LLC’s (d/b/a Leadpoint Business Services) employees.40 On May 10, 2014, the NLRB issued Notice and Invitation to file briefs concerning Browning–Ferris Industries of California, Inc. v. Sanitary Truck Drivers Local 350, International Brotherhood of Teamsters,41 in which the NLRB invited amici “to address one or more of the following questions”:

1. Under the Board’s current joint-employer standard, as articulated in TLI, Inc., 271 NLRB 798 (1984), enforced mem., 772 F.2d 894 (3d Cir. 1985), and Laerco Transportation, 269 NLRB 324 (1984), is Leadpoint Business Services the sole employer of the petitioned-for employees?

2. Should the Board adhere to its existing joint-employer standard or adopt a new standard? What considerations should influence the Board’s decision in this regard?

3. If the Board adopts a new standard for determining joint-employer status, what should that standard be? If it involves the application of a multifactor test, what factors should be examined? What should be the basis or rationale for such a standard?42

In his June 26, 2014, amicus brief, the NLRB General Counsel—while nominally stating that he “maintained an interest in this proceeding, but expresses no view on the merits of this case”—revealed both the purported logical underpinnings of the determination regarding McDonald’s and what appears to be a lack of understanding about franchising as a business model and, of more concern, a tendency to conflate and confuse franchising and corporate outsourcing of employment.43 The amicus brief contends that large companies use franchising as a means of shielding themselves from employer responsibilities:

Franchising (and outsourcing arrangements that triangulate employment relationships) also illustrates how the current joint-employer standards undermine meaningful collective bargaining. In these commercial arrangements, an employer inserts an intermediary between it and the workers and designates the intermediary as the workers’ sole “employer.” But notwithstanding the creation of an intermediary, franchisors typically dictate the terms of franchise agreements and can exert significant control over the day-to-day operations of their franchisees, including the number of workers employed at a franchise and the hours each employee works. Although franchisors generally claim that they have no influence over the wages franchisees pay to their employees, some franchisors effectively

42. Id.
control such wages by controlling every other variable in the business except wages. Some franchisors even keep track of data on sales, inventory, and labor costs; calculate the labor needs of the franchisees; set and police employee work schedules; track franchisee wage reviews; track how long it takes for employees to fill customer orders; accept employment applications through the franchisor’s system; and, screen applicants through that system. Thus, current technological advances have permitted franchisors to exert significant control over franchisees, e.g., through scheduling and labor management programs that go beyond the protection of the franchisor’s product or brand. Some scholars have posited that franchisors consider avoidance of unionization and the collective-bargaining process to be the prime advantage of franchising, and in some cases, the driving force behind the conversion of fully integrated, employee-operated businesses to franchised operations in an attempt to prevent or remove the supposedly harmful effects of unionization and thereby increased profits.44

The paucity of scholarly opinion and resources underlying these characterizations is of particular concern. Among the sources cited are an article published by NELP,45 another article describing software programs available to help franchisees manage staff schedules and costs,46 and, a third article describing technology that helps hair stylist network Great Clips’ franchisees schedule the optimum number of hair stylists at the right time.47 The brief makes no mention of the Federal Trade Commission (FTC), the FTC Franchise Rule,48 the FTC Franchise Rule Compliance Guide,49 the FTC Franchise Rule Statement of Basis and Purpose,50 or the myriad of state registration and disclosure laws.

The Browning-Ferris amicus brief urges the NLRB to adopt a new standard that takes account of the totality of the circumstances. . . . Under this test, if one of the entities wields sufficient influence over the working conditions of the other entity’s employees such that meaningful bargaining could not occur in its absence, joint employer status would be established.51

The “new” approach is actually not new at all; the brief calls upon the NLRB to revert to joint employer standards that applied before the 1984 cases of Laerco Transportation52 and TLI, Inc.53 Under these pre-1984 joint employer standards, contends the NLRB General Counsel,

44. Id. at 14–15 (internal citations and quotation marks omitted).
45. Ruckelshaus et al., supra note 17, at 7–8.
the Board consistently held, with court approval, that an entity was a joint employer where it exercised direct or indirect control over significant terms and conditions of employment of another entity’s employees; where it possessed the unexercised potential to control such terms and conditions of employment; or where “industrial realities” otherwise made it an essential party to meaningful collective bargaining. 54

According to the NLRB General Counsel’s brief, this “‘traditional’ standard had been applied since the inception of the [National Labor Relations] Act.” 55

Elaborating on this pre-1984 standard, the brief contends:

When applying its traditional joint-employer standard, the Board considered that control over the following terms and conditions of employment would make an employer an essential party to collective bargaining: wages; employee personnel issues; the number of employees needed to perform a job or task; establishing employee work hours, schedules, work week length, and shift hours; employee grievances, including administration of a collective-bargaining agreement; authorizing overtime; safety rules and standards; production standards; break and/or lunch period; assignment of work and determination of job duties; work instructions relating to the means and manner to accomplish a job or task; training employees or establishing employee training requirements; vacation and holiday leave and pay policies; discipline; discharge; and, hiring. 56

The brief further asserts that under the NLRB’s pre-1984 “traditional” test, “indirect control over certain terms and conditions of employment was sufficient to find joint-employer status.” 57 Indirect control over employee wages and potential—but not exercised—control over employee work conditions were found by the NLRB to support a finding of joint employment. 58

The amicus brief in Browning-Ferris concludes by arguing that:

The Board’s [pre-1984] traditional joint-employer standard better effectuates the policies and purposes of the [National Labor Relations] Act than the Board’s current, narrow standard, and the Board should return to it (citation omitted). That standard would broadly construe the term “employer,” as intended by Congress. It would allow employees to bargain over their working conditions with the entities that control those working conditions based on economic reality. Collective bargaining involves a give-and-take between the parties. Employees should expect that their union have that give-and-take directly with the employers that have control of whatever employment terms are being negotiated. 59

The NLRB’s decision in Browning-Ferris was not rendered as of April 2015 (when this article was finalized).

If the NLRB reverts to the pre-1984 standards sought by its general counsel in Browning-Ferris, it would be more likely that the NLRB, invoking those standards, will determine that McDonald’s is the joint employer of its

54. Brief for the NLRB General Counsel, supra note 43, at 5.
55. Id.
56. Id. at 18–19.
57. Id. at 20.
58. Id.
59. Id. at 22–23.
franchisees’ employees. One might also predict that McDonald’s and other franchisors will seek and obtain relief from such a determination from the federal courts and that, given those courts’ decisions on the subject (as detailed below), such relief may be swiftly forthcoming.

**The Business Principles and Structures of Franchising**

For those unfamiliar with them, this section will briefly address the business norms and structures of franchising.

Just fifty years ago, franchising was barely a blip on the radar screen of the American economy (and virtually unknown outside of the United States). In the early 1980s, the U.S. Department of Commerce estimated franchise network collective gross revenues at $350 billion; in 1985, $529 billion.60 Today, franchising not only entirely dominates certain industries—such as guest lodging, real estate brokerage, quick-service restaurants, vehicle repair, tax preparation, lawn care, pest control, and convenience stores—but has propelled itself to the forefront of not only the American economy but, increasingly, the global economy as well. According to the U.S. Census Bureau and the International Franchise Association, franchising companies and their franchisees account for nearly $1.3 trillion in annual U.S. retail sales—a reported 40 percent of all retail sales in this country—along with $304 billion in payroll and $802 billion of output."61

These sources reveal that U.S. franchise networks operate over 825,000 units in this country and employ more than nine million people—over 6 percent of total nonagricultural employment.62 Approximately one out of every twelve retail establishments is a franchised business. McDonald’s alone daily serves nearly 50 million customers at over 36,000 restaurants in the United States and more than 100 countries, which employ 1.9 million people.63

What is franchising? Simply put, franchising is a means of establishing a network of independently owned businesses, operating under an independent contractor relationship, which are licensed to sell products or services under a common brand name.64 It is a system of marketing and distribution in which an independent business (the franchisee) is granted—in return for a fee—the right to market the goods and services of another (the franchisor) in accordance with the franchisor’s established standards and practices.

---

63. McDonald’s, Getting to Know Us, http://www.aboutmcdonalds.com/mcd/our_company.html.
64. DAVID J. KAUFMANN ET AL., AN INTRODUCTION TO THE LAW OF FRANCHISING § 2, at 1 (Int'l Franchise Ass'n).
The economic underpinnings of franchising center around brand names and the public’s perception of quality and uniformity associated with those brand names. Indeed, it has been observed that trademarks “are the foundation of any franchise system.”

In pre-industrial times, branding served to identify the ownership and/or source of an item, such as the brands burned into livestock by ranchers to identify their cattle. As the United States became more industrialized in the nineteenth century, factories began mass producing goods that previously were manufactured either in homes or in small, local establishments. In order to both identify their products and distinguish them from others, these factories affixed their brands—that is, their names or logos—on the containers, packaging, barrels, or other vessels containing their goods. Industrialized companies selling mass-produced goods soon realized that branding served an important purpose beyond source identification—generating familiarity and loyalty in a customer base situated far from the factory and which, until then, was used to purchasing only local goods that typically were not branded. Among the first brands to appear were Campbell’s Soup, Coca-Cola, Wrigley’s, Juicy Fruit, Aunt Jemima pancake mix, Quaker Oats, Uncle Ben’s rice, Kellogg’s breakfast cereals, and Scott Paper Company’s “Waldorf” toilet paper. As branding appeared on the American economic scene, consumer demand for the uniform products offered by brands dramatically escalated—which, in turn, led to the appearance of more and more national and regional brands. Soon, branding ventured into the realm of retailing, with regional and then national chains appearing for the very first time.

Until franchising’s advent, the only way a business could establish a regional, national, or even international network of units operating under its brand name was to go out and find each unit’s location; either purchase or lease that location; build and equip the unit; hire all personnel necessary to operate the unit; procure the unit’s required inventory (in the case of products) or service providers (in the case of services); secure all required licenses, permits, and other government approvals; and then open and operate that unit, at all times being responsible for all aspects of that unit’s operation and expense, and at all times being liable for any mishaps which may occur. The cost of establishing such a network of business units on a regional, national, or international scale is staggering. And the time required to do so successfully is massive.

Franchising is the evolutionary business response to this predicament. Through franchising, the economic burdens of establishing a regional, national, or international network are shared between the franchisor and its franchisees. While a few businesses have created national or international platforms utilizing only company-owned units (e.g., Chipotle), the vast majority of regional, national, and international business networks established over the past fifty years have been franchise networks.

In the franchise paradigm, it is the franchisor that develops the business unit model—what products or services will be sold from each unit; where the unit should be situated; how the unit should be built and equipped; what standards must be adhered to in the operation of the unit; and, what type of marketing or advertising will be engaged in—along with selecting and adopting for use throughout the network its all-important brand identity. It is the franchisee which, in return for the payment of a fee to the franchisor, acquires the right and assumes the obligation to build and operate a unit under the franchisor’s brand name. The entire expense of developing, opening, and operating a franchised unit—buying or leasing the real estate; erecting and equipping the business premises; paying for all inventory; being financially liable for all aspects of the unit; and, critical for this discussion, hiring and paying all employees—is almost always borne solely by the franchisee.

It is the franchisee alone that reaps the profits or absorbs the losses of its franchised unit. This critical distinction between a franchisee and an employee—the ability of a franchisee to invest in its business and derive profits therefrom—is central to the judicial “economic reality”69 and “entrepreneurial opportunity”70 tests for determining employment versus independent contractor status.71 But this central feature of the franchise relationship and this key identifying characteristic of franchisees is nowhere referenced or even alluded to in the Browning–Ferris amicus brief, the announcement that McDonald’s is being charged as a “joint employer” of its franchisees’ employees, or any of the academic works addressing the issue of “franchisor as joint employer” referenced earlier in this article.

Franchising has two generally recognized subcategories. “Product franchising” refers to networks in which franchisees sell one company’s proprietary product line and acquire some of the identity of the product manufacturer/supplier. Dominating product franchising are motor vehicle manufacturers and oil refiners with their franchised networks of automobile dealers and gasoline service stations. As opposed to business format franchises (discussed immediately

---

70. FedEx Home Delivery v. NLRB, 563 F.3d 492 (D.C. Cir. 2009).
below), the uniformity of appearance and operation of product franchises is of secondary concern, which is why the appearance and operation of gasoline stations and automobile dealers vary so significantly from one to the other.

The other subcategory of franchising is the one chiefly responsible for franchising’s meteoric growth over the past half-century, “business format franchising.” A business format franchise conveys to the franchisee all of the systems, specifications, procedures, and details for developing, opening, and operating a franchised unit, usually requiring strict adherence to fixed standards in the operation of that business throughout the life of the franchise relationship. Business format franchising obeys the prime command of branding—uniformity. Each franchised unit sells the same products or services (with variations sometimes permitted); has certain common physical characteristics; and follows the same prescribed methods of operation, all to ensure that the consumer expectation of quality and uniformity, the very hallmarks of a brand, are fulfilled. 72

As explained in further detail below, the Lanham Act not only fosters the notion of brand uniformity but requires trademark and/or service mark licensors—and every franchisor is a trademark and/or service mark licensor—to impose standards and controls upon their licensees (and every franchisee is a trademark and/or service mark licensee) to ensure that the mark in question serves its intended purpose: uniformity of goods or services of a certain type and quality, uniformity of appearance, and uniformity of operations. Critically, as will be explored, if a franchisor (as licensor) does not impose upon franchisees such standards, that franchisor’s trademark (applicable to goods) or service mark (applicable to services) may be deemed abandoned as a matter of law, as it could be viewed as standing for nothing. 73

Thus, franchisors almost always impose upon franchisees—both to achieve the uniformity which the consuming public desires and expects and to comply with the requirements of the Lanham Act—a series of standards that may address virtually all elements of the operation of a franchised unit. These are the very standards of operation which, as detailed above, the Browning-Ferris amicus brief of the NLRB General Counsel asserts would make a franchisor the “joint employer” of its franchisees’ employees. By doing so, that opinion disregards the Lanham Act’s mandate requiring franchisors to impose quality standards, the consumer’s desire for uniformity prompting such standards, and the distinction between imposing standards and controlling the day-to-day operations of franchisees (a distinction which has led the courts to rule


again and again, with very few exceptions, that a franchisor is not the employer or joint employer of its franchisees or their employees. 74

Most critically, the NLRB General Counsel’s brief in *Browning-Ferris* also ignores a vital fact: a franchisor never pays the wages of any franchisee employee or dictates the pay rate of any franchisee employee. As noted, a franchised business is an independently owned establishment. It is built with franchisee funds. It employs and pays its own workers. Although a franchisor will frequently seek to aid its franchisees in the optimal operation of their businesses by suggesting staffing levels and pay rates, these are never obligatory but are suggested only to enhance franchisee profitability. This is what the small franchise owner desires and needs: guidance from its franchisor as to how to best operate its independently owned franchised unit.

The *Browning-Ferris* amicus brief argues that such staffing advice is indicative of a “joint employer” scenario, but it serves no other purpose than to assist the franchisee to achieve optimal results. For instance, McDonald’s Corporation is charged by law with ensuring that its quality standards are adhered to throughout its network. It is therefore reasonable to expect the company to tell its franchisees how many staff members (restaurant manager, assistant manager, cashiers, line cooks, and so forth) are required to operate a franchised McDonald’s restaurant in accordance with such standards. Silence from the franchisor would be inimical to the franchisees’ ability to earn a profit on their significant investments as without such imperative information, the franchisees may engage too many employees and improperly schedule and assign them work.

As well, while franchisors typically specify the minimum staffing required of a franchised unit to achieve brand uniformity and consistency of service, the authors are unaware of any franchisor restricting a franchisee from exceeding those requirements. Thus, if it desires, a franchisee can staff its franchised unit well above the franchisor’s specified levels. Although it may be most unwise for franchisees to do so from an economic perspective, it is important to note that the ability of a franchisee to do so freely negates any suggestion that a franchisor “controls” its franchisees’ employment practices.

It is also critical that, although franchisors may suggest pay rates for each category of franchised unit employee, those rates are not obligatory. Any franchisee is free to pay its employees any amounts it desires, within the bounds of the law, and the authors are unaware of any franchise agreement that states or suggests otherwise. If a franchisee desires to overpay one or more of its employees (who may be a relative and, indeed, may not perform many functions at all in return for his or her pay), that decision is entirely within the franchisee’s purview. Although it may prove counterproductive and lack economic sense, the franchisor cannot forbid it. As long as the required minimum standards of staffing to achieve brand uniformity and consistency are adhered to, the franchisor likely will not care.

74. *Id.*
In any event, it is clear that franchising plays a critical and central role in
the American economy: delivering to consumers the brand and service uniformity they desire; enabling small, independently owned franchised businesses to align in regional, national, or international networks with salutary returns on investment; and permitting franchisors to create regional, national, and international networks featuring products and services the public desires delivered in a uniform and expected fashion.

The investments and entrepreneurial risks/rewards of McDonald’s franchisees have been overlooked in the debate over whether McDonald’s should be considered the joint employer of its franchisees’ employees. To obtain a McDonald’s franchise, a franchisee must pay to McDonald’s an initial franchise fee of $45,000.75 Thereafter, the franchisee must spend between $986,350 and $2,137,050 to outfit its restaurant (signs, seating, equipment, and décor), obtain opening inventory, expend miscellaneous opening costs, and absorb its first three months of rent and working capital (such as employee wages, utilities, payroll taxes, advertising, promotion, operating and office supplies, insurance, and other operating capital).76

In return, during calendar 2012, 73 percent of McDonald’s franchisees had annual sales volumes in excess of $2.2 million; 62 percent had annual sales volumes in excess of $2.4 million; and 51 percent had annual sales volumes in excess of $2.6 million—with the average annual sales volume of domestic McDonald’s restaurants open at least one year as of December 31, 2012, being $2,664,000.77 In 2012, those McDonald’s franchisees whose annual sales volume was $2,200,000 enjoyed operating income before occupancy costs (that is, excluding rent, service fees, depreciation and amortization, interest, and income taxes) in the amount of $570,000.78 Those McDonald’s franchisees whose annual sales volume was $2.4 million enjoyed operating income before occupancy costs of $643,000.79 And those franchisees whose sales volumes were $2.6 million enjoyed operating income before occupancy costs of $716,000.80 McDonald’s itself is the lessor of the majority of its franchisees’ restaurants. But even with the range of effective rent percentages in 2012 for franchised restaurants between 0 percent and 37.31 percent,81 it remains the case that owning, investing in, and reaping the profits of a franchised McDonald’s restaurant is an extraordinarily lucrative endeavor—and reveals activity that far from resembles the conduct of an “employee.”82

75. McDonald’s USA, LLC Franchise Disclosure Document, Issuance Date May 1, 2013, as amended Oct. 25, 2013, Item 5, p. 12.
76. Id. at Items 7, 18–19.
77. Id. at Items 19, 36.
78. Id.
79. Id.
80. Id. at Item 37.
81. Id. at Item 37, n.3.
82. All figures for franchised McDonald’s restaurants pertain to “traditional” restaurants and exclude what McDonald’s characterizes as “small town oil,” “small town retail,” and “satellite” locations.
One other important note. Franchising is the introduction to the American economy for many Americans (and recent immigrants to America). That role used to be performed by America’s low-skill manufacturing base. It was there that unskilled labor could go, get a job, and obtain its introduction to the American economy. But those manufacturing jobs have long since been outsourced. Today, the very jobs whose pay rates are of concern to the NLRB General Counsel are often the only jobs many unskilled Americans and workers who have been laid off from their previous employment can obtain. Indeed, it is in franchise network establishments that many Americans first learn the skills necessary to be an employee and ultimately climb the economic ladder.83

Trademark Law Requires Franchisors to Exert Control

Not only does the franchising business paradigm depend upon the franchisor’s ability to establish and impose upon franchisees uniform standards of appearance, operations, and products/services—uniformity much desired by the consuming public and its affinity for brands—but such controlling standards are also required by trademark law. The NLRB General Counsel appears to ignore the Lanham Act’s requirements, putting it in direct conflict with that Act and many decades of its enforcement.

Every franchise agreement, as noted above, subsumes a trademark license agreement. Indeed, as elucidated hereafter, the very definition of the term “franchise” under federal and state laws requires the presence of a trademark license from franchisor to franchisee to exist for a franchise to be found.84

Trademark licensing was rarely used until the beginning of the twentieth century. Indeed, under the Trademark Act of 1905 and under common law as well, trademark licensing was customarily prohibited on the assumption that, if licensed, a mark could no longer serve its function as an indicator of origin, and consumers could be confused.85 By the end of the 1920s, however, brands had exploded on the American economic scene and, with them, the necessity for brand owners to license their trademarks.86 As a result,

84. Our use of the term “trademark” subsumes both trademarks and service marks. A trademark is affixed to goods. A service mark is used in connection with the furnishing of services. A mark may function as both a trademark and a service mark. For example, the pint of ice cream you purchase from a Hagen–Dazs store bears the trademark “Hagen-Dazs” while the sign over the store’s entrance, offering the “service” of selling ice cream and other items, bears the same mark which, in this instance, acts as a “service mark.”
85. See, e.g., MacMahan Pharm. Co. v. Denver Chem. Mfg. Co., 113 F.468, 474–75 (8th Cir. 1901) (“A trademark cannot be . . . licensed, except as incidental to a transfer of the business or property in connection which it has been used.”).
licensing became an important part of the economy, with courts inclined to uphold this practice. 87

Starting in the 1920s, and continuing to today, the courts have held that trademarks not only signify commercial source but also serve as symbols of product quality. To reconcile this “quality assurance” function with the traditional “source theory,” courts and scholars expanded the interpretation of the latter and argued that, rather than indicating “actual” product source, trademarks represented product source “at large,” that is, the source “controlling” the products regardless of the actual manufacturer. 88

As a predicate to this legal theory, however, courts required that trademark licensors control their licensees to guaranty consistent product quality. If trademark owners failed to exercise such control, courts adopted the approach that the license was invalid because the mark could not guarantee against changes in product quality and this, in turn, could lead to consumer confusion. 89

Trademark law in the United States was completely overhauled to reflect modern times, the evolution of commerce, and the critical role that trademark licensing played in that evolution by the Lanham Trademark Act of 1946. 90 The Lanham Act legitimized trademark licensing by providing that a mark can validly be used by “related companies.” Specifically, Section 5 of the Lanham Act provides:

Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such manner as to deceive the public. 91

So it is in the Lanham Act that the need first arises for a trademark licensor to exert control over its licensees’ use of its mark in order to avoid public deception, that is, in order to avoid the mark not standing for the standards of quality, product/service, and other attributes associated with the mark. In turn, Section 45 of the Lanham Act defines the term “related company” as meaning: “[Any] person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used.” 92

The judiciary has paid heed to this precept, holding that quality control is an indispensable element of a trademark license. And if a franchisor fails to exert sufficient trademark controls over its franchisees, what is the consequence under the Lanham Act? A third-party petition to cancel the federal

87. Id.
88. Id. at 362.
89. Id. at 363.
91. Id. § 1055.
92. Id. § 1127.
registration of that trademark under Section 14 of the Lanham Act, which provides:

A petition to cancel a registration of a mark . . . may be filed . . . by any person who believes that he is or will be damaged . . . if the registered mark is being used by, or with the permission of, the registrant so as to misrepresent the source of the goods or services on or in connection with which the mark is used.93

Even worse, franchisors that fail to enforce trademark controls over their franchisees can have their licensed marks declared abandoned by the judiciary. “[W]hen any course of conduct of the owner, including acts of omission as well as commission, causes the mark . . . to lose its significance as a mark,” the mark may be deemed abandoned regardless of its owner’s intent.94

So it is that the Lanham Act requires mark owners to control the nature and quality of goods and services bearing their marks, including those that are provided or sold by their licensees.95 “The only effective way to protect the public where a trademark is used by licensees is to place on the licensor the affirmative duty of policing in a reasonable manner the activities of his licensees,” held the court in Dawn Donut Co. v. Hart’s Food Stores, Inc.96 “Otherwise, the public will be deprived of its most effective protection against misleading uses of a trademark,” and “the risk that [it would] be unwittingly deceived will be increased.”97

And it is not enough for a franchisor merely to recite in its franchise agreements that it has the right to exercise trademark control—it must actually do so, or else the trademark license in its franchise agreements may be determined to be “naked” licenses and the subject trademark deemed abandoned.98

Thus, if through its acts or omissions a franchisor fails to establish standards associated with its mark and similarly fails to compel its franchisees to observe those standards, that franchisor—whether it intended to or not—may find its mark judicially deemed abandoned.99 The judiciary continually drives home the point that franchisors must exert actual control, rather than mere contractual control, over their franchisees in order for a trademark

93. Id. § 1064.
96. 267 F.2d 358 (2d Cir. 1959).
97. Id.; see also Taco Cabana Int’l, Inc. v. Two Pesos, Inc., 932 F.2d 1113 (5th Cir. 1991); Two Pesos, Inc. v. Taco Cabana, Inc., 505 U.S. 763 (1992); Ky. Fried Chicken Corp. v. Diversified Packaging Corp., 549 F.2d 368 (5th Cir. 1977).
99. Barcamerica Int’l USA Trust v. Tyfield Importers, Inc., 289 F.3d 589 (9th Cir. 2002) ("[W]here the licensor fails to exercise adequate quality control over the licensee, ‘a court may find that the trademark owner has abandoned the trademark, in which case the owner would be estopped from asserting rights to the trademark’ (citation omitted").
license to be declared valid. Therefore, even if a franchise agreement con-
tains quality control provisions, trademark abandonment can be forthcoming
if the franchisor does not take measures to actually take control of its fran-
chisees’ use of the franchisor’s mark. Accordingly, courts generally place
an affirmative duty upon franchisors to take reasonable measures to control
their franchisees’ use of the franchisor’s marks and to ensure that they are
not utilized by franchisees on products or services that are inferior in quality
or entirely unauthorized.

So it is beyond dispute that under the Lanham Act and all decisional law
both preceding and succeeding the 1946 enactment of that statute, it is an
absolute requirement that a trademark licensor (and thus every franchisor)
must promulgate, impose, and police standards of operations and quality as-
associated with its marks in order for those marks to maintain their legal stand-
ing and not be deemed abandoned.

In the franchise setting, this legal doctrine compels a franchisor to promul-
gate, impose upon franchisees operating under that franchisor’s mark, and
strictly enforce a multitude of standards. As opposed to “pure” trademarks
(which are affixed to a product), almost all franchisors feature a mark that
serves as both a trademark (affixed to products) and a service mark (technically
indicating a source of service, that is, the sign over the franchised establish-
ment’s door). Consumer expectations about a franchise establishment far sur-
pass any particular good or product. To the contrary, whether we are speaking
of a fast food establishment, a hotel, a convenience store, or most any other
franchised establishment, the consumer expects and associates with the fran-
chisor’s trademarks and service marks a broad scope of uniformity. This ex-
pectation includes the typical locations of a network’s franchised establish-
ments; their exterior and building characteristics; their interior trade dress;
the products and services offered; the means of payment accepted by such
franchise network establishments; the amenities offered by such franchised
units; typical price points for goods/services; the time it takes to consummate
transactions; accommodations for the very young, the very old, and the dis-
abled; and a plethora of other franchise network unit characteristics which
the consumer desires and expects to experience.

To comply with trademark standards, a franchisor must achieve unifor-
mity among its company-owned and franchised units; to achieve that goal,
elaborate and voluminous standards are developed, imposed, and policed.
But the NLRB General Counsel’s recent position seeks to contort these

---

1343 (2d Cir. 1974); Dawn Donut Co. v. Hart’s Food Stores, Inc., 267 F.2d 358 (2d Cir. 1959).
101. Dawn Donut Co., 267 F.2d at 358; Transgo, Inc. v. Ajac Transmission Parts Corp., 768
F.2d 1001 (9th Cir. 1985).
102. William A. Finkelstein & Christopher P. Bussert, Trademark Law Fundamentals and Re-
lated Franchising Issues, in FUNDAMENTALS OF FRANCHISING, 1, 39 (Rupert M. Barkoff & Andrew
C. Selden eds., 2004).
standards. Rather than recognizing them as consistent with the Lanham Act and a century of judicial decisions recognizing a franchisor’s obligation to protect its trademark and service marks (and achieve the uniformity which consumers demand and expect), that position asserts that these trademark standards may constitute a franchisor’s “control” of its franchisees sufficient to declare the franchisor the “joint employer” of its franchisees’ employees.103

Such a finding ignores who actually hires these employees; sets their pay rates; supervises them on a day-to-day basis; disciplines them when necessary; pays, in addition to their salaries, all taxes and contributions associated with their employment (unemployment insurance contributions, workers’ compensation insurance, and so forth); sets their schedules; and, fires them when necessary. In every franchised network it is always the franchisee that performs these functions and never the franchisor. At most, to assist its franchisees in achieving the optimal performance of their franchised units, a franchisor may certainly suggest recommended staffing levels, shift lengths, pay rates, and other attributes of employment.

The trademark standards that franchisors impose on their franchisees may impact the expenses borne by those franchisees and, in turn, the monies they have available to pay their employees. But imposing standards to which franchisees must adhere at their expense, with the result they only have so much money allocated for employee salaries, does not equate to the franchisor serving as the “joint employer” of its franchisees’ employees. Supply and demand drive franchisee employee pay rates. As noted earlier, a franchisee can hire as many employees as it desires (so long as it maintains the minimum staffing levels deemed necessary by the franchisor to achieve the level of quality and service associated with its trademark and service mark). That franchisee can pay its employees whatever it likes. In certain markets, supply and demand compels franchisees to pay their employees well above minimum wage.

The attempt to characterize franchisors as the “joint employers” of their franchisees’ employees as a consequence of the myriad standards imposed by those franchisors upon their franchisees entirely disregards the requirements of the Lanham Act and a century of decisional law requiring standards to maintain the integrity of their trademarks and service marks. As well, and as has been noted, this determination ignores the fundamental business principle associated with the remarkably successful franchise format of distributing goods and services—the independent contractual relationship between a franchisor and its franchisees.

103. Brief for the NLRB General Counsel, supra note 43.
Federal and State Law Definitions of “Franchise” Assume a Franchisor’s Imposition of Standards and Controls

The very definition of the term “franchise” found in every federal and state franchise registration or disclosure law features a definitional element that—reflecting the structures and economic realities of franchising (as discussed above)—requires that a franchisor impose standards and controls on its franchisees.

Yet not once in the forty-five years since the first of these laws was enacted has any authority or agency administering them ever determined or even suggested that such franchisor standards and controls yield the result that the Complaints suggest they do: that a franchisor is either the employer or joint employer of its franchisees or their employees. Not a single administrative decree. No formal or informal opinion. No litigation submissions of any kind (complaint, petitions, memoranda of law). No testimony before any legislature, administrative agency, or other government body. Nothing at all affirms the position asserted in the Complaints—that the very standards and controls imposed by franchisors upon their franchisees that are so fundamental to franchising that they form a critical definitional element of the term “franchise” in every federal and state law somehow render franchisors the employer of their franchisees or the joint employer of their franchisees’ employees.

In every court in the country, the opinions of agencies with specialized knowledge of franchising is accorded, invariably, “great weight” or “controlling weight.” Yet the NLRB’s recent action against McDonald’s entirely disregards both the federal and state franchise law definitions of “franchise” and ignores as well the expert federal and state authorities governing franchising and possessing sophisticated knowledge of the franchise arena (including the NLRB’s sister agency, the Federal Trade Commission, which has been regulating franchising since 1979).

As most readers know, franchise sales activities are governed both at the federal and state levels pursuant to a series of laws enacted in the 1970s and 1980s to combat what was a scourge of fraud which accompanied franchising’s explosive growth in the 1950s, 1960s, and 1970s. On the federal level, franchising is governed by the Federal Trade Commission Franchise Rule,


105. K AUFMANN ET AL., supra note 64, § 2 at 5–6.

106. FTC Franchise Rule, 16 C.F.R. Part 436, §§ 436.1 et seq.
on October 21, 1979. The FTC Franchise Rule does not preempt analogous state laws. 107

Under both the FTC Franchise Rule and the fifteen state franchise registration/disclosure laws addressed below, franchisors—prior to offering or selling a franchise—must prepare and disseminate to prospective franchisees a prospectus-type, comprehensive disclosure document containing all material information necessary for such prospects to make informed investment decisions. Unlike the FTC Franchise Rule protocol (under which disclosure is mandated but no pre-review or registration of the disclosure document is required), ten of the fifteen state franchise registration/disclosure laws feature an elaborate registration protocol pursuant to which both the franchisor seeking to offer franchises, and the disclosure document it intends to utilize to do so, are closely scrutinized and almost always commented upon by state regulators before any franchise registration is forthcoming (unless the franchisor qualifies for one of the exemptions from registration that many of these laws make available).

Section 436.1(h) of the FTC Franchise Rule defines the term “franchise” as meaning:

[A]ny continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

(1) The franchisee will obtain the right to operate a business that is identified or associated with the franchisor’s trademark, or to offer, sell, or distribute goods, services, or commodities that are identified or associated with the franchisor’s trademark;

(2) The franchisor will exert or has authority to exert a significant degree of control over the franchisee’s method of operation, or provide significant assistance in the franchisee’s method of operation; and

(3) As a condition of obtaining or commencing operation of the franchise, the franchisee makes a required payment or commits to make a required payment to the franchisor or its affiliate. 108


108. 16 C.F.R. § 436.1(h) (emphasis added).
In the 2007 Franchise Rule Compliance Guide, the staff of the Federal Trade Commission elaborated upon the above-quoted definition of “franchise” featured in the FTC Franchise Rule. The Guide states:

[T]o be deemed “significant (control or assistance),” the control or assistance must relate to the franchisee’s overall method of operation—not a small part of the franchisee’s business. . . . Significant types of control include:

- Site approval for unestablished businesses;
- Site design or appearance requirements;
- Hours of operation;
- Production techniques;
- Accounting practices;
- Personnel policy;
- Promotional campaigns requiring franchisee participation or financial contribution;
- Restrictions on customers;
- Locale or area of operation;
- Formal sales, repair, or business training programs;
- Establishing accounting systems;
- Furnishing management, marketing, or personnel advice;
- Selecting site locations;
- Furnishing system-wide networks and website; and
- Furnishing a detailed operating manual.

So the very controls and assistance purportedly giving rise to a franchisor-as-employer status are, to the contrary, characterized by the FTC—the sole federal authority possessing nearly a half-century of expertise governing franchising throughout the United States, its territories and possessions—as the *sine qua non* of the definition of the term “franchise.” The opinions of administrative agencies (such as the FTC) that possess expertise in their area of governance are entitled as a matter of law to “significant weight” or “controlling weight” in judicial proceedings. The NLRB, by contrast, not only possesses no experience governing or regulating franchising, but also appears even to have failed to consult with the FTC before the complaints were filed.

**State Franchise Registration/Disclosure Law Definitions of the Term “Franchise”**

As with the FTC Franchise Rule, state franchise registration/disclosure statutes make clear that franchisor “controls” are the hallmark of a franchise. Stated conversely, absent such controls, no franchise exists as a matter of law.

---

110. *Id.* at 10.
under such state franchise statutes, with a very few exceptions described below.

State franchise laws define the term “franchise” by reflecting franchising’s underlying economic realities, the chief predicate of which is the independent contractual relationship between a franchisor and its franchisees. Although there is no single, uniform definition of “franchise” among these state laws, they are virtually identical from one to another with the exception noted below.

Most state franchise registration/disclosure statutes deem a franchise to exist whenever a franchisee, in return for a franchise fee, is granted the right to sell goods or services under a marketing plan or system prescribed in substantial part by the franchisor, where the operation of the franchisee’s business pursuant to that marketing plan or system is substantially associated with the franchisor’s trademark, service mark, or other commercial symbol.112 The definition of “franchise” found in Section 31005 of the California Franchise Investment Law (CFIL) is representative of the definitions found in the vast majority of state franchise registration/disclosure laws:

“Franchise” means a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

1. A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor;
2. The operation of the franchisee’s business pursuant to such a plan or system is substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and
3. The franchisee is required to pay, directly or indirectly, a franchise fee.113

Thus, inherent in state franchise law definitions of the term “franchise” is the franchisor’s “prescription” of a “marketing plan or system.” The Merriam-Webster Dictionary defines the term “prescribed” as meaning “to lay down a rule; to lay down as a guide, direction, or rule of action.”114 So it is clear that a franchisor’s “prescribing” a “marketing plan or system” has a compulsory element to it—“control.”

Just what is a “marketing plan or system?” The answer is the very “controls” now claimed to make a franchisor the “joint employer” of its franchisees’ employees but which, under state franchise statutes, must be present for

---

112. The exception to this rather standard definition, referenced above, pertains to a handful of state franchise registration/disclosure laws that substitute a “community of interest” test—under which the franchisor and its franchisees have a community of interest in the marketing of goods or services—for the “prescribed marketing plan or system” definitional prong featured in the vast majority of franchise registration/disclosure statutes’ definition of the term “franchise.” Those states featuring this “community of interest” definitional element are: Hawaii (HAW. REV. STAT. § 482-E2); Minnesota (MINN. STAT. § 80C.01); and South Dakota (S.D. CODED LAWS § 37-5B-1).


a “franchise” to exist as a matter of law. While some states do not define the term “prescribed marketing plan or system” at all, Illinois,115 Maryland,116 and Wisconsin117 feature regulations that define the term.

By far the most useful examination of what constitutes a “marketing plan or system” is found in Release Number 3-F Revised (June 22, 1994),118 issued by the California Department of Corporations (now the California Department of Business Oversight) to provide interpretive guidance concerning the definition of a “franchise” under the CFIL. Franchise administrators and courts of other jurisdictions have referred to these principles and this reasoning when franchise definition issues arise. “While any one of the [following] examples of restrictions may not amount to a ‘marketing plan or system prescribed in substantial part by a franchisor,’ several such restrictions taken together may be sufficient to amount to such a plan or system,” states Release 3-F, citing the following:

- Giving detailed directions and advice concerning operating techniques
- Assigning exclusive territory
- Providing for uniformity or distinctiveness of appearance
- Limiting sale of competitive products
- Requiring approval of advertising and signs
- Prohibiting engaging in other activities
- Providing training sessions
- Use of a manual119

Critically, Release 3-F states:

Significance attaches to provisions imposing a duty of observing the licensor’s directions or obtaining the licensor’s approval with respect to the selection of locations, the use of trade names, advertising, signs, sales pitches, and sources of supply, or concerning the appearance of the licensee’s business premises and the fixtures and equipment utilized therein, uniforms of employees, hours of operation, housekeeping, and similar declarations.120

Furthermore, Release 3-F also states:

The implementation of these and other similar directions by procedures for inspection by, and reporting to, the franchisor with respect to the conduct of the franchised business . . . are indicative of the franchisor’s control over the franchisees’ operations and, consequently, of a marketing plan prescribed by the franchisor.121

Thus, under the CFIL and analogous state franchise registration/disclosure laws, rules, and regulations, only where the putative “franchisor” exercises control over its franchisees does a franchise exist. Absent such controls,

115. ILL. ADMIN. CODE § 200.102.
116. MD. REGS. CODE § 02.02.08.02B.
117. WIS. ADMIN. CODE § 31.01(6).
119. Id. § I(B)(2)(g).
120. Id. § I(B)(2)(c).
121. Id. (emphasis added).
no “franchise” legally exists under such state franchise laws (or, as has been observed, under the FTC Franchise Rule as well).

As with the FTC, state officials administering franchise registration/disclosure statutes are possessed with deep and lengthy expertise, which, in the judicial setting, is given “great weight” or “controlling weight.”122 Yet in the forty-four years since California enacted the first franchise registration/disclosure law, not a single franchise regulator in that state or in any state featuring such a law (some of whom also administer their states’ labor laws) has ever stated, suggested, inferred, or implied that the franchisor’s “controls” identified above are indicative of an “employment” relationship. Nor has any other government official of any such state. In this vein, it is important to recall that the vast majority of employment and employment-related laws, rules, and regulations are under the jurisdiction of the states, not the federal government.

Against this backdrop, it is clear that the idea that franchisor “controls” transform the independent contractual franchise relationship into an employment relationship is belied by every state franchise registration/disclosure statute; state franchise regulations; interpretations by state franchise regulatory officials; and, as detailed below, virtually all judicial precedent addressing the subject. The perversion of the franchise concept in this manner could destroy the franchise industry as it exists today, a harsh consequence considering franchising’s remarkable economic benefits and the incredibly salutary impact it has had on the American economy.

Statutory Definitions of “Employer,” “Employee,” and “Independent Contractor”

Whether a franchisor is the employer of its franchisees and/or the “joint employer” of its franchisees’ employees hinges in large part on how the terms “employer” and “employee” are defined under federal and state laws.

These laws, however, feature no uniform definition of the terms “employer” and “employee.” Instead, federal and state laws have varying, sometimes divergent, definitions. So it is that the terms “employer” and “employee” are inconsistently defined under the federal Fair Labor Standards Act (FLSA)123 and under state labor, unemployment insurance, workers’ compensation, and other laws, rules, and regulations. Further, as the judiciary has noted, the varying definitions of “employer” and “employee” are concurrently diminutive and broad, presumably to enable the judiciary to apply those terms in an expansive and extensive fashion.124

123. 29 U.S.C.A. §§ 201 et seq.
The FLSA defines the term “employer” as including: “...Any person acting directly or indirectly in the interest of an employer in relation to an employee. ...”125 In turn, the FLSA defines the term “employee” as meaning “any individual employed by an employer” and further defines “employ” as “...to suffer or permit to work.”126

By contrast, under the federal Americans with Disabilities Act (ADA), the term “employee” is defined as “an individual employed by an employer,”127 but the term “employer” is vastly different than under the FLSA, with the ADA defining “employer” as meaning:

A person engaged in an industry affecting commerce who has fifteen or more employees for each working day in each of 20 or more calendar weeks in the current or preceding calendar year, and any agent of such person, except that, for two years following the effective date of this subchapter, an employer means a person engaged in an industry affecting commerce who has 25 or more employees for each working day in each of 20 or more calendar weeks in the current or preceding calendar year, and any agent of such person.128

Varying again are the definitions of “employment” and “employee” found in the federal Internal Revenue Code, where the definition of the term “employment” consumes six pages of very small font text (and is so detailed as to include in the definition “service performed as the President or Vice President of the United States”). The definition of “employee” is similarly broad and invokes “the usual common law rules applicable in determining the employer-employee relationship.”129

On the state level, too, the definitions of “employer” and “employee” vary within each state depending upon the statutory scheme in question. The laws of New York and California are representative. New York features varying definitions of the terms “employer” and “employee” under its Labor Relations Act,130 Minimum Wage Act,131 Disability Benefits Law,132 Construction Industry Fair Play Act,133 Labor and Management Improper Practices Act,134 and Unemployment Insurance Law.135 (This listing does not come close to exhausting the number of definitions of the term “employer” and “employee” found in New York law, and the foregoing are but examples of same.)

Turning to our second state example, California features differing definitions under its Employment Relations Act,136 Occupational Safety and

---

126. 29 U.S.C.A. § 203(e)(1), (g).
129. 26 U.S.C.A. § 3121(b), (d).
130. N.Y. LAB. LAW § 701(2) (McKinney 2010).
131. N.Y. LAB. LAW § 651(5).
132. N.Y. LAB. LAW § 201(4), (5).
133. N.Y. LAB. LAW § 861-C(1).
134. N.Y. LAB. LAW § 721(5).
135. N.Y. LAB. LAW § 511(1).
136. CAL. LAB. CODE § 2750 (West).
Health Act; Unemployment Insurance Code; and Workers’ Compensation and Insurance Act.

It should be noted as well that certain states define the term “independent contractor”—a critical term given the centrality to franchising of the independent contractual relationship between a franchisor and its franchisees. Of the two states examined here, New York features no definition of the term “independent contractor,” but the California Workers’ Compensation and Insurance Act defines “independent contractor” as meaning “any person who renders service for a specified recompense for a specified result under the control of his principal as to the result of his work only and not as to the means by which such result is accomplished.” In California, there is a presumption—rebuttable though it may be—that a worker performing service for which a license is required under California law is an “employee” rather than an “independent contractor.” The same presumption applies in California Division of Labor Standards enforcement actions under California Labor Code § 3357, in which the division starts with the presumption that a worker is an employee and not an “independent contractor,” a presumption that is rebuttable.

The issue of whether a franchisor is the employer of its franchisees and/or the joint employer of its franchisees’ employees thus hinges on broad and frequently conflicting definitions of the term “employer” and “employee” found in federal and state laws, rules, and regulations. But those are hardly the only or most important inconsistencies pertinent to the issue at hand. The tests applied by the judiciary to determine who is legally an “employer” and “employee” vary depending on the body of law at issue (fair labor standards, unemployment insurance, workers’ compensation, disability, taxation, and occupational health and safety, to name just a few).

Judicial Tests for Determining “Employer” and “Employee” Status

The determination of whether a franchisor is the employer of its franchisees or the joint employer of its franchisees’ employees hinges not only on the varying, broad, and somewhat amorphous definitions of the terms “employer,” “employee,” and “independent contractor” set forth in federal and state laws, rules, and regulations, but also depends upon the varying tests devised by the judiciary when considering who is an “employee” as opposed to an “independent contractor.”

As summarized by Professor Mitchell H. Rubinstein, four and perhaps five tests exist: the common law test; the primary or statutory purpose test;
the economic reality test; a hybrid combination of the common law and economic reality tests; and, a fifth, emerging test denominated the “common law entrepreneurial test.”

The application of these tests by the judiciary in cases construing the distinction between “employers,” “joint employers,” and “employees” will be discussed below. For now, it is sufficient to identify these various judicial tests, which illustrate the complexity and conflicting nature of determinations regarding who is to be characterized as an “employee” as opposed to an independent contractor “franchisee.”

The first test—the common law test—is a “right to control” test and derives from common law tort principles involving vicarious liability of employers.143 This common law agency test has been judicially described as the “default standard” to be applied where a statute does not adequately or specifically define the term “employee.”144

Under the common law test, courts consider the following factors when determining who is an “employee”:

1. the hiring party’s right to control the manner and means by which the product is accomplished; . . .
2. the skill required;
3. the source of the instrumentalities and tools;
4. the location of the work;
5. the duration of the relationship between the parties;
6. whether the hiring party has the right to assign additional projects to the hired party;
7. the extent of the hired party’s discretion over when and how long to work;
8. the method of payment;
9. the hired party’s role in hiring and paying assistants;
10. whether the work is part of the regular business of the hiring party;
11. whether the hiring party is in business; and
12. the provision of employee benefits;
13. the tax treatment of the hired party.145

As Professor Rubinstein notes, the common law test is utilized in most Title VII employment discrimination cases; ERISA cases; NLRB enforcement actions; cases under the Uniform Services Employment and Re-employment Act; and, other employment law statutes, including many state employment laws.146

The second test employed by the judiciary in determining who is an “employee” is the “statutory or primary purpose test,” considered broader than the common law standard.147 Under this test, the U.S. Supreme Court held that independent contractors were not excluded from the definition of “employee” under the NLRA and rejected the common law test as being too narrow.148 The “statutory or primary purpose test” of employee status is:

Whether, given the intended national uniformity (of the NLRA), the term “employee” includes such workers . . . must be answered primarily from the history,

---

146. Rubinstein, supra note 71, at 619.
148. Hearst Publ’ns, 322 U.S. at 120, 123.
terms and purposes of the legislation. The word is not treated by Congress as a word of art having a definite meaning. . . . Rather, it takes color from its surroundings (in) the statute where it appears and derives meaning from the context of that statute, which must be read in light of the mischief to be corrected and the end to be attained. 149

As noted by Professor Rubinstein, the U.S. Supreme Court seems to have resurrected the primary purpose test in a recent Title VII case holding that the term “employee” applied to former employees. 150

The third test for determining who is an “employee”—and, as will be elucidated below, the most important test in the franchise context—is the “economic realities test.” This test focuses on “whether the employee, as a matter of economic reality, is dependent upon the business to which he renders service.” 151 The Second Circuit has identified four factors to be considered under the economic reality test: “whether the alleged employer (1) has the power to hire and fire the employees; (2) supervised and controlled employee work schedules or conditions of employment; (3) determined the rate and method of payment; and (4) maintained employment records.” 152

The Third Circuit has a varying definition of the economic reality test, identifying six factors to determine whether a worker is an “employee”:

1. the degree of the alleged employer’s right to control the manner in which the work has to be performed;
2. the alleged employee’s opportunity for profit or loss depending upon his managerial skill;
3. the alleged employee’s investment in equipment or materials required for his task, or his employment of helpers;
4. whether the service rendered requires a special skill;
5. the degree of permanence of the working relationship; and
6. whether the service rendered is an integral part of the alleged employer’s business. 153

Again, because the economic realities test is most frequently applied in construing who is an employee under the FLSA, this test is important to the issue of whether a franchisor is the employer of its franchisees or the joint employer of its franchisees’ employees, as evidenced by the review of case law addressing this subject set forth below.

The fourth test, denominated as a “hybrid test,” was widely applied to Title VII cases. Following the U.S. Supreme Court’s statement in Nationwide Mutual Insurance Co. v. Darden that the common law test is the default standard, the hybrid test, which combines elements of both the common law and economic realities tests, is no longer widely used. 154

149. Id. at 124 (internal quotation marks and citations omitted).
150. Rubinstein, supra note 71, at 623, citing Robinson v. Shell Oil Co., 519 U.S. 337 (1997); see also Smith Castaways Family Diner, 453 F.3d 971, 985–86 (7th Cir. 2006).
151. Nowlan v. Resolution Trust Corp., 33 F.3d 498, 505 (5th Cir. 1994).
152. Herman v. RSR Sec. Servs. Ltd., 172 F.3d 132, 139 (2d Cir. 1999), quoting Carter v. Dutchess Cnty. Coll., 735 F.2d 8, 12 (2d Cir. 1984) (internal quotation marks and other citations omitted).
154. Rubinstein, supra note 71, at 626; Muhammad v. Dallas Cnty. Cnty. Supervision & Corrections Dep’t, 479 F.3d 377, 380 (5th Cir. 2007) (”. . . we apply a hybrid economic reali-
There appears to be some support for the development of another test of employee status (or at least another aspect of the common law right to control test) that is referred to as the “common law entrepreneurial control test.”\(^{155}\) As enunciated by the D.C. Circuit in *FedEx Home Delivery v. NLRB* (discussed in detail below),\(^{156}\) courts applying the common law “right to control test” determine whether the individuals in question are independent contractors under the NLRA and examine whether the “. . . position presents the opportunities and risks inherent in entrepreneurialism.”\(^{157}\) Whether the “common law entrepreneurial control test” is its own distinct test of employment, as opposed to an offshoot of the common law test addressed above, is the subject of some scholarly debate.\(^{158}\)

*The Vast Majority of Judicial Decisions Affirm That a Franchisor Is Not the Employer of Its Franchisees or the Joint Employer of Its Franchisees’ Employees*

The NLRB General Counsel’s assertion that McDonald’s is the “joint employer” of its franchisees’ employees is directly contradicted by the vast majority of judicial decisions addressing the issue, regardless of the test employed.

The exceptions to this general outcome, as elucidated below, involve janitorial service franchises, which feature atypical structures, and cases in which the judiciary determined that it was simply premature in the absence of the presentation of evidence, whether on a motion to dismiss or a motion for summary judgment, to rule that a franchisor was or was not the employer of its franchisees or the joint employer of its franchisees’ employees.

This article examines each such category of cases but first examines judicial decisions rendered over the years confirming the central feature of the franchise structure: that the relationship between a franchisor and franchisee is that of independent contractors.

1. Judicial Decisions Almost Universally Affirm That the Franchisor-Franchisee Relationship Is That of Independent Contractors

The number of judicial decisions rendered over the past five decades holding that franchisors and franchisees are independent contractors—the very foundation of the franchise business model—is staggering in number. The classic formulation of this principle is found in *Cislaw v. Southland Corp.*, where the court held that “the franchisor’s interest in the reputation of its entire system allows it to exercise certain controls over the enterprise without

---

\(^{155}\) Rubinstein, *supra* note 71, at 619.

\(^{156}\) 563 F.3d 492 (D.C. Cir. 2009).

\(^{157}\) *Id.* at 497 (citation omitted).

\(^{158}\) Rubinstein, *supra* note 71, at 620–22.
running the risk of transforming its independent contractor franchisee into an agent.”  

Likewise, in Kaplan v. Coldwell Banker Residential Affiliates, Inc., the court made clear that the bedrock principle of franchising is that franchisors and franchisees operate under an independent contractor relationship; indeed, “if the law was otherwise, every franchisee who independently owned and operated a franchise would be the true agent or employee of the franchisor.”

2. The General Rule of Judicial Decisions: A Franchisor Is Not the Employer of Its Franchisees or Their Employees

The judiciary has had ample opportunity over the past decades to analyze and determine the issue of whether a franchisor is the employer of its franchisees or the joint employer of its franchisees’ employees. Almost universally, judicial decisions confirm that no such employment relationship exists between a franchisor and its franchisees or its franchisees’ employees, rebutting and refuting the premise underlying the NLRB Complaints against McDonald’s.

Perhaps the most eloquent and insightful judicial decision in this vein is also one of the most recent—Patterson v. Domino’s Pizza, LLC.176 In Patterson, an employee of a franchised Domino’s Pizza outlet commenced an action against both the franchisee and franchisor Domino’s alleging that she was sexually harassed and assaulted at her job. Domino’s moved for summary judgment, contending that it was not the employer of its franchisee’s employee, a motion the trial court granted. The court issued a lengthy decision holding that Domino’s did not control the day-to-day operations or employment practices such that its franchisee was an agent of Domino’s or that its franchisee’s employee was an employee of Domino’s. On appeal, the California Court of Appeal reversed, holding that reasonable inferences could be drawn from the Domino’s franchise agreement that the Domino’s franchisee lacked managerial independence and finding evidence that Domino’s meddled in its franchisee’s employment decisions.

The California Supreme Court reversed the appellate court and reinstated the trial court’s grant of summary judgment in Domino’s favor. Of particular import is the detailed reasoning of the Patterson court, which began by observing:

Franchising, especially in the fast-food industry, has become a ubiquitous, lucrative, and thriving business model. This contractual arrangement benefits both parties. The franchisor, which sells the right to use its trademark and comprehensive business plan, can expand its enterprise while avoiding the risk and cost of running its own stores. The other party, the franchisee, independently owns, runs, and staffs the retail outlet that sells goods under the franchisor’s name. By following the standards used by all stores in the same chain, the self-motivated franchisee profits from the expertise, goodwill, and reputation of the franchisor. . . .

Today, the economic effects of franchising are profound. Annually, this sector of the economy, including the fast food industry, employs millions of people, carries payrolls in the billions of dollars, and generates trillions of dollars in total sales.

Under the business format (franchise) model, the franchisee pays royalties and fees for the right to sell products or services under the franchisor’s name and trademark. In the process, the franchisee also acquires a business plan, which the franchisor has crafted for all of its stores. This business plan requires the franchisee to follow a system of standards and procedures. A long list of marketing, production,
operational and administrative areas is typically involved. The franchisor’s system can take the form of printed manuals, training programs, advertising services, and managerial support, among other things.177

The California Supreme Court in *Patterson* then addressed the very point we have advanced repeatedly in this paper: the centrality in franchising of the trademark license and the concomitant requirements of trademark law that a franchisor exercise controls with respect to those operating under its licensed name, marks, and logos to protect same:

The system-wide standards and controls [addressed in this previous quoted section of this opinion] provide a means of protecting the trademarked brand at great distances. The goal—which benefits both parties to the contract—is to build and keep customer trust by ensuring consistency and uniformity in the quality of goods and services, the dress of franchise employees, and the design of the stores themselves. *The franchisee is often an entrepreneurial individual who is willing to invest his time and money, and to assume the risk of loss, in order to own and profit from his own business. In the typical arrangement, the franchisee decides who will work as his employees, and controls day-to-day operations in his store. The franchise arrangement puts the franchisee in a better position than other small businesses. It gives him access to resources he otherwise would not have, including the uniform operating system itself.*178

In a footnote to its decision, the California Supreme Court makes clear that: “Federal trademark law plays some role in this process,” citing scholarly articles that the court summarized as “stating that federal law obligates a licensor of trademarks, such as a franchisor, to protect the integrity of its registered and unregistered marks by monitoring their use, as well as the quality of the goods and services bearing such marks,” and noting that a “trademark may be deemed abandoned under federal law if a licensor fails to exercise sufficient control over its use by its licensee.”179

Synthesizing the foregoing, the court distinguished franchisor trademark controls from the day-to-day control of the franchised unit, holding:

A franchisor, which can have thousands of stores located far apart, imposes comprehensive and meticulous standards for marketing its trademarked brand and operating its franchises in a uniform way. To this extent, the franchisor controls the enterprise. *However, the franchisee retains autonomy as a manager and employer. It is the franchisee who implements the operational standards on a day-to-day basis, hires and fires store employees, and regulates work place behavior.*

Analysis of the franchise relationship . . . must accommodate these contemporary realities. *The imposition and enforcement of a uniform marketing and operational plan cannot automatically saddle the franchisor with responsibility for employees of the franchisee who injure each other on the job. The contract-based operational division that otherwise exists between the franchisor and the franchisee would be violated by holding the franchisor accountable for misdeeds committed by employees who are under the direct supervision of the franchisee, and over whom the franchisor has no contractual or operational control. It follows that potential liability on the

---

177. Id. at 477, 489–90 (emphasis added, citations omitted).
178. Id. at 490–91 (citations omitted, emphasis added).
179. Id. at 491 n.15 (citations and internal quotation marks omitted).
theories pled here requires that the franchisor exhibit the traditionally understood characteristics of an “employer” or “principal;” i.e., it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees. . . .

Here, the franchisor prescribed standards and procedures involving pizza-making and delivery, general store operations, and brand image. These standards were vigorously enforced through representatives of the franchisor who inspected franchised stores. However, there was considerable, essentially uncontradicted evidence that the franchisee made day-to-day decisions involving the hiring, supervision, and disciplining of his employees . . . Nothing contractually required or allowed the franchisor to intrude on this process. . . .

The uncontradicted evidence showed that the franchisee imposed discipline consistent with his own personnel policies, declined to follow the ad hoc advice of the franchisor’s representative, and neither expected nor sustained any sanction for doing so.180

Emphasizing the general rule that franchisors do not control the day-to-day operations of their franchisees’ businesses and thus cannot be deemed the joint employers of their franchisees’ employees, the California Supreme Court observed:

[F]ranchisees are owner-operators who hold a personal and financial stake in the business. A major incentive is the franchisee’s right to hire the people who work for him, and to oversee their performance each day. A franchisor enters this arena, and becomes potentially liable for actions of the franchisee’s employees, only if it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees. Any other guiding principle would disrupt the franchise relationship. . . .

We cannot conclude that franchise operating systems necessarily establish the kind of employment relationship that concerns us here. A contrary approach would turn business format franchising on its head.181

The California Supreme Court concluded its opinion in Patterson by stating the converse rule which, in the franchise arena, is generally inapplicable:

Nor do we mean to imply that franchisors, including those of immense size, can never be accountable for sexual harassment at a franchised location. A franchisor will be liable if it has retained or assumed the right of general control over the relevant day-to-day operations at its franchised locations that we have described, and cannot escape liability in such a case merely because it failed or declined to establish a policy with regard to that particular conduct.182

Concluding that franchisor Domino’s “had no right or duty to control employment or personnel matters for its franchisee . . . [and] lacked contractual authority to manage the behavior of [its franchisee’s] employees while performing their jobs,” and further noting that “[no] reasonable inference can be drawn that Domino’s . . . retained or assumed the traditional right of

180. Id. at 478–79 (emphasis added, citations omitted).
181. Id. at 497–99 (emphasis added, internal citations omitted).
182. Id. at 503.
general control an employer or principal has over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees,” the court found that there was no basis on which to find a triable issue of fact that an employment or agency relationship existed between Domino’s and its franchisee’s employees. Accordingly, the court reinstated the order of summary judgment granted to Domino’s by the trial court.

Another state supreme court decision, this one from the Supreme Court of Wisconsin, likewise eloquently refutes the notion that franchisor McDonald’s may be deemed the “joint employer” of its franchisees’ employees by emphasizing what has been posited earlier in this article: that the franchise relationship is premised on “controls” and that, in fact, the Lanham Act mandates that franchisors establish such controls to maintain the validity of their trademarks and service marks.

In Kerl v. Dennis Rasmussen, Inc., an individual employed by a franchised Arby’s restaurant shot and seriously injured his former girlfriend and killed her fiancé. The girlfriend and the estate of her fiancé sued both the franchisee and the franchisor, Arby’s, Inc. At the trial court level, Arby’s moved for summary judgment, which the Wisconsin Circuit Court granted and the Wisconsin Court of Appeals affirmed. On further appeal, the Wisconsin Supreme Court affirmed the lower court’s grant of summary judgment to Arby’s.

The Wisconsin Supreme Court in Kerl, a vicarious liability action, emphasized that franchisor “controls” over its franchisees are vital to the franchise relationship:

If the operational standards included in the typical franchise agreement for the protection of the franchisor’s trademark were broadly construed as capable of meeting the “control or right to control” test that is generally used to determine respondeat superior liability, then franchisors would almost always be exposed to vicarious liability for the torts of their franchisees. We see no justification for such a broad rule of franchisor vicarious liability. If vicarious liability is to be imposed against franchisors, a more precisely focused test is required.

We conclude that the marketing, quality and operational standards commonly found in franchise agreements are insufficient to establish the close supervisory control or right of control necessary to demonstrate the existence of a master/servant relationship for all purposes or as a general matter. We hold, therefore, that a franchisor may be held vicariously liable for the tortious conduct of its franchisee only if the franchisor has control or a right of control over the daily operation of the specific aspect of the franchisee’s business that is alleged to have caused the harm.

Here, although the license agreement . . . imposed many quality and operational standards on the franchise, Arby’s did not have control or the right to control [its franchisee’s] supervision of its employees. 185

183. Id. at 563.
184. 273 Wis. 2d 106 (Wis. 2004).
185. Id. at 113 (emphasis added).
Emphasizing the distinction between the franchisor-franchisee relationship and the employer-employee relationship, the court observed:

[A] franchise is a commercial arrangement between two businesses which authorizes the franchisee to use the franchisor’s intellectual property and brand identity, marketing experience, and operational methods. It is quite different from a contract of employment. For one thing, it is the franchisee that pays, not the franchisor. Furthermore, although franchise agreements typically impose detailed requirements on the franchisee’s operations . . . , the existence of these contractual requirements does not mean that franchisors have a role in managing the day-to-day operations of their franchisees. To the contrary, the imposition of quality and operational requirements by contract suggests that the franchisor does not intervene in the daily operation and management of the independent business of the franchisee.186

The court similarly confirms the propriety of this article’s earlier observation that, in fact, the Lanham Act actually requires franchisors to impose the very type of “controls” that the NLRB General Counsel suggests are instead indicia of “employment”:

[B]ecause many franchise relationships include a license to use the franchisor’s trade or service mark, the detailed quality and operational standards and inspection rights specified in a franchise agreement are integral to the protection of the franchisor’s trade or service mark under the Lanham Act . . . . The purpose of the Lanham Act . . . is to ensure the integrity of registered trademarks, not to create a federal law of agency . . . [or to] automatically saddle the licensor with the responsibilities under state law of a principal for his agent.187

Similarly refuting the NLRB General Counsel’s approach against McDonald’s is the court’s observation in Kerl that the control of a franchisor does not consist of routine, daily supervision and management of a franchisee’s business, but, rather, is contained in contractual quality and operational requirements necessary to the integrity of the franchisor’s trade or service mark. The perceived fairness of requiring a principal who closely controls the physical conduct of an agent to answer for the harm caused by the agent is diminished in this context.188

Citing a plethora of decisions from other jurisdictions, both federal and state, the court noted that

[T]he clear trend in the case law in other jurisdictions is that the quality and operational standards and inspection rights contained in a franchise agreement do not establish a franchisor’s control or right of control over the franchisee sufficient to ground a claim for vicarious liability as a general matter or for all purposes.189

Accordingly, the court concluded that franchisor Arby’s did not control or [have the] right to control the daily operations of the franchisee sufficient to give rise to vicarious liability. . . . We hold that a franchisor may be held

186. Id. at 125.
187. Id. at 125–26 (citing Oberlin v. Marlin Am. Corp., 596 F.2d 1322, 1327 (7th Cir. 1979)).
188. Id. at 126.
189. Id. at 126–27.
vicariously liable for the tortious conduct of its franchisee only if the franchisor has control or a right of control over the daily operation of the specific aspect of the franchisee’s business that is alleged to have caused the harm.  

Indeed, the issue of whether McDonald’s and its franchisees serve as the “joint employers” or combined “single employers” of McDonald’s franchisees’ employees has already been litigated and decided in McDonald’s favor. In Gray v. McDonald’s USA, LLC, an employee of a McDonald’s franchise was assaulted while at work and filed suit against both McDonald’s and the franchisee. The plaintiff advanced causes of action sounding in civil rights and tort. Arguing that it was not the plaintiff’s “employer,” McDonald’s moved for summary judgment and was granted same following a “single employer” analysis, which was conducted to determine whether two entities are so interrelated that they may be considered a “single employer” or an “integrated enterprise,” similar to the “joint employer” concept in theory and practice.

Rejecting the plaintiff’s approach, the court held that:

In the instant case, the undisputed evidence establishes that McDonald’s and [its franchisee] are not so interrelated that they may be considered a single employer or an integrated enterprise. First, there is no evidence indicating interrelation of operations: although [the franchisee] submits monthly sales reports to McDonald’s, the companies maintain separate bank accounts and separate offices. Second, no evidence indicates that the parties shared common management. . . . Third, although Plaintiffs provide some evidence that McDonald’s provides discrimination and harassment training for [the franchisee’s] management level employees, no evidence indicates that McDonald’s retains the ability to hire, fire, or discipline an employee. . . . Any directives pertaining to personnel management—including obligating franchisees to “employ adequate personnel so as to operate the Restaurant at its maximum capacity and efficiency,” and to ensure all employees wear uniforms, “present a neat and clean appearance,” and “render competent and courteous service”—are far too general to constitute control rising to the level of employment.  

The plaintiff in Gray then asked the court to apply the common law agency test discussed earlier in this paper and hold McDonald’s liable as her employer. Noting that the common law agency test has two elements (a right to control component, which focuses on whether the alleged employer has the right to hire and fire the employee, and an economic realities component, which focuses on whether the alleged employer paid the employee’s salary, withheld taxes, provided benefits, and set the terms and conditions of employment), the court concluded that there was no evidence to indicate that McDonald’s hired the plaintiff; had the right to hire, supervise, or set her work schedule; and, accordingly, that McDonald’s was not the plaintiff’s employer under the common law agency test. The court thus granted summary judgment to McDonald’s.

190. Id. at 131–32.
192. Id. at 750 (internal citations and quotation marks omitted).
We note that, fifteen years earlier, the Oregon Supreme Court reached a contrary conclusion with respect to McDonald’s, reversing a lower court’s grant of summary judgment to McDonald’s in a vicarious liability case and instead holding that there was an issue of fact for trial on whether McDonald’s had the right to control the precise element of its franchisee’s business that allegedly resulted in harm to the plaintiff (who bit into a sapphire stone while eating a Big Mac at a franchised McDonald’s restaurant).\textsuperscript{193} However, as the Wisconsin Supreme Court observed in Kerl: “Miller appears to run contrary to the prevailing rule that quality and operational standards contained in a franchise agreement are generally insufficient to support franchisor vicarious liability.”\textsuperscript{194} The more typical result is found in Alberto v. McDonald’s Corp.,\textsuperscript{195} in which an employee’s effort to have McDonald’s declared his “employer” in a Title VII action met with defeat and with McDonald’s being granted summary judgment.

Another recent case directly refuting the principles advanced by the NLRB General Counsel—and involving the Fair Labor Standards Act—was the Fifth Circuit’s decision in Orozco v. Plackis.\textsuperscript{196} Orozco involved a Craig O’s franchisee’s employee who initially sued the franchisee claiming FLSA violations (failure to pay overtime or minimum wage) and thereafter added the owner of the Craig O’s franchise network as a defendant. At trial, the jury returned a verdict in favor of the plaintiff with the trial court thereafter denying the franchise network owner’s motion for judgment as a matter of law. The franchise network owner was Craig Plackis, and his Craig O’s network consisted of five restaurants, including the franchised restaurant at issue. Plackis appealed, and the Fifth Circuit reversed the trial court’s denial of judgment as a matter of law, instead rendering judgment in favor of Plackis.

The court began its analysis by noting that it was deploying the “economic reality test.” Addressing each prong of the economic reality test (power to hire and fire employees, supervision and control of employee work schedules or conditions, determining rate and method of payment, and maintaining employment records), the court concluded that, while the remedial purpose of the FLSA required it to define “employer” perhaps more broadly than the term would be interpreted in traditional common law applications, nevertheless, Plackis did not fulfill any of the “economic reality test” prerequisites. The court held:

To satisfy the first element of the economic reality test, Orozco had to present evidence that Plackis possessed the power to hire and fire him . . . Notably, Orozco testified that (the franchisee’s representative) hired him and had the authority to fire him. As for Plackis, Orozco stated that he neither hired him nor possessed the power to fire him . . .

\textsuperscript{193} Miller v. McDonald’s Corp., 945 P.2d 1107 (Or. Ct. App. 1997).
\textsuperscript{194} 273 Wis. 2d 106, 131 (Wis. 2004).
\textsuperscript{195} 70 F. Supp. 2d 1138 (D. Nev. 1999).
\textsuperscript{196} 757 F.3d 445 (5th Cir. 2014).
Orozco also failed to present legally sufficient evidence in support of the second element of the economic reality test—that Plackis supervised and controlled employee work schedules or conditions of employment. The mere fact that Plackis reviewed the [franchisee’s employee] schedules fails to demonstrate that he actually had control over Orozco’s schedule or employment conditions. Similarly, training... Orozco does nothing to suggest that Plackis supervised or controlled the employees at the [franchise] location... It is reasonable to assume that a franchisor would provide training to new franchisees and their employees...

Orozco also failed to adduce legally sufficient evidence in support of the third element—that Plackis determined Orozco’s rate and method of payment. Noting that it was not “suggest[ing] that franchisors can never qualify as the FLSA employer for a franchisee’s employees,” the court held that plaintiff Orozco “failed to produce legally sufficient evidence to satisfy the economic reality test and thus failed to prove that Plackis was his employer under the FLSA.”

Another federal case applying FLSA “economic reality test” standards to the franchise sector is Reese v. Coastal Restoration and Cleaning Services, Inc. In Reese, franchisor SERVPRO moved for summary judgment with respect to a franchisee employee’s claim of FLSA violations directed at both SERVPRO and its franchisee. The plaintiff asserted that both SERVPRO and its franchisee were his “joint employers.” SERVPRO moved to dismiss the action against it or, in the alternative, for summary judgment. The court rejected the plaintiff’s “joint employer” argument:

The issue presented by the instant action is whether SERVPRO is Reese’s joint employer for FLSA purposes. A claim brought under the FLSA first requires facts showing the existence of an employment relationship between Plaintiff and Defendant, in this case between Reese and SERVPRO... The Supreme Court has stated that “employer” under FLSA is to be defined “expansively” and includes individuals with “managerial responsibilities” and “substantial control of the terms and conditions of the work of the employees”... To facilitate determination of FLSA coverage, the courts have established the “economic reality test”... Consideration of these factors in the instant case leads the Court to conclude that SERVPRO was not Reese’s employer for FLSA purposes (the court finding that SERVPRO did not have the power to hire or fire its franchisee’s employees and that SERVPRO’s standards for franchisees did not reflect supervision or control of its franchisees’ employees’ work schedules or conditions of employment or in any fashion controlling what its franchisee paid plaintiff Reese). Finding summary judgment appropriate, the court concluded: “Reese’s position that his employment ‘extended through’ [the franchisee] to SERVPRO by virtue of the franchise license agreement between the latter, is unsupported by the record evidence.”

197. Id. at 449–51.
198. Id. at 452.
200. Id. at 4.
201. Id.
Two other FLSA cases that are not strictly franchise-related are nevertheless worthy of note given their direct refutation of the contention that a franchisor’s imposition of standards equates to its “control” of its franchisees sufficient to render the franchisor a “joint employer.”

In the first case, In re Enterprise Rent-A-Car Wage & Hour Employment Practices Litigation, managers and assistant managers of subsidiary entities owned by ultimate parent Enterprise Holdings, Inc., the thirty-eight entities which actually rented and sold vehicles to the public, sued both the Enterprise subsidiaries and Enterprise itself, asserting FLSA violations and contending that Enterprise was their “joint employer.”

Upholding the district court, the Third Circuit held that parent corporation Enterprise was not the managers’ and assistant managers’ “joint employer,” notwithstanding the fact that Enterprise directly and indirectly furnished administrative services and support to each of its subsidiary business entities, including business guidelines, employee benefit plans, rental reservation tools, a central customer contact service, insurance, technology, and legal services. In addition, Enterprise furnished to its subsidiaries human resource services, including, inter alia, job descriptions, best practices, compensation guides, health plans, employee training materials, and employee review forms.

Applying the “economic reality test,” the Third Circuit concluded that Enterprise was not a “joint employer” of its subsidiaries’ employees because Enterprise Holdings, Inc. had no authority to hire or fire assistant managers, no authority to promulgate work rules or assignments, and no authority to set compensation, benefits, schedules, or rates or methods of payment. Furthermore, Enterprise Holdings, Inc. was not involved in employee supervision or employee discipline, nor did it exercise or maintain any control over employee records. The court further held:

While the plaintiffs contend that Enterprise Holdings, Inc. functionally held many of these [employment] roles by way of the guidelines and manuals it promulgated to its subsidiaries, we are not influenced by this claim . . . Enterprise Holdings exercised no control, let alone significant control over the assistant managers.

The other non-franchise FLSA case, Jacobson v. Comcast Corporation, similarly has great significance to the issue at hand. In Jacobson, a group of cable technicians employed by a company engaged by Comcast to install cable service for Comcast customers contended that, in addition to their nominal employer, Comcast was their “joint employer” within the meaning of the FLSA. Comcast moved for summary judgment.

In support of their contention, the cable technicians noted that Comcast had a close business relationship with its independent contractor installation

---

203. Id. at 471.
204. Id. (emphasis in original).
companies, referred to them as “business partners,” had the authority to pro-
hibit the hiring of prospective technicians in its sole discretion, specified the
nature of the services which the cable technicians would provide, established
policies and procedures to which the technicians had to adhere, were issued
Comcast ID badges, directed technicians to specific work sites and specified
time frames, monitored individual technicians’ activities, and had the author-
ity to “deauthorize” a specific technician. The plaintiffs also contended that,
because Comcast paid its independent contractor installation companies for
each completed service, Comcast exercised practical control over whether
technicians would be paid for their work.

The court rejected the cable technicians’ arguments, holding that, under
the “economic reality test,” Comcast was not their employer or joint em-
ployer. Critical to the franchise arena—and entirely rejecting the argument
that franchisor “controls” equate to “employer” status—the court in Jacobson
observed:

[S]upervision and control is probative of an employment relationship only when
the oversight demonstrates the effective control over the schedule and conditions
of employment. . . . The nature of the control exercised by putative joint employer
is the key element in this analysis. This factor does not contemplate the generic
control exercised by a supervisor over an independent contractor. . . . Therefore,
detailed instructions and a strict quality control mechanism will not, on their own, indicate
an employment relationship. . . . Indeed, detailed instructions and close monitoring are key
components in many independent contractor and franchise relationships.

A high level of supervision and control is not an automatic trigger for joint em-
ployment. . . . While Comcast’s supervision and control may appear substantial in
degree, it is qualitatively different from the control exercised by employers over
employees.206

For similar holdings in FLSA cases rejecting allegations of a “joint em-
ployer” relationship, see Moreau v. Air France,207 Zheng v. Liberty Apparel
Co.,208 Chen v. Street Beat Sportswear,209 Zhao v. Bebe Stores, Inc.,210 and Her-
man v. Mid-Atlantic Installation Service.211

These cases are not to say that a “joint employment” scenario will never
result when the alleged joint employer in fact exercises day-to-day control
over employees of a separate entity—see, for example, Torres-Lopez v. May,212 where a farm owner was deemed the employer of harvesters in
part because the owner supervised the harvesters’ picking routine, picking
quality, schedules, and selected the days which should be worked.

206. Id. at 690–92 (emphasis added) (citations omitted).
207. 356 F.3d 942 (9th Cir. 2004).
208. 355 F.3d 621 (2d Cir. 2003).
212. 111 F.3d 633 (9th Cir. 1997).
In stark contrast to the suggestion that a franchisor’s imposition of standards upon its franchisees equates to “control” of those franchisees sufficient to render the franchisor a “joint employer” of those franchisees’ employees, courts determining franchisor “vicarious liability” cases have held exactly the opposite. For example, in Coworx Staffing Services, LLC v. Coleman, the Superior Court of Massachusetts was called upon to determine whether the franchisor of a temporary staffing company could be held vicariously liable for the alleged acts of its franchisee, who allegedly interfered with the contractual relations of a competitive staffing business. Granting Express Services’ motion for summary judgment, the court pointedly observed:

The franchise relationship is very different in nature from the traditional master/servant relationship applicable to a contract for employment. The franchisor must exert some degree of control over the franchisee to protect its trade or service mark. As a consequence, the majority of courts look to whether the franchisor exercised control over the day-to-day operations of the franchisee or controlled through the franchise agreement the instrumentality which caused the harm. . . . Applying strict liability to a franchisor for the acts of its franchisee would be unfair because the franchisor’s control usually does not consist of routine, daily supervision and management of the franchisee’s business, but, rather, is contained in contractual quality and operational requirements necessary to the integrity of the franchisor’s trade or service mark.

For other cases in which courts granted summary judgment to franchisors holding that they could not be vicariously liable for the acts, errors, or omissions of its franchisees unless they exercised sufficient control over their day-to-day operations, see Schoenwandt v. Jamfro Corp., Lewis v. McDonald’s Corp., Folsom v. Burger King, Helmchen v. White Hen Pantry, Inc., Schlotzsky’s, Inc. v. Hydel, and Hart v. Marriott International, Inc.

Courts adjudicating Title VII actions have often reached the same result. In Matthews v. International House of Pancakes, Inc., employees of an IHOP franchise brought an action against both the franchisee and IHOP itself

214. Id. at *5–6, citing Kerl v. Dennis Rasmussen, Inc., 273 Wis. 2d 106 (Wis. 2004).
215. 689 N.Y.S.2d 461 (N.Y. App. Div. 1999) (deeming summary judgment appropriate where the relationship is merely franchisor-franchisee and there is no showing that the franchisor exercised complete domination and control over the franchisee’s operations).
216. 664 N.Y.S.2d 477 (N.Y. App. Div. 1997) (affirming lower court’s grant of summary judgment to McDonald’s in an action brought by customers of a McDonald’s franchised restaurant who were assaulted in that restaurant’s parking lot).
217. 958 P.2d 301 (Wash. 1998) (en banc) (holding the estates of murdered employees of a franchised Burger King restaurant could not proceed in a wrongful death action against franchisor Burger King since it did not retain control over the security of the franchised restaurant).
221. 597 F. Supp. 2d 663 (E.D. La. 2009).
complaining of racial and gender discrimination. IHOP moved to dismiss the complaint or, in the alternative, for summary judgment. Granting IHOP’s motion, the court noted that “none of the IHOP entities ever had any day-to-day authority or control over the management or personnel [of the franchised restaurant].”222 A similar result was reached in Bricker v. R&A Pizza, Inc.,223 in which female employees of a franchised Domino’s restaurant brought a Title VII action against both the franchisee and Domino’s itself. Granting Domino’s motion to dismiss, the court observed that “a franchisor is not the employer of employees of the franchisee” and that under either the “single employer test” or the “joint employer test,” the plaintiffs in this action failed to advance factual allegations sufficient to withstand Domino’s motion to dismiss.224

Another recent Title VII decision drives home the distinction between a franchisor imposing standards upon its franchisees and such standards giving rise to the franchisor being the “joint employer” of its franchisees’ employees. In Courtland v. GCEP-Surprise, LLC,225 a case in which a bartender and server at a franchised Buffalo Wild Wings restaurant sued both the franchisee and Buffalo Wild Wings alleging sexual discrimination, harassment, and retaliation, the court granted franchisor Buffalo Wild Wings’ motion for summary judgment, applying the “economic reality test” and holding:

A franchisor is not a joint employer unless it has significant control over the employment relationship. . . . Employee and operational supervision does not equate joint employment if the franchisor exercises it for a specific purpose and it is different than the control exercised by an employer . . . [Buffalo Wild Wings] did not have control over the daily conduct of the Restaurant’s managerial staff . . . which [had] sole responsibility for hiring, training, supervising, scheduling, compensating, reviewing and terminating employees as well as addressing HR issues or grievances. . . . The undisputed facts show that [Buffalo Wild Wings] worked with and trained the Restaurant’s managerial staff only to the extent necessary to protect its brand name and dictate product presentation. [It] did not mandate employee-related policies, was not involved in the daily staff management, and did not address employee grievances.226

For an example of how two courts disparately determined the “joint employer” issue under the NLRA in cases involving the same company and the same facts, see FedEx Home Delivery v. National Labor Relations Board227 [FedEx I] and Alexander v. FedEx Ground Package System, Inc. c/b/a FedEx Home Delivery228 [FedEx II].

In FedEx I, FedEx sought a review of the NLRB’s determination that the company committed an unfair labor practice by refusing to bargain with the
union certified as the collective bargaining representative of its Wilmington, Massachusetts, drivers. The NLRB cross-applied for enforcement of its orders. The drivers in question were purportedly independent contractors whom FedEx engaged to furnish package delivery services. FedEx had independent contractor agreements with about 4,000 such contractors nationwide.

Applying both the common law and “entrepreneurial potential” tests described earlier in this article, the D.C. Circuit Court of Appeals granted FedEx’s petition to review the NLRB order, granted same, vacated the NLRB order, and denied the NLRB’s cross-application for enforcement of its order. Contending that the common law test of “control” must take into account the entrepreneurial opportunity enjoyed by an independent contractor, the court held: “[W]hile all the considerations at common law remain in play, an important animating principle by which to evaluate those factors in cases where some factors cut one way and some the other is whether the position presents the opportunities and risks inherent in entrepreneurialism.”\textsuperscript{229} The court concluded:

We have considered all the common law factors, and, on balance, are compelled to conclude they favor independent contractor status. The ability to operate multiple routes, hire additional drivers (including drivers who substitute for the contractor) and helpers, and to sell routes without permission, as well as the partners’ intent expressed in the contract, augurs strongly in favor of independent contractor status. Because the indicia favoring a finding the contractors are employees are clearly outweighed by evidence of entrepreneurial opportunity, the Board cannot be said to have made a choice between two fairly conflicting views. . . . [T]he evidence supporting independent contractor status is more compelling.\textsuperscript{230}

In \textit{FedEx II}, the Ninth Circuit Court of Appeals held directly to the contrary: that FedEx home delivery drivers were employees of FedEx and not independent contractors, reversing the lower court’s grant of summary judgment entered in favor of FedEx, and remanding the matter to the district court with instructions to enter summary judgment for plaintiffs-employees on the question of employment status. The court held:

The [FedEx contract with its independent contractors] grants FedEx a broad right to control the manner in which its drivers perform their work. The most important factor of the right-to-control test thus strongly favors employee status. The other factors do not strongly favor either employee status or independent contractor status. Accordingly, we hold that plaintiffs are employees as a matter of law under California’s right-to-control test.\textsuperscript{231}

Among the factors cited by the Ninth Circuit in support of its decision was FedEx’s control over the means and manner in which its drivers do their jobs (the essential “right to control” prong of the common law test of employment): FedEx controls the “appearance of its drivers and their

\textsuperscript{229.} \textit{FedEx I}, 563 F.3d at 497.
\textsuperscript{230.} \textit{Id.} at 504.
\textsuperscript{231.} \textit{FedEx II}, 765 F.3d at 997.
vehicles” \textsuperscript{232}; the times its drivers could work and the specification of its drivers’ hours; “how and when drivers deliver packages” \textsuperscript{233}; driver loading and unloading schedules at FedEx terminals; in which areas drivers could make deliveries; who the drivers’ customers would be (that is, FedEx’s customers, not the drivers’ own customers); rates to be charged to customers; and all billing and payment activities. \textsuperscript{234}

The Ninth Circuit distinguished the D.C. Circuit’s decision in \textit{FedEx I} by stating that, even if said decision was correct, it “has no bearing on this case. There is no indication that California has replaced its longstanding right-to-control test with the new entrepreneurial-opportunities test developed by the D.C. Circuit. Instead, California cases indicate that entrepreneurial opportunities do not undermine a finding of employee status.” \textsuperscript{235}

A trio of decisions involving convenience store franchisor 7-Eleven, Inc. similarly reject the notion that a franchisor’s imposition of standards makes the franchisor the employer of either its franchisees or their employees. These decisions are of particular consequence, given the rather unique nature of the 7-Eleven franchise network: 7-Eleven purchases or leases its franchisees’ real estate; builds out their stores; stocks them with inventory; and fronts all payroll, tax, and inventory replenishment expenses. \textsuperscript{236} Accordingly, 7-Eleven’s business format reflects far more “control” of its franchisees’ activities than is usually the case. Nevertheless, the courts have been virtually unanimous in declaring that 7-Eleven is not the employer of its franchisees or their employees.

One of the earliest cases so holding is \textit{Cislaw v. Southland Corp.} \textsuperscript{237} (Southland Corporation subsequently changed its corporate name to 7-Eleven, Inc.). In this action, parents of a teenager who died after consuming clove cigarettes purchased at a franchised 7-Eleven store sued 7-Eleven, contending that its franchisee was 7-Eleven’s agent and not an independent contractor. 7-Eleven moved for summary judgment. The trial court granted same and the teenager’s parents appealed.

Applying the common law “right to control” test addressed above, the California Court of Appeal affirmed the lower court’s grant of summary judgment to 7-Eleven. In applying the test, the court noted that its franchisee made all inventory decisions and, in fact, determined by itself to sell the clove cigarettes that allegedly killed the plaintiffs’ son; 7-Eleven did not recommend selling that product or advertising it to the public. The court also noted that 7-Eleven could not block its franchisee’s sale of clove cigarettes at the franchisee’s store. Moreover, the court found that the 7-Eleven franchisee made all employment decisions at its store; had the “sole right to employ

\textsuperscript{232.} \textit{Id.} at 989.  
\textsuperscript{233.} \textit{Id.} at 990.  
\textsuperscript{234.} \textit{Id.} at 989–90, 992–93.  
\textsuperscript{235.} \textit{Id.} at 993.  
\textsuperscript{236.} 7-Eleven, Inc. Franchise Disclosure Document, issuance date Mar. 10, 2011.  
and discharge staff” as it saw fit; had “full responsibility for the conduct of [its employees], including . . . the supervising, disciplining, compensation (and taxes relating thereto), and work schedules,” and paid all operating expenses.238

For these reasons, the court held that, as a matter of law, no agency relationship existed between 7-Eleven and its franchisee and that summary judgment was properly entered in favor of 7-Eleven.239

Similarly, in an FLSA action entitled Singh v. 7-Eleven, Inc.,240 the plaintiffs sought to recover from 7-Eleven, and not from the franchised store where they worked, unpaid overtime and meal break compensation under both the FLSA and the California Labor Code, contending that 7-Eleven was their “joint employer” under the FLSA. Applying the economic reality test described earlier, the court rejected the plaintiffs’ approach, holding:

The Ninth Circuit has specified that whether an entity is an employer under the FLSA is a question of law that must be determined by applying the economic reality test. Under the economic reality test, a court must consider the totality of the circumstances of the relationship, including whether the alleged employer has the power to hire and fire the employees, supervises and controls employee work schedules or conditions of employment, determines the rate and method of payment, and maintains employment records. . . .

[N]o evidence indicates that 7-Eleven exercised any control over any terms of the employment, including training of employees, or influenced [its franchisee’s] choice of employees or manner of hiring. . . .

Moreover, simply setting the standards without actual control of day-to-day operations is not sufficient to establish an employer-employee relationship between 7-Eleven and plaintiffs. Such policies are merely reflective of an inherent interrelation of operations between the two entities and 7-Eleven’s goal of attaining conformity to certain operational standards and details. . . . The court finds that 7-Eleven was not responsible for setting plaintiffs’ wages, using its funds to pay plaintiffs, or providing any employment benefits. . . . Although 7-Eleven generates paychecks, this is merely a convenience for the franchisees.241

Accordingly, the court held that 7-Eleven was not the plaintiffs’ employer under the economic reality test and granted it summary judgment.

Most recently, the California Court of Appeal reached the same result in Aleksick v. 7-Eleven, Inc.242 In Aleksick, an employee of a franchised 7-Eleven store commenced an action against 7-Eleven complaining of its payroll practice when it came to computing partial hours worked. 7-Eleven was granted summary judgment by the trial court and the plaintiff appealed. Affirming the lower court’s grant of summary judgment, the court held:

. . . (C)ontrol over wages means that a person or entity has the power or authority to negotiate and set an employee’s rate of pay, and not that a person or entity is physically involved in the preparation of an employee’s paycheck. . . . The preparation of

238. Id. at 391–94.
239. Id. at 394.
241. Id. at *3–6 (emphasis added) (citations and internal quotation marks omitted).
payroll is largely a ministerial task. . . . The employer, however, is the party who hires the employee and benefits from the employee’s work and thus it is the employer to whom liability should be affixed for any unpaid wages. . . . 7-Eleven exercised no control over (its franchisee’s) employees, including their hiring or firing, rate of pay, work hours and conditions; 7-Eleven did not “suffer or permit” the employees to work; and it did not engage them in work.243

This does not mean to suggest that earlier contrary cases did not hold that franchisees were “agents” of their franchisors (under either actual or apparent agency principles). However, these contrary cases are quite old, largely dating from the 1970s and before the judiciary had the opportunity to establish case law addressing the franchisor-franchisee relationship in the context of the FLSA, vicarious liability, agency, and other claims asserted against franchisors based on their franchisees’ acts, errors, and omissions. Examples of these earlier cases include: Holland v. Nelson;244 Porter v. Arthur Murray, Inc.;245 and Nichols v. Arthur Murray, Inc.246 One more recent case found there was sufficient evidence to support a trial court judgment that a franchisor—a tax and loan service company—was vicariously liable for its franchisees’ illegal advertising.247

However, it remains true that virtually all judicial decisions issued over the past twenty-five years—that is, following the judiciary’s development of principles applicable to the franchisor-franchisee relationship specifically in the realm of employment, agency, and vicarious liability—refute and reject the position that a franchisor is either the employer or joint employer of its franchisees or their employees.

3. An Exception to the General Rule: Judicial Decisions Involving Janitorial Service Franchises

Janitorial service franchise networks predominantly operate under a different franchise model than most other networks. In the janitorial services sector (and a few other franchise sectors, including home health care and temporary staffing), the franchisor solicits and secures customers (in the janitorial sector, typically office buildings, health care facilities, stadiums, malls, and other commercial settings); assigns customers, cleaning jobs, or both to franchisees to service; bills and collects payment from customers; and, after deducting a royalty or other service fee, remits to the franchisee the customer’s payment for such service.

In terms of “economic reality,” the janitorial service franchise sector has to operate this way. Simply stated, it would be impossible to obtain janitorial service contracts from the nation’s building owners, malls, universities, stadiums, health care facilities, and other venues—whose properties are located

243. Id. at 804–05.
in multiple cities and increasingly overseas as well—if there were not a national or international franchisor capable of bidding for the work and then assigning customers and their contracts to franchisees to fulfill. It is important to note, however, that individual franchisees generally have the opportunity and are encouraged to secure their own clients beyond those apportioned by their franchisors and may turn down assignments offered by the franchisor.

Perhaps because of its unusual franchise structure, the janitorial services franchise sector has seen a number of widely disparate judicial decisions addressing the issue of whether a franchisor is the employer of its franchisees.

In *Juarez v. Jani-King of California, Inc.*,\(^{248}\) one of the largest janitorial service franchisors, Jani-King, was a defendant in a putative class action that alleged violations of California’s Labor Code, asserting that Jani-King was the franchisees’ “employer” due to its alleged control of its franchisees’ activities. The court rejected the franchisees’ argument while denying their motion to certify a class action.

Critically, the court in *Juarez* rejected the contention that a franchisor’s imposition of standards upon its franchisees is tantamount to franchisors “controlling” those franchisees, holding that:

Under California law, the principal test of an employment relationship is whether

the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired. . . . As common proof of their Labor Code claims, Plaintiffs
toffered Jani-King’s franchise manuals and other documents, which they claim show that Jani-King directs the franchisees’ method of cleaning, their cleaning schedule, their contact with customers, and their manner of dress, as Jani-King requires franchisees to wear uniforms with a Jani-King logo. Plaintiffs submit, as evidence of “control,” that franchisees must be reachable by Jani-King within four hours of contact and must notify Jani-King before going on vacation; that franchisees were not permitted to handle customer complaints without notifying Jani-King and following specific procedures; . . . and that franchisees must always use Jani-King’s name and Jani-King’s phone number with clients. Plaintiffs cite Jani-King’s advertising material—which touts the company’s “quality control” over its franchisees—as evidence of an employer-employee relationship. . . .

Jani-King argues that Plaintiffs’ common proof shows nothing more than that which makes the owners franchisees. . . . The Court agrees with Jani-King. . . . [E]mployers have a strong mode to avoid [employment] costs through creatively classifying their workers as independent contractors . . . Franchisors, however, are subject to a considerable amount of regulation that does not apply to independent contractors or employees. For instance, franchisors are compelled by state and federal law to make detailed disclosure to prospective franchisees, and must provide a fourteen-day waiting period between the provision of a disclosure document and the sale of the franchise. Thus, the above policy concerns do not weigh as heavily in the franchise context. . . .

While the answer is not entirely clear, the Court finds it likely that under California law, the franchisee must show that the franchisor exercised control beyond that necessary to protect and maintain its interest in its trademark, trade name and good will to establish a prima facie case of an employer-employee relationship. As

---

such, the Court can safely exclude from the employee-employer relationship analysis facts that merely show the common hallmarks of a franchise—those that constitute a “marketing plan or system” under which the franchisee’s operation is “substantially associated with the franchisor’s trademark, service mark, trade name,” or goodwill [citing to the California Franchise Investment Law]. Jani-King’s franchisees are required to follow specific methods of cleaning and handle customer complaints a certain way because that is part of Jani-King’s required franchise system.

Once it sets aside the policies required to protect Jani-King’s service mark and good will, the Court finds very little—if any—common evidence tending to prove an employer-employee relationship between Jani-King and its franchisees. 249

Just three months later, the U.S. District Court for the District of Southern Mississippi suggested to the contrary when it rejected Jani-King’s motion for summary judgment in Hayes v. Eamon Enterprises, LLC. 250 In Hayes, an employee of a company whose janitorial services were furnished by a Jani-King franchisee slipped and fell on a wet restroom floor, sustained injuries, and sued both the franchisee and franchisor Jani-King, asserting vicarious liability against the latter. In its opinion denying Jani-King’s motion for summary judgment, the court observed:

[U]ltimately, when viewed in the light most favorable to [plaintiff’s] case, the evidence supports the conclusion that Jani-King was not concerned only with the end results of [its franchisee’s] work. Its Franchise Agreement contained provisions designed to control the training of [the franchisee’s] employees, the location and appearance of [the franchisee’s] place of business and the policies, practices, procedures and standards by which [the franchisee] performed its work. . . . Undoubtedly, the relationship does not closely resemble the employer-employee relationship as most laymen conceive it. But for all the murkiness of this body of law, Mississippi courts abide fundamentally by the principle that a servant is a person employed by a master to perform service in his affairs whose physical conduct in the performance of the services is controlled or is subject to the right to control by the master. Close though the question is, when read as consistently as possible with [plaintiff’s] position, the Franchise Agreement demonstrates a degree of control over [the Jani-King franchisee’s] physical conduct too great to pass off the relationship as one creating an independent contractor. 251

Sometimes, such directly conflicting opinions regarding whether janitorial service franchisees are independent contractors or employees of their franchisor occur in the very same jurisdiction. This is particularly so in Massachusetts. In De Giovanni v. Jani-King International, Inc., 252 Jani-King franchisees commenced a putative class action against their direct franchisor, Jani-King of Boston, Inc., which was actually a master franchisee, having been granted the right by Jani-King International, Inc. to offer and sell franchises in the greater Boston metropolitan area, and against Jani-King International, Inc. as well, alleging that both violated the Massachusetts Wage Act

249. Id. at 581–83 (internal citations and quotation marks omitted).
251. Id. at *6 (internal citations and quotation marks omitted).
by classifying said franchisees as independent contractors instead of employees. Both sides moved for summary judgment. The U.S. District Court for the District of Massachusetts granted summary judgment in favor of plaintiff-franchisees in an oral decision. In turn, both defendants filed a motion for reconsideration, which was denied and became the subject of the cited decision.

At issue in *De Giovanni* were the provisions of Massachusetts’ Independent Contractor/Misclassification Law,\(^{253}\) which in essence provides that an individual is to be deemed an “employee” under Massachusetts law unless the services at issue are performed “(a) free from control or direction of the employing enterprise; . . . (b) outside of the usual course of business, or outside of all the places of business [of the employing enterprise]; and (c) as part of an independently established trade, occupation, profession, or business . . . of the worker.”\(^{254}\)

Critically, noted the court, the defendants in *De Giovanni* did not attempt to distinguish themselves as “franchisor” or “master franchisee.” Indeed, observed the court,

> [D]efendants could have argued in their voluminous briefing of the motions for summary judgment that even if one of them is an ‘employer’ for the purpose of the Massachusetts Wage Act, the others are not. However, they chose to brief the issue as if the three defendants were similarly situated.\(^{255}\)

This failure to distinguish between Jani-King International, Inc. and its master franchisee, Jani-King of Boston, Inc., proves critical given the decision in *Depianti*, discussed below.\(^{256}\)

It is possible that the court left an opening for Jani-King International, Inc. by holding:

> It has been established that at least [Jani-King of] Boston is liable for having misclassified plaintiffs. It is important that the parties and the court now focus on determining the amount of damages to be awarded. . . . After damages are determined, if requested, the court will permit the filing of another motion to reconsider concerning the issues of direct employment and joint employment. These issues will have practical impact only if [Jani-King of] Boston does not have assets sufficient to pay the judgment in this case.\(^{257}\)

Contrast *De Giovanni* with *Depianti v. Jan-Pro Franchising International, Inc.*,\(^{258}\) in which janitorial franchisees alleged that they had been misclassified as independent contractors and were instead employees of both their immediate franchisee (a master franchisee) and the ultimate franchisor, Jan-Pro

---

itself. As with its competitor Jani-King, Jan-Pro features a three-tiered system of franchising, in which regional master franchisees are granted the right to sell unit franchises within their territories and enter into contracts with franchisees in those territories.259

After the district court in Depianti obtained clarification on certain issues from the Supreme Judicial Court of Massachusetts, it granted Jan-Pro’s motion for summary judgment on the employee misclassification issue. Distinguishing De Giovanni and Awuah v. Coverall of North America, Inc.,260 discussed in detail below, the court held:

Plaintiffs argue that . . . this case is now no different in substance from other cases in which [Jan-Pro’s] competitors have been held to have misclassified the workers that perform the cleaning services for those companies (citing plaintiffs’ brief invoking De Giovanni and Awuah). This argument is not accurate. . . . Plaintiffs’ argument ignores a potentially crucial difference between [Jan-Pro] and some of its competitors: the three-tiered structure of [Jan-Pro’s] business model. In Awuah . . . [t]he court found that Coverall had not satisfied the second prong of the Misclassification Statute, namely the requirement that the worker’s service be performed outside the usual course of the business of the employer. . . . Unlike Coverall, [Jan-Pro] did not . . . train Depianti, provide him with equipment, or bill the customers to whom Depianti provided cleaning services. . . . Accordingly, the reasoning of Awuah does not imply that [Jan-Pro], like Coverall, should be considered to be Depianti’s employer.

The court’s decisions in the De Giovanni case also do not undermine [this] reasoning. . . . The plaintiffs in De Giovanni, who also perform janitorial services, brought suit against three defendants. . . . The court explained that although, in principle, there may be material differences between the various defendants, summary judgment was appropriate as to all three because they chose to brief the issue as if the three defendants were similarly situated.

Thus, this court did not determine, in De Giovanni, that a franchisor whose franchisees are themselves franchisors, like [Jan-Pro], is legally indistinguishable from its intermediate franchisees. The entry of summary judgment against the three defendants in De Giovanni was, rather, a result of those parties’ own decision to litigate that case as if they represent a single party. . . .

These decisions do not mean that every franchisor whose franchisees perform cleaning services—or whose franchisees’ franchisees perform cleaning services—itself sells cleaning services, and is therefore the employer of those franchisees as a matter of law.261

So it is that the deliberations of the U.S. District Court for the District of Massachusetts may have evolved such that franchisor Jani-King—which franchise structure is virtually identical to that of competitor Jan-Pro—may have hope that, as the court suggested in its opinion, it may meet with more success in the damages phase of De Giovanni, at which juncture the court virtually invited Jani-King to readdress the issue of its standing as the “employer” of its franchisees’ employees.

259. Id. at *1.
261. Id. at *12–13.
This analysis brings us to the critical case of Awuah Coverall North America, Inc.,\textsuperscript{262} a case that sent shock waves through the franchise community. In \textit{Awuah}, franchisees commenced an action against franchisor Coverall alleging that they were misclassified as independent contractors and were instead employees. Applying the above-referenced three-prong test of the Massachusetts Independent Contractor/Misclassification Law, the court found that Coverall could not satisfy any of the three required elements necessary to avoid classification as an employer and that the services rendered by Coverall franchisees were not “outside the usual course of the business of the employer.” Instead, the court held that: “[T]he undisputed facts established that Coverall sells cleaning services, the same services provided by these plaintiffs. Because the franchisees did not perform services outside the usual course of Coverall’s business, Coverall fails to establish that the franchisees are independent contractors.”\textsuperscript{263} Accordingly, the court granted plaintiff-franchisees’ motion for partial summary judgment.

The court’s application of Massachusetts’ independent contractor statute to franchising in \textit{Awuah} seems to reflect ignorance of, and even hostility to, franchising, which the \textit{Awuah} court uncharitably referred to as resembling a “Ponzi scheme.” The court was quick to state, however, that the pejorative description did not apply to franchisor Coverall.\textsuperscript{264} The NLRB General Counsel’s approach appears similar to that in \textit{Awuah}.

Few franchisors are “pure” franchisors—that is, franchisors which do not own and operate units of their own, whether directly or through affiliates or subsidiaries. Yet, under the court’s analysis in \textit{Awuah}, the fact that a franchisor engages in the same economic activity as its franchisees automatically transforms it into the “employer” of those franchisees because all three prongs of the Massachusetts independent contractor statute must be satisfied to avoid the “employer” designation. The failure of the court in \textit{Awuah} to apply the law in a fashion adaptive to the economic realities, norms, and structures of franchising is disturbing and could prove most dangerous.

On the eve of oral argument of Coverall’s appeal to the First Circuit, in January 2015 the parties reached a proposed class settlement; filed a motion to remand the case back to the U.S. District Court (which motion was granted); and, on April 15, 2015, the parties filed a consent motion seeking district court approval of the proposed $5.5 million settlement (pursuant to which Coverall will also cease doing business in Massachusetts).

4. The Other Exception to the General Rule: Judicial Determinations That It Is Premature to Rule on the “Joint Employer” Issue

The issue of whether a franchisor is the employer of its franchisees or the “joint employer” of its franchisees’ employees has frequently been presented

\textsuperscript{262} 707 F. Supp. 2d 80 (D. Mass. 2010).
\textsuperscript{263} Id. at 84.
\textsuperscript{264} Id.
to the judiciary in the context of pre-trial dispositive motions, i.e., motions to dismiss and motions for summary judgment. In a number of these cases, the judiciary has determined that the issue is not sufficiently ripe such that additional discovery or a trial on the merits is required so that a full exposition of the facts may be adduced. Counsel for franchisees or franchisees’ employees tout such judicial decisions denying franchisor dispositive motions as confirmation of the principle that a franchisor is, indeed, the employer of its franchisees or those franchisees’ employees. However, nothing could be further from the truth.

Under Rule 12(b)(6) of the Federal Rules of Civil Procedure and analogous state procedural codes governing motions to dismiss, a complaint must merely contain sufficient factual matter to state a claim for relief that is plausible on its face, and all reasonable inferences must be drawn in the plaintiff’s favor. Further, when deciding a motion to dismiss, a court is obliged to accept all allegations in the complaint as true.

Similarly, on a motion for summary judgment under Rule 56(c) and analogous state procedural codes, the moving party bears the burden of establishing that there are absolutely no genuine issues of material fact for the court to decide, that it is entitled to judgment as a matter of law, and the court must construe the facts and all reasonable inferences in the light most favorable to the non-moving party.

Accordingly, courts frequently refuse to dismiss at the pleading stage a complaint asserting that a franchisor is a joint employer of its franchisees’ employees and similarly often express reluctance to grant summary judgment on the issue. Instead, the courts often wait for discovery to be conducted, a record established, and sometimes a trial held before rejecting such a contention.

A representative case is Cordova v. SCCF, Inc., in which the franchisor of Sophie’s Cuban Cuisine Restaurants was alleged to be the joint employer or a single integrated employer of its franchisees’ employees in a putative class action alleging FLSA and New York Labor Law violations. Sophie’s moved to dismiss the complaint. However, the court denied Sophie’s motion as being premature:

The Second Circuit has not yet considered whether a franchisor can qualify as a joint employer, but [Sophie’s] cites decisions from other circuits in which courts, using versions of the economic reality test established by the Supreme Court, have generally concluded that franchisors are not employers within the meaning of the FLSA (citations omitted). The decisions that [Sophie’s] cite, however, were all issued on motions for summary judgment after the parties had completed discovery. Here, however, there has not been any discovery and the question on this motion practice is whether the allegations pleaded in the [complaint] are sufficient plausibly to state a claim for relief. While it is not far from this juncture that

266. In re NYSE Specialists Sec. Litig., 503 F.3d 89, 95 (2d Cir. 2007).
Plaintiffs will need to show that [Sophie’s] qualifies as a joint employer, taking the facts in the light most favorable to Plaintiffs, the Court finds that Plaintiffs have plausibly pleaded facts suggestive of joint employment.\textsuperscript{269}

Accordingly, the defendant’s motion to dismiss the complaint was denied.

The same result pertained in \textit{Olvera v. Bareburger Group LLC},\textsuperscript{270} a putative class action alleging that the franchisor of Bareburger restaurants, as a joint employer, violated the rights of its franchisees’ employees under the FLSA and New York Labor Law. The franchisor moved to dismiss but, again, its motion was denied as being premature:

Taking these pled facts as true, as the Court must at this stage, they state a plausible claim that the franchisor defendants were plaintiffs’ joint employers under the FLSA and NYLL. The cases on which the franchisor defendants rely are not to the contrary. In these cases, franchisors were held not to be employers but, in all but one, this determination was made not on the pleadings but at summary judgment. . . . These cases may signal the challenge plaintiffs may face in establishing their claims after discovery but, at this stage, plaintiffs need only plead enough facts to “state a claim to relief that is plausible on its face.”

Although plaintiffs may ultimately fail to prove that the franchisor defendants were joint employers under the FLSA and NYLL, they have pled enough facts to survive a motion to dismiss, and are thus entitled to test their claims in discovery.\textsuperscript{271}

In other words, although the facts adduced in discovery will generally support a franchisor’s claim that it in no fashion serves as the joint employer or co-employer of its franchisees’ employees, it is enough, at the pleading stage, for franchisees to adequately allege franchisor co-employment to survive an initial motion to dismiss.

Similarly, in \textit{Cano v. DPNY, Inc. d/b/a Domino’s Pizza},\textsuperscript{272} the plaintiffs—current and former employees of franchised Domino’s Pizza stores—commenced an action against their franchisee-employers seeking damages and injunctive relief under the FLSA and the New York Labor Law. The employees then moved for leave to file an amended complaint naming as additional defendants their additional alleged “joint employers,” the subject franchisor entities Domino’s Pizza, Inc., Domino’s Pizza LLC, and Domino’s Pizza Franchising LLC (collectively, Domino’s). The plaintiffs’ complaint against their franchisee-employers alleged that said employers willfully engaged in unlawful employment practices in violation of both the FLSA and the New York Labor Law, contending that said franchisees removed recorded hours from time records and required employees to work off-the-clock. The plaintiffs alleged that as a consequence they were paid less than the minimum wage; were entitled to overtime wages; and, in some cases, were not paid for the hours they worked.

\textsuperscript{269} Id. at *4–5.
\textsuperscript{271} Id. at *5–6.
\textsuperscript{272} 287 F.R.D. 251 (S.D.N.Y. 2012).
The plaintiff-employees’ desired amended complaint would name Domino’s as their “employer” within the meaning of the FLSA and New York Labor Law. Specifically, they contended that Domino’s promulgated and implemented employment policies, such as compensation, hiring, training, and management policies for all company-owned and franchised Domino’s restaurants, including the restaurants in which they worked; that Domino’s exercised its authority to control, directly or indirectly, the defendants’ timekeeping and payroll practices by requiring the use of a proprietary computerized record-keeping system that tracked hours and wages and retained payroll records, all of which were regularly submitted to and monitored by Domino’s; that Domino’s knew or should have known of the alleged unlawful practices at the franchisee-defendants’ restaurants by virtue of said computerized records; that Domino’s maintained control over many aspects of the franchisee-defendants’ stores directly related to their employment, including specifying uniforms, equipment, vehicles, and supplies; setting their delivery areas and monitoring delivery times; detailing the methods and procedures for performing their work; that Domino’s enforced its policies by means of a computer program that tracked employee performance and by exercising its right to inspect and audit the franchisee-defendants’ stores; and that Domino’s had the power to stop the franchisees’ alleged employment violations by terminating, or threatening to terminate, the subject franchise agreements.

Holding that “plaintiffs have pled enough to survive a motion to dismiss,” the court granted the plaintiff-employees’ motion for leave to file an amended complaint naming Domino’s as their co-employer, observing that “the appropriate time to adjudicate (issues raised by Domino’s) is on a motion for summary judgment, when the plaintiffs have had an opportunity for discovery.”

Similarly, in Naik v. 7-Eleven, Inc., plaintiffs contended that 7-Eleven was their employer for FLSA purposes and survived a 7-Eleven motion to dismiss, the court noting that it was “required to accept all well-plead allegations in the Complaint as true.” For other examples of cases in which franchisor motions for summary judgment were denied on the ground that there were questions of fact requiring resolution by means of a trial, see Myers v. Garfield & Johnson Enterprises, Inc.,276 Equal Employment Opportunity Commission v. Papin Enterprises, Inc.,277 and Miller v. D.F. Zee’s, Inc.278

273. Id. at 257.
274. Id. at 260.
276. 679 F. Supp. 2d 598 (E.D. Pa. 2010) (in which a former employee of a tax preparation franchise commenced a Title VII action alleging that, under apparent authority theory, the franchisor was her employer).
278. 31 F. Supp. 2d 792 (D. Or. 1998) (in which female employees of a franchised Denny’s restaurant filed suit against their franchisee-employer and the franchisor, alleging sexual discrimination, harassment, and retaliation under Title VII).
Thus, while there are a plethora of pre-trial dispositive motion judicial decisions holding that employees of franchisees have presented sufficient evidence to withstand a motion to dismiss or a motion for summary judgment on the issue of whether their actual employer or joint employer was the franchisor in question, it is important to note that none of these cases actually adjudicated the issue. Instead, as noted above, these cases simply confirm the elementary principle that a motion to dismiss will not be granted if a complaint sufficiently alleges a cause of action (whether or not the facts alleged are true and with all inferences being drawn in favor of the plaintiff) and that summary judgment will be denied if the court believes that material issues of fact require a trial.

The Ramifications for Franchisors and Franchisees Should Franchisors Be Deemed Joint Employers of Their Franchisees’ Employees

The weight of extant precedent cited extensively in this article, if followed, should overcome the NLRB General Counsel’s position. However, should the NLRB General Counsel’s position prevail, the structures, norms, and economics of franchising—which have proven so remarkably successful over the past half century for franchisors, franchisees, and the American economy—will be upended and forever altered if the theory of franchisor as joint employer be adopted by the NLRB and thereafter by the judiciary.

The implications for franchisors are clear. Should they be deemed the joint employer of their franchisees’ employees, franchisors may find themselves required by federal law to negotiate with unions with respect to franchised unit employee wages, benefits, and other incidents of employment. As well, franchisors under respondent superior theory may also become jointly liable for their franchisees’ employees’ acts, errors, and omissions. In addition, the franchisor may also find itself jointly liable for its franchisees’ tax, workers’ compensation, health insurance, unemployment insurance, sick leave, maternity leave, and other obligations owed by its franchisees to their employees.

The implications for franchisees, should franchisors be found to be the “joint employers” of their franchisees’ employees (or the employer of the franchisees themselves), could prove ruinous.

First, at the very least, franchisees will find the economics of their relationships with franchisors negatively impacted in a harsh fashion. Given the scope of liabilities inuring to franchisors under this scenario, franchisors will by necessity dramatically increase franchisee payments to make up for the economic dislocation. This economic realignment will take place the very first time a franchisor has the opportunity to enter into a new franchise agreement with an existing franchisee (or to offer a franchise to a new franchisee).

In addition, franchisee indemnification obligations will be dramatically expanded to subsume all of the employment duties, obligations, and liabilities
being thrust upon franchisors. In an attempt to avoid liability, many franchisors may abandon the hiring and staffing guidance and employee training functions they now offer franchisees that prove so meaningful to them.

More ominously, it may be that franchisors find the landscape of franchising so fundamentally damaged that they simply stop franchising altogether. Not only would this deny new franchisees their entrepreneurial desires, but existing franchisees would no longer have the ability to acquire and operate additional franchised units, a common desire in franchising.

But the most dramatic implication should the position that franchisors are the “joint employers” of their franchisees’ employees be adopted could be the elimination of existing franchises altogether. This determination regarding McDonald’s was not foreseeable—to the contrary, a half-century of decisional law, the Lanham Act, and the very definitions of the term “franchise” set forth in federal and state franchise laws, rules, and regulations (dating back to 1971) would appear to render the determination not only unforeseeable but impossible to conceive. And the basic premise of the franchise relationship—that a franchisee is an independent contractor of its franchisor—has been a bedrock of franchising since its inception and a most basic assumption of the franchise relationship.

With this in mind, the “frustration of purpose” legal doctrine may entitle franchisors to terminate all of their franchise agreements on the ground that an unforeseeable event subsequent to the formation of those agreements renders those franchise agreements impracticable and subject to termination.

As stated in the Restatement of Contracts (Second):

Where, after a contract is made, a party’s performance is made impracticable without his fault by the occurrence of an event the non-occurrence of which was a basic assumption on which the contract was made, his duty to render that performance is discharged, unless the language or the circumstances indicate the contrary.279

The Restatement explains that in order for a party’s performance to be discharged by supervening frustration, the frustrated purpose:

Must have been a principal purpose of that party in making the contract. It is not enough that he had in mind some specific object without which he would not have made the contract. The object must be so completely the basis of the contract that, as both parties understand, without it the transaction would make little sense.280

The doctrine of frustration of purpose excuses a contracting party’s performance only where a virtually cataclysmic, wholly unforeseeable event renders the contract valueless to one party281 and is unavailable if the difficulties that frustrate the purpose of the contract reasonably could have been foreseen.282 But if unforeseeable, frustration will excuse performance of a con-
tract if the basic purpose of the contract was destroyed by the supervening event; the frustration must be so severe that it is not fairly to be regarded as within the risks that were assumed under the contract; and the value of counter-performance to the promisor seeking to be excused must be substantially or totally destroyed.283

Under the judicial “frustration of purpose” doctrine, a franchisor might elect to terminate all of its extant franchise agreements on the ground that this change in the law so upsets the fundamental economic nature of franchisor-franchisee relationship and was so unforeseeable as to justify widespread termination. Because many franchise agreements entitle franchisors to reacquire the assets of their franchisees following franchise termination, usually at fair market value or book value, franchisors may find the economics of doing so more advantageous than the skewed economics that would prevail following a “joint employer” determination.

A more perverted outcome could hardly be imagined. Franchisees—the very class which has had special protections afforded them by “franchise relationship” statutes enacted in twenty-one states (and Washington, D.C., Puerto Rico, and the U.S. Virgin Islands)284—would have their enterprises terminated their ability to earn profits evaporated, and their futures destroyed.

Conclusion

The assertion in the Complaints that McDonald's is the “joint employer” of its franchisees’ employees is contradicted by virtually the entirety of judicial precedent addressing the subject; the legal definitions of “franchise” under federal and state laws, rules and regulations; the Lanham Act and its


requirements; the norms, structures, and paradigms of franchising; and, the independent contractor relationship between franchisors and franchisees, as affirmed by hundreds of courts. In the absence of any NLRB hearings, investigations, or evidence-gathering, the authors believe that the NLRB’s thrust is entirely unsupported by any legal or business precepts.

But if adopted by the NLRB and thereafter upheld by the judiciary following challenge, this approach would cripple or even eradicate franchising as we know it; destroy the investments and profitability of both franchisors and franchisees; and, stifle or eliminate one of the most dynamic and fertile engines of economic growth and opportunity in the United States over the past half-century.
Your Store Is Gross! How Recent Cases, the FTC, and State Consumer Protection Laws Can Impact a Franchise System’s Response to Negative, Defamatory, or Fake Online Reviews

Eleanor Vaida Gerhards

Online reviews drive business. They have a powerful, lasting impact but people are more likely to share their negative reviews. While 45 percent of people use social media to share bad customer service experiences, only 30 percent use social media to share good customer service experiences.1 In one survey, 90 percent of people who recalled reading online reviews claimed that positive online reviews influenced their buying decisions, while 86 percent of people said negative online reviews influenced their buying decisions.2 These statistics explain why a franchise system and its franchisees would use any and all available resources to ensure that their brands, products, and services are above reproach. The Internet can be a harsh and unforgiving forum for even the most respected brands and products. Franchise systems are particularly vulnerable to negative online press because one location with a negative online profile can taint an entire system and potentially impact revenues across the country with a speed and scope that were unfathomable ten years ago. Unfortunately, not even impeccable customer service and flawless products guarantee a problem-free online presence. The impact that online reviews now have on consumer habits has spurred a new headache for businesses: defamatory and fraudulent reviews.

A franchisor or franchisee victimized by a defamatory post has limited legal remedies, even with the massive impact that bad online reviews may

---

2. Id.

Eleanor Vaida Gerhards (egerhards@foxrothschild.com) is an attorney in the Franchising, Licensing and Distribution Practice Group of Fox Rothschild LLP where she focuses on transactional and regulatory compliance matters.
have. In addition, a franchise system must ensure that its elected remedy does not violate state or federal consumer protection laws.

Part I of this article discusses the legal theories under which businesses have sued online review sites and the hurdles they face in holding these sites responsible for defamatory reviews. Part II of this article discusses cases involving businesses asserting claims directly against individual online reviewers. Part III provides recommendations to minimize risk while staying within the confines of state and federal law.

I. Lawsuits Against Online Review Websites

The legal theories under which businesses assert claims against online review sites are fairly broad and include violations of state unfair competition laws, civil extortion, defamation, and invasion of privacy. Despite this assortment of available legal theories, businesses tarnished by online reviews generally do not succeed in litigation against online review sites.

A. Federal Communications Decency Act

Section 230 of the Federal Communications Decency Act of 1996 (CDA) will, in many instances, bar claims against online review sites based on defamatory statements from third-party reviewers who are not affiliated with the review site. The law’s umbrella immunity extends to protect sites from claims for trade libel, slander, invasion of privacy, and misappropriation. The CDA provides that “no provider or user of an interactive computer service shall be treated as the publisher or speaker of any information provided by another information content provider.” The CDA grants immunity so long as

(1) the defendant is a provider or user of an interactive computer service, (2) the asserted claims treat the defendant as a publisher or speaker of information, and (3) the challenged communication is information provided by another content provider.

Under the CDA, an

“interactive computer service” means “any information service, system, or access software provider that provides or enables computer access by multiple users to a computer server, including specifically a service or system that provides access to the Internet and such systems operated or services offered by libraries or educational institutions.”

5. Doe v. Myspace, 474 F. Supp. 2d 843 (W.D. Tex. 2007); see also Barnes v. Yahoo!, Inc., 570 F.3d 1096, 1101 (9th Cir. 2009).
The CDA provides protection to all forms of interactive computer services, including social media websites, online review sites, blogs, forums, and listservs. For example, Amazon.com, Inc., an online market that allows users to review books and other products sold on its site, has successfully invoked immunity under the CDA in a number of cases over the past decade to avoid liability for third-party product reviews posted on its site.\(^9\) CDA’s immunity provision extends even to editorial acts.\(^10\) “Lawsuits seeking to hold a service provider liable for its exercise of a publisher’s traditional editorial functions—such as deciding whether to publish, withdraw, postpone or alter content—are barred.”\(^11\) In short, the CDA provides a nearly airtight defense to prevent a franchise from successfully suing an online review site for false or defamatory content in a third-party review. Because the CDA bars most actions against online review sites, plaintiffs must find alternative methods for successfully suing online review sites.

B. Cases Against Yelp and TripAdvisor

Recent cases attempting to circumvent the CDA show that legal recourse through the court system remains unlikely. For example, Yelp, a well-known online review site, has faced a barrage of lawsuits.\(^12\) Individual users post comments on and rate businesses ranging from restaurants to dog salons. Over the years, businesses, especially small businesses, have accused Yelp of unsavory practices.\(^13\) Last year, the *Wall Street Journal* received a Freedom of Information Act\(^14\) response from the Federal Trade Commission (FTC), stating that the FTC received 2,046 complaints against Yelp between 2008 and 2014.\(^15\)

The Ninth Circuit recently issued an opinion in the highly publicized case, *Levitt v. Yelp*.\(^16\) In *Levitt*, a group of small businesses alleged that the site attempted to extort advertising payments from them by manipulating user reviews and writing negative reviews about the plaintiffs.\(^17\) The court distinguished the facts in *Levitt* from prior cases preempted by the CDA because the issue was not the content of the reviews but Yelp’s business

---

10. Schneider, 31 P.3d at 40.
11. Id. at 41.
15. Loten, supra note 13.
16. Levitt v. Yelp, 765 F.3d 1123 (9th Cir. 2014).
17. Id. at 1125.
practices. According to the plaintiffs, after they refused to purchase advertising on the website, Yelp deleted their positive reviews and highlighted their negative ones. Yelp did not deny that its automated filtering software system ranked reviews based on the reviewer’s involvement nor did it deny that the system might rearrange both good and bad reviews so that comments from more active reviewers were more conspicuous and prominent under a business’s profile. Yelp claimed that the system was “entirely automated to avoid human bias” and “affects both positive and negative reviews.” The plaintiffs argued that Yelp created negative reviews and deliberately manipulated the ratings to induce the plaintiffs to purchase advertising, constituting extortion and attempted extortion in violation of the California Unfair Competition Law (CAUCL).

The Ninth Circuit held that even if Yelp manipulated user reviews, it was not extortion and not a violation of the CAUCL. According to the court, “unless a person has a preexisting right to be free of the threatened economic harm, threatening economic harm to induce a person to pay for a legitimate service is not extortion.” In Levitt, the court held that the plaintiffs had no preexisting right to have positive reviews appear on Yelp’s website, and Yelp had no obligation to provide them. Thus, even assuming Yelp did remove positive reviews, the court held that it could not amount to economic extortion because the business had no right to such reviews under any agreement with Yelp or under any law.

Prior to the decision in Levitt, another court also had found that the practices of the well-known travel review website TripAdvisor were not actionable. In Seaton v. TripAdvisor LLC, Kenneth Seaton, the owner of Grand Resort Hotel and Convention Center in Pigeon Forge, Tennessee, sued TripAdvisor for ranking the establishment as one of its “2011 Dirtiest Hotels.” As did the plaintiff in Levitt, Seaton did not base his lawsuit on the substance of the third-party reviews but on TripAdvisor’s use of the reviews to compile its “Dirtiest Hotels” list. Seaton alleged defamation and false light invasion of privacy, claiming that the website used an improper method.

---

18. Id. at 1131.
19. Id. at 1127–28.
20. Id. at 1125.
21. Id.
23. Levitt at 1130. The court did not address the plaintiff’s claim that Yelp wrote negative reviews because it found that the plaintiffs pled insufficient facts to establish a plausible claim. Id.
24. Id. (citing United States v. Vigil, 523 F.3d 1258, 1265 (10th Cir. 2008)).
25. Id. at 1133. The Ninth Circuit also found that the plaintiffs did not allege facts sufficient to support a claim that Yelp authored fake negative reviews. Id. at 1135.
26. Id. at 1133.
27. Seaton v. TripAdvisor, LLC, 728 F.3d 592 (6th Cir. 2013). Seaton also moved to amend his complaint to include claims for tortious interference with prospective business relationships and trade libel but the court denied the motion. Seaton, 728 F.3d at 595.
28. Id.
to compile its list and relied on unverifiable data. The district court granted TripAdvisor’s motion to dismiss Seaton’s suit. The Sixth Circuit upheld the district court decision, ruling that the “Dirtiest Hotels” list was the protected and subjective opinion of TripAdvisor’s users and incapable of being defamatory. The court found that the list could not reasonably be interpreted as asserting that Seaton’s hotel was, in fact, the dirtiest hotel in America “because the list employed loose hyperbolic language with a general tenor undermining any assertion that the list was anything more than opinion.” According to the court, readers would clearly understand that the list was compiled with users’ opinions and experiences—not an actual fact that the plaintiff was one of the dirtiest hotels in America. The court also pointed to the language on the webpage where the list was located: “Dirtiest Hotels—United States as reported by travelers on TripAdvisor.” The court held that language was further evidence that readers would discern that TripAdvisor did not conduct a scientific study to determine which ten hotels were objectively the dirtiest in America. As a result, Seaton’s argument that TripAdvisor used flawed methodology or an improper system to compile the data did not support a claim for defamation.

The CDA insulates websites from lawsuits by businesses for publishing third-party false and defamatory reviews. Moreover, the Levitt and TripAdvisor decisions certainly will make it more difficult to hold online review sites accountable for their methods and practices related to publishing, summarizing, and utilizing third-party reviews. If this is true, are there any protections for franchisees and franchise systems that suffer economic loss from defamatory reviews? The Levitt decision garnered its fair share of critics who feared that the decision might open the door to allow online review sites free rein to commit any and all unsavory practices. Critics may have exaggerated that fear. First, the court in Levitt emphasized that it was not holding that “no cause of action exists that would cover conduct such as that alleged, if adequately pled.” The court specifically limited its holding to disallow only a cause of action for extortion or unfair practices under the CAUCL. Thus, the door remains open for potentially successful claims against Yelp and other online review sites.

If a business owner can present sufficient facts to establish that it suffered a tangible injury to its reputation or income, the possibility of a successful breach of contract, trade libel, or violation of state unfair competition law claim remains. For example, in Levitt, the court seems to suggest that if the plaintiff had alleged a contractual right to positive Yelp reviews, instead

---

29. Id.
30. Id.
31. Id. at 596.
32. Id.
33. Id. at 598.
34. Id. at 598–99.
35. Id. at 600–01.
36. Levitt v. Yelp, 765 F.3d 1123, 1137 (9th Cir. 2014).
of alleging only that she knew they could be “tweaked,” she may have been able to assert a viable breach of contract claim. The case also leaves open the potential for a trade libel claim if a plaintiff can connect its reputational harm to a specific allegation of wrongful conduct. Finally, the plaintiffs failed to demonstrate a violation of California’s unfair competition law because none were able to show that Yelp “violated any ‘legislatively declared policy,’” alleging only generally that Yelp’s conduct harmed competition. A well-pleaded complaint may survive dismissal where a plaintiff points to a specific action by Yelp that significantly threatens or harms competition in violation of a state unfair competition law.

The case of Small Justice LLC v. XCentric Ventures, LLC may provide an additional avenue for beleaguered businesses. In Small Justice, an attorney, Richard A. Goren, sued XCentric Ventures, LLC, the company that owns and operates the website “Ripoff Report.” Ripoff Report solicits victims of defamatory reports to participate in a program it offers to achieve positive search engine listings for a fee. After the site refused to remove a defamatory report about him, Goren obtained a default judgment against the author of the report for libel and tortious interference. The court transferred ownership of the copyright of the libelous report to Goren and appointed Goren as attorney-in-fact for the author, including the power to execute on any assignment of the copyright. Although Ripoff Report successfully invoked the CDA to shield itself from Goren’s claims for libel or intentional interference with prospective contractual relationships, he successfully defended against Ripoff Report’s motion to dismiss his claim for violation of Massachusetts’s Consumer Protection Act (MCPA). The MCPA provides a private cause of action to

[a]ny person who engages in the conduct of any trade or commerce and who suffers any loss of money or property, real or personal, as a result of the use or employment by another person who engages in any trade or commerce of an unfair method of competition or an unfair or deceptive act or practice.

Goren alleged in his complaint that Ripoff Report violated the MCPA by refusing to take down a libelous and defamatory report “while simultaneously advertising services by which Goren can pay XCentric to restore

37. Id. at 1134 (“[I]t may be that by manipulating Chan’s ratings to induce her to increase her advertising dollars, Yelp ‘breached [its] duties under the contract.’”).
38. Id.
39. Id. at 1136.
40. Id. at 1137
42. Id. at 2.
43. Id. at 15.
44. Id.
45. Id. at 14.
46. MASS. GEN. LAWS Ch. 93A, § 11 (2004).
its reputation." The Massachusetts trial court denied XCentric’s motion to dismiss, finding that Goren sufficiently pleaded that Ripoff Report’s actions were within the “‘penumbra’ of ‘unfairness,’ or they are ‘immoral, unethical, oppressive or unscrupulous,’ or they interfered with trade or commerce.”

Thus, the holdings in Small Justice and Levitt do appear to leave the door open for potential claims by business owners.

II. Lawsuits Against Reviewers

Businesses have had mixed success in suing the third-party reviewers who post on online review sites. The practical considerations are a significant motivator for businesses, and, in most cases, the potential negative publicity when a business sues one of its own customers is far worse than a bad review itself. National or large regional franchisors with recognizable brands do not wish to alienate the online community by suing every reviewer who leaves negative commentary.

Moreover, many individual reviewers post anonymously or with screen names, making it time consuming and difficult to identify and locate the authors. For example, Yelp claims that it receives approximately six subpoenas each month, many of which seek the names of anonymous reviewers. A recent, publicized attempt to uncover an anonymous online reviewer involved the famous New York restaurant Sparks Steak House. Sparks made news when it filed a petition with the Supreme Court of New York demanding that Yelp disclose the true name of an account user going by the name Besfort S. Besfort S. had written a review on Yelp, claiming that he was an employee at Sparks, that he frequently spit in guests’ food, and that Sparks did not pass a New York City health code inspection. Sparks alleged that the comments were defamatory, that a person with the name Besfort S. never worked at Sparks, that a person named Besfort Shala interviewed with Sparks but was never hired, and that Besfort Shala filed a police report once he learned that someone was using his name online. Although Yelp took down the offending post and banned the offender from its site, the petition likely gave this review more publicity than it otherwise would have received.
Another consideration for a business contemplating filing a lawsuit against an online reviewer is the potential for an anti-SLAPP suit in response. Anti-SLAPP laws, i.e., strategic lawsuits against public participation, exist in twenty-nine states and the District of Columbia to ensure that a speaker’s First Amendment rights are not stifled.⁵⁷ Although state laws vary, anti-SLAPP statutes generally permit a defendant to file a motion to strike or dismiss all or some portion of a complaint to limit meritless, costly, or vexatious litigation strategically aimed to suppress free speech.⁵⁸ These statutes traditionally have applied to “lawsuits targeting persons communicating on public concern” or in connection with an issue of public interest.⁵⁹ If a party can establish that a claim arises from the exercise of free speech and a reasonable probability exists that it will not succeed on its merits, a court may grant a motion to strike or dismiss and potentially award attorney fees based on an anti-SLAPP law.⁶⁰

Further increasing the difficulty for a business to protect its online reputation by suing reviewers who post defamatory comments is the judicially expanded definition of an “issue of public interest,” which may now include online reviews and derogatory statements made on websites like RipoffReport.com and ScamFraudAlert.com.⁶¹ In AR Pillow Inc. v. Payton, the U.S. District Court for the Western District of Washington granted a motion to strike a complaint filed against a website for unfair competition, defamation, and tortious interference.⁶² The defendant website reviewed infant health and safety products and posted a review critical of the plaintiff’s product.⁶³ The court granted the review site’s anti-SLAPP motion and dismissed the suit, ruling that the review might assist others in addressing infant health

---


⁶². *Id.*

⁶³. *Id.* at *1.
problems and that the quality of the product was a matter of public concern.\textsuperscript{64} Similarly, in \textit{Chaker v. Mateo}, a California court found that the anti-SLAPP statute protected the derogatory statements made about the owner of a forensic business. There, the commenter was the mother of the business owner’s girlfriend. Her comment on RipoffReport.com described the business owner as “a criminal and deadbeat.” Despite the personal relationship, the court held that the postings “plainly [fell] within the rubric of consumer information about Chaker’s ‘Counterforensic’ business and were intended to serve as a warning to consumers about his trustworthiness.”\textsuperscript{65} Accordingly, the appellate court affirmed the motion to strike under California’s anti-SLAPP statute.\textsuperscript{66}

On the other hand, some businesses have succeeded in both asserting defamation claims and avoiding the anti-SLAPP statutes.\textsuperscript{67} For example, in \textit{Neumann v. Lilies}, the operator of a wedding venue sued a patron for making defamatory comments about the service at a wedding he attended. The Oregon Court of Appeals rejected the defendant’s anti-SLAPP motion because the comments that the venue “forced guests to leave earlier than agreed upon” was an assertion of fact and his statement that the operator was “two-faced” and “crooked” suggested dishonesty and could be defamatory.\textsuperscript{68} Even an experienced practitioner would have difficulty distinguishing between the “criminal and deadbeat” comment found protected in \textit{Chaker} and the “two-faced” and “crooked” comment, which a court held could be defamatory and thus unprotected, in \textit{Neumann}. These disparate results have made it difficult to determine with any degree of certainty when the anti-SLAPP statutes apply. In addition, state anti-SLAPP laws have subtle differences, and courts applying similar tests may reach different conclusions for virtually identical statements.

At times, however, businesses have succeeded and have recovered large damage awards against authors of defamatory reviews. In \textit{Fireworks Restoration Co. v. Hosto},\textsuperscript{69} a co-founder of a company providing lead generation services to restoration companies wrote three fabricated and defamatory reviews on Google and Yahoo after the business relationship had dissolved. The co-founder used real customers’ names and information and pretended to write on behalf of multiple, unhappy customers.\textsuperscript{70} He described the company’s purportedly “untrustworthy business practices and poor customer service.”\textsuperscript{71} The company won $1,150,000, including $150,000 in punitive damages, which award the appellate court affirmed on appeal.\textsuperscript{72} In another case, a

\textsuperscript{64}. Id. at *5.
\textsuperscript{65}. Id. at 1142.
\textsuperscript{66}. Chaker v. Mateo, 147 Cal. Rptr. 3d 496 (2012).
\textsuperscript{68}. Id. at 528.
\textsuperscript{69}. 371 S.W.3d 83 (Mo. Ct. App. 2012).
\textsuperscript{70}. Id. at 86.
\textsuperscript{71}. Id.
\textsuperscript{72}. Id. at 85.
California state court held a business liable for false and defamatory statements made on Ripoff Report, Yelp, and MerchantCircle. The court stated, “while courts have recognized that online posters often ‘play fast and loose with the facts,’ this should not be taken to mean online commentators are immune from defamation liability.”

In the recent and closely watched case of Dietz Development and Dietz v. Perez, a general contractor filed a defamation suit against a disgruntled customer who authored scathing reviews of its services on Yelp and Angie’s List. The customer alleged that Dietz damaged her home and invoiced her for work he failed to complete and that jewelry disappeared from her home during the time Dietz was working; Dietz replied to her posts with his own accusations. The case garnered national attention from both free speech advocates and businesses reeling over what they perceived to be a lack of available remedies against defamatory online reviews. In February 2014, after a five-day trial and eight-hour deliberation, a jury found that both parties had defamed each other online and awarded neither damages. Although this case may have provided some Pyrrhic vindication for Dietz, the contractor ultimately had no compensation for its tarnished reputation and years of litigation. One clear lesson from Dietz is that serious repercussions may result from taking an aggressive stance and responding to customers online.

The holdings in Fireworks Restoration, Sanders, and Dietz suggest that a franchisor or franchisee may have a chance to bring a successful suit against an online reviewer; however, the initial legal hurdles, coupled with the risk of damage to a franchise system’s brand and reputation, may outweigh the potential benefit.

III. Preventing and Contending with Bad Reviews

Desperate times call for desperate measures. Because litigation costs are high and success rates against reviewers are low, a franchisor or franchisee may look for alternative remedies to filing a lawsuit. A franchisee facing a downturn in business it attributes to defamatory online reviews may resort to taking actions that are not in the best interest of the franchise system and sometimes against the law. Not surprisingly, statistics show that businesses with fewer reviews, bad reviews, or changing patterns of competition are

74. Id. at 864 (citing Summit Bank v. Rodgers, 206 Cal. App. 4th 669 (2012)).
76. Id.
78. Id.
the most likely to engage in online review fraud.\textsuperscript{79} Navigating a business’s potential legal options can be difficult and confusing. State and federal laws governing online opinions, advertising, endorsements, and customer relationships are constantly changing to account for new forms of electronic communications and social media. This section reviews what franchisors and franchisees should and should not do when faced with an online reputation issue.

A. Replacing Negative Reviews with Glowing Recommendations

No franchisor or franchisee should combat negative reviews by encouraging, requiring, or enabling, directly or indirectly, employees, agents, or insiders to post online reviews of its products, services, or location. First, businesses commonly bungle such attempts, and the results are embarrassing and expensive to remedy. Whole Foods, the natural food supermarket chain, endured public backlash and an investigation by the Securities and Exchange Commission, which later ended without enforcement action, after the \textit{Wall Street Journal} revealed that CEO John Mackey spent seven years posting negative comments about a rival under a pseudonym.\textsuperscript{80}

If general ethical considerations and embarrassment are insufficient deterrents, the FTC’s \textit{Guides Concerning the Use of Endorsements and Testimonials in Advertising}\textsuperscript{81} provide guidance for complying with Section 5 of the FTC Act,\textsuperscript{82} which holds advertisers liable for “failing to disclose material connections between themselves and their endorsers.”\textsuperscript{83} The FTC Act requires endorsers to disclose any connection that could “materially affect the weight or credibility of the endorsement.”\textsuperscript{84} The FTC \textit{Endorsement Guidelines} provide examples of what relationships require this disclosure.\textsuperscript{85} Example 8 outlines a scenario where an employee posts messages on an online discussion board promoting her employer’s product.\textsuperscript{86} The FTC \textit{Endorsement Guidelines} conclude that knowledge of the endorser’s employment is likely to affect her credibility, so the employee must disclose her relationship to the readers of the message board.\textsuperscript{87} Example 8 became a real world scenario in September 2014 when the FTC discovered and investigated Yahoo’s employees’ positive reviews of Yahoo’s mobile application without properly disclosing their connection to the company.\textsuperscript{88} Although Yahoo’s social media policy

\textsuperscript{81} 16 C.F.R. § 255.
\textsuperscript{83} 16 C.F.R. § 255.1(c).
\textsuperscript{84} 16 C.F.R. § 255.5.
\textsuperscript{85} 16 C.F.R. § 255.5.
\textsuperscript{86} 16 C.F.R. § 255.5.
\textsuperscript{87} 16 C.F.R. § 255.5.
required all employees to disclose their employment status, the FTC stated that Yahoo had not adequately informed the employees of the policy. The FTC did not pursue an enforcement action against Yahoo, but the investigation and public admonishment demonstrate the FTC’s resolve.

It is undoubtedly a strong temptation for a restaurant, store, or business to reply to negative online reviews on websites like Yelp, TripAdvisor, Google+, Facebook, Merchant Circle, and Angie’s List with its own manipulated “reviews.” Technology research company Gartner, Inc. released a 2012 survey estimating that companies pay for 10 percent to 15 percent of all reviews and ratings posted on social media sites. A similar study found that 16 percent of restaurant reviews on Yelp are fraudulent.

Posting fraudulent reviews clearly violates Section 5 of the FTC Act if the reviewer has any material connection or relationship with a referenced franchise system and that relationship is not disclosed in the review. These rules extend beyond the clear employer-employee relationship. A connection can be material even if the social media endorser is not an employee or agent for the business. When Nordstrom sent $50 gift cards to social media influencers in exchange for attending a store opening last year, the FTC sent a letter chastising the retail giant for failing to remind the attendees who posted about the event online to disclose that each had received gifts for attending. The FTC did not pursue an enforcement action against Nordstrom at the time, but reserved the right to do so in the future. The FTC conducted similar investigations of Hewlett-Packard and Ann Taylor in connection with their practices of providing bloggers with product gifts. In the case of Ann Taylor, the company failed to require bloggers to disclose gifts that each received for attending an Ann Taylor summer collection preview event. The FTC found that Ann Taylor’s posting of a sign at the event reminding bloggers to disclose the gifts in any online comments was insufficient to satisfy Section 5.

89. Id.
90. Id.
92. Lucs & Zervvas, supra note 79.
95. Id.
96. Dohse, supra note 80, at 384.
98. Id.
The FTC keeps abreast of all forms of online social media, and a violation in any form may be cause for an FTC investigation. In 2014, the FTC investigated fashion company Cole Haan after a contest it conducted through the social media site Pinterest.\(^99\) Cole Haan had offered to award a $1,000 shopping spree to the contestant who designed the most creative Pinterest board featuring Cole Haan shoes.\(^100\) The FTC ruled that the contestants’ Pinterest boards qualified as endorsements of Cole Haan products and investigated the company for failing to instruct contestants to label their Pinterest “pins” to clarify that the display of Cole Haan products was part of a contest to win a cash prize.\(^101\) The investigation was the first instance where the FTC found that entry into a contest was a “material connection” under Section 5 of the FTC Act.\(^102\)

The FTC typically reserves its resources to combat more egregious violators, and a small company’s inadvertent or minor infraction is not a likely target. But even a minor slap on the wrist can quickly become a public relations nightmare for a franchise system because the FTC publicizes every settlement in a press release.\(^103\) In addition, if similar violations exist across multiple franchises or if the FTC identifies a pattern of violations, an entire franchise system may be subject to heightened scrutiny or investigation.

The FTC is not the only agency policing the Internet for misleading or false reviews. State investigations of “astroturfing”—the practice of “preparing or disseminating a false or deceptive review that a reasonable consumer would believe to be a neutral, third-party review”\(^104\)—increased following the 2009 settlement between the New York Attorney General’s Office and the cosmetic surgery company Lifestyle Lift.\(^105\) Astroturfing is a violation of multiple New York laws prohibiting false advertising and illegal and deceptive business practices.\(^106\) Lifestyle Lift, which at the time of the settlement had over forty locations throughout the United States, had combatted negative postings on message boards by having employees create false accounts on online message boards and review sites to post positive reviews and comments about their

---

100. Id.
101. Id.
102. Id.
106. Schneiderman Press Release, supra note 104; see N.Y EXEC. LAW § 63(12); N.Y. GEN. BUS. § 349-350-A.
employer and its services. The Attorney General’s Office uncovered emails proving that Lifestyle Lift gave specific instructions to its employees describing how to pose as satisfied customers online. In addition to posting false reviews, these employees also attacked legitimate critical or negative customer reviews. As part of the settlement, Lifestyle Lift agreed to pay $300,000 in penalties and costs to the State of New York and cease posting anonymous, false positive reviews about its business. The Attorney General’s Office called Lifestyle Lift’s practices cynical, manipulative, and illegal and pledged to continue its mission to protect customers from “emerging fraud and deception, including ‘astroturfing,’ on the Internet.” Last year, the New York Attorney General’s Office completed a year-long investigation called Operation Clean Turf, which resulted in a $350,000 settlement with nineteen companies and an agreement that they would stop selling fake reviews to businesses for posting on online review sites like Yelp and Citysearch. In that case, the offending companies were third-party providers of fake reviews that marketing themselves as search engine optimization companies (SEOs) offering online reputation management services. As part of the investigation, representatives from the Attorney General’s Office called some of the leading SEOs. The investigators posed as businesses needing help bolstering their online reputations and battling negative customer reviews posted on the Internet. A number of the SEOs immediately offered to write false reviews and post them on sites like Yelp and Citysearch.

Finally, even Yelp entered the fray by suing online reputation management sites that promise to deliver only positive reviews and to filter negative reviews. On February 13, 2015, Yelp filed a lawsuit against three named companies and twenty other “Does” alleging trademark infringement, unfair competition, cybersquatting, and other California state or common law claims. According to the complaint, the companies claim the ability to
generate higher star reviews that “stick to the front page of Yelp” and filter or remove negative reviews. Yelp is alleging trademark infringement based on the companies’ use of the name “Yelp” in advertising its services and interference with contractual relations by inducing Yelp users to violate its service terms.120

B. Contracting Away a Customer’s Right to Honestly Review

Many businesses have included inconspicuous nondisparagement clauses on receipts, invoices, or contracts with customers or patrons. In some cases, companies include liquidated damages clauses or fees for customers who share negative reviews of their experiences.121 In addition to simply being bad business, a franchisee should never attempt to contract away a customer or patron’s right to give a bad review. One of the most well-publicized cases is that of John Palmer and Jennifer Kulas, who wrote a negative review of the online novelty store, Kleargear, when it failed to deliver an order Palmer placed with the company.122 After Kleargear discovered the negative review, it demanded a $3,500 fee for violating the nondisparagement clause posted on its website.123 Palmer and Kulas disputed the charge, but Kleargear reported the couple to a debt collector, tarnishing their credit.124 In 2014, Palmer and Kulas obtained a default judgment against Kleargear for violations of the Fair Credit Reporting Act,125 defamation, intentional interference with prospective contractual relations, and intentional infliction of emotional distress;126 they received $102,250 in compensatory damages and $204,500 in punitive damages.127 This practice has garnered harsh criticism, and politicians have responded with legislation aimed to prevent such nondisparagement clauses. In September 2014, California Governor Jerry Brown signed into law a bill making a contract unlawful if it contains a provision requiring the consumer to waive his or her right to make any statement regarding the consumer’s experience with the business, or to threaten or seek to enforce such a provision, or to otherwise penalize a consumer for making such a statement unless the waiver was knowing, voluntary and intelligent.128

Companies violating the law are subject to a $2,500 penalty for the first violation, $5,000 for subsequent violations, and up to $10,000 for willful,
reckless, or intentional violations. Following the signing of the California law, two California representatives introduced the Consumer Review Freedom Act of 2014 (CRF Act) in the House of Representatives. The CRF Act is similar to the California law, but it also prohibits businesses from claiming copyrights over customer reviews and photographs. Proponents of the CRF Act contend it will curb “review retaliation.” The bill’s sponsor, Representative Eric Swalwell, said it will “allow people to share honest reviews without fear of litigation.” Although all fifty states have not yet outlawed the practice, businesses are likely to take the hint that nondisparagement clauses in consumer contracts are rarely, if ever, a good idea. Courts have shown no favor for such clauses, and the public ridicules them and the businesses that use them.

C. Steps to Avoid Liability

No franchise system wants to see its franchisees connected with a lawsuit or a federal or state investigation involving alleged illegal and deceptive business practices. To ensure compliance with federal and state laws prohibiting false or misleading advertising online, franchisors should take certain steps.

First, if not included already, revise and update social media policies to include provisions addressing best practices when providing free services; gifts, including gift cards or other promotional items; or anything of monetary value to social media influencers. Any social media policy should contain a provision stating that a franchisee or outlet will not issue any gift to a social media influencer without first explicitly reminding the influencer that he or she must disclose the gift if writing about the franchisee’s products, services, or events. The FTC did not recommend an enforcement action against Nordstrom, Ann Taylor and Cole Haan, in part, because each revised its respective social media policies to include the disclosure language. This policy should encompass all forms of social media, including, at a minimum, Facebook, Twitter, Pinterest, and Instagram. The company should also docu-

---

129. Id.
131. Id.
133. Chris Moran, Online Retailer Will Fine You $250 If You Even Threaten to Complain About Purchase, CONSUMERIST, Aug. 27, 2014, http://consumerist.com/2014/08/27/online-retailer-will-fine-you-250-if-you-even-threaten-to-complain-about-purchase/. The subject of the article, Accessory Outlet, contained the follow provision in its terms section on its website:

You agree not to file any complaint, chargeback, claim, dispute, or make any public forum post, review, Better Business Bureau complaint, social media post, or any public statement regarding the order, our website, or any issue regarding your order, for any reason, within this 90 day period, or to threaten to do so within the 90 day period, or it is a breach of the terms of sale, creating liability for damages in the amount of $250, plus any additional fees, damages—both consequential and incidental, calculated on an ongoing basis. Id. A customer is now suing the business for charging these damages after the customer disputed a credit card bill for items never shipped by the company. Id.
ment the actions it has taken to ensure that its employees and social media influencers are aware of the policies. As shown with the Yahoo investigation, merely having a policy in place is insufficient. 134

Second, make certain franchisees and managers are aware that any type of false or misleading online posts or reviews about their business or a competitor’s business is a violation of the franchise agreement. If revisions to the franchise agreement are necessary to clarify this point, then franchise systems should make such revisions.

Third, thoroughly research any SEO, prior to engagement, to confirm that it has a history, policy, and practice of compliance with the FTC and any applicable state laws when providing online reputation management services. 135 Some SEOS operate by constantly searching the Internet for any and all reviews about a business client and providing review “alerts” that allow a client to respond immediately to any complaints or comments posted online. 136 That SEO business model is likely acceptable, but it is critical to ensure that the SEO is not also providing illegitimate services.

IV. Conclusion

Regardless of size, social media and the online global community have made companies more vulnerable to negative online reviews. Franchises are not immune. They are at a greater risk of harm because the business model depends on the consistency and sameness of the brand wherever a customer goes, which means whatever reputation the brand has, all of the franchisees may share it. The best course of action is to take preventive measures to decrease the risk of potential disputes with customers, proactively addressing customer concerns offline through private email and telephone calls. Franchisees should not use veiled threats, coercion, or hidden contracts to eliminate negative reviews online. Unless a customer review contains false and severely damaging facts about the product or service, threats of legal action against a reviewer are unlikely to help. If there is a credible belief that a competitor, disgruntled former employee, or business partner authored the review, a franchisor or franchisee may consider subpoenaing the online review site for the name of the reviewer. Often, sites like Yelp, Angie’s List, and TripAdvisor, which rely on honest third-party reviews, will cooperate with businesses attempting to ferret out fake reviews and users that violate the website policies.137

As with all areas of operating a franchise system, it is a difficult balance to control the potential risks to the brand image while allowing franchisees to

135. Dohse, supra note 80 at 373, n.106.
136. Id. at 373, n.107.
137. Id. at 378.
operate and manage their businesses independently. Operations manuals, guidelines, and training seminars can list suggestions for addressing customer complaints—both real and fake. Thorough social media and online review policies, guidelines, and suggestions may prevent an embarrassing incident from going viral and limit the necessary damage control.
Developing Domain Name Enforcement Options

Jonathan S. Jennings

Websites are a gateway for businesses, and domain names play a part in how customers reach these websites. Although search engines have made domain names less relevant, people still type them in to find websites. Recognizing this reality, unscrupulous businesses and individuals have long targeted domain names to divert potential customers and create page views and revenues or with the expectation that the legitimate owner of the trademark incorporated in the domain names will purchase the domain names from them in the equivalent of an electronic ransom payment. This conduct is typically described as “cybersquatting” and the perpetrators are called cybersquatters.

Sometimes disputes can occur between franchisors and franchisees over domain names, which typically concern the former franchisee’s use after the termination of the franchise relationship and are not the prototypical cybersquatting situations. These disagreements also occur when the franchisee registers or uses the franchisor’s mark as a domain name in contravention of the terms of the franchise agreement. In some cases, these disputes arise from vague contract terms or inconsistent practices. In other words, the disputes derive from a good faith misunderstanding. Differentiating between bad faith disputes, which characterize cybersquatting, and good faith disputes stemming from a misunderstanding, will help franchisors select the best forum for domain name disputes.

The Internet Corporation for Assigned Names and Numbers (ICANN) has established some popular dispute resolution procedures for domain name disputes, including the well-known Uniform Domain Name Dispute Resolution Policy (UDRP) and, most recently, the Uniform Rapid Suspension (URS) System.1 These forums are best suited to address bad faith use

---

1. ICANN, Contacting ICANN Regarding Contractual Compliance Complaint, https://www.icann.org/resources/pages/complaints-2013-03-22-en. There are other domain name dis-
and registration of domain names. The Anticybersquatting Consumer Protection Act (ACPA), which is part of the Lanham Act, also targets bad faith cybersquatting and provides for a more thorough evidentiary consideration for more complicated disputes. The ACPA requires a federal civil action and consequently an enhanced level of commitment from the franchisor. Understanding the relative benefits of each forum helps all brand owners stop the unauthorized registration and use of their domain names in a more efficient and cost-effective manner.

I. Domain Name Enforcement

A. UDRP Proceedings

1. How They Work

ICANN describes the type of domain names eligible for a UDRP action as follows:

If someone has registered a domain name in a generic top-level domain (gTLD) operated under contract with ICANN that you believe may be infringing on your trademark, you may be able to file a Uniform Domain Name Dispute Resolution Policy (UDRP) proceeding against the registrant.

Under the UDRP, a domain name registrant can be ordered to submit to a mandatory arbitration proceeding if a complainant asserts that (1) the registrant’s domain name is identical or confusingly similar to the complainant’s mark, (2) the registrant has no rights or legitimate interests in the domain name, and (3) the registrant’s domain name has been registered and is being used in bad faith.

The requirement that the domain name at issue be identical or confusingly similar to the complainant’s mark is usually the least problematic prong for a brand owner to meet. Typically, panels will find similarity where the domain name has only a slight variation from the mark. When the differences are more apparent, the UDRP may not be the proper forum for the cybersquatting dispute because the bad faith required is less
clear in such situations. UDRP proceedings against cybersquatters generally are less contentious than those between franchisors and franchisees because cybersquatters frequently default. It certainly is easier for a franchisor to establish all of the elements required to argue for a domain name transfer when a registrant uses an identical or confusingly similar mark to that of the franchisor and has neither a prior relationship with the franchisor nor any bona fide use of the mark.

A UDRP claim must also include an analysis of whether the respondent has any rights or legitimate interests in the domain name at issue (an area where franchisor/franchisee disputes are likely to arise). Some panels will look at a license/franchise agreement between the parties to determine if the licensee/franchisee had the right to register the domain name in question. In *Heel Quik!, Inc. v. Goldman*,

6 for example, the panel noted with regard to the UDRP policies and the dispute it faced that:

Any use in violation of the License Agreement cannot be a bona fide use within the meaning of the Policy. The License Agreement gave Respondents no ownership interests in the HEEL QUIK trademark. The Agreement merely granted to Respondents the privilege to use the mark with the consent of Heel Quik!. The Agreement provided that the licensee could not register the trademark without the express permission of Heel Quik!.

The most difficult hurdle in UDRP proceedings is that of the third and final prong—bad faith registration and use. The UDRP sets forth a list of nonexclusive factors for a finding of bad faith:

[T]he following circumstances, in particular but without limitation, if found by the Panel to be present, shall be evidence of the registration and use of a domain name in bad faith:

(i) circumstances indicating that you have registered or you have acquired the domain name primarily for the purpose of selling, renting, or otherwise transferring the domain name registration to the complainant who is the owner of the trademark or service mark or to a competitor of that complainant, for valuable consideration in excess of your documented out-of-pocket costs directly related to the domain name; or

(ii) you have registered the domain name in order to prevent the owner of the trademark or service mark from reflecting the mark in a corresponding domain name, provided that you have engaged in a pattern of such conduct; or

(iii) you have registered the domain name primarily for the purpose of disrupting the business of a competitor; or

(iv) by using the domain name, you have intentionally attempted to attract, for commercial gain, Internet users to your website or other on-line location, by creating a likelihood of confusion with the complainant’s mark as to the source, sponsorship, affiliation, or endorsement of your website or location or of a product or service on your website or location.

7. Id.
8. See ICANN, Uniform Domain Name Dispute Resolution Policy, supra note 4 (UDRP policy terms).
Franchisors target cybersquatters with such bad faith claims. In *Dunkin’ Brands, Inc. v. Paydues Inc/Domain Administrator*, for instance, the panel transferred the domain names <dunkindonutsfranchise.net>, <dunkindonutsfranchise.org>, and <baskinrobbinsfranchise.net> to Dunkin’ Donuts, the franchisor, when the facts revealed that the respondent was using the websites to attract people who were interested in learning more about becoming a franchisee of Dunkin’ Donuts.9 The respondent/cybersquatter in this proceeding had been the subject of at least fourteen other UDRP proceedings for infringing the rights of other national franchisors and at least one federal suit; the willingness of this cybersquatter to become the target of such actions underscores the tenacity of some cybersquatters and the difficulty in fighting them.10 Finally, in some cases, franchisors do not prevail under the UDRP where they cannot establish bad faith use (as opposed to registration).11 The determination of bad faith use is very fact specific and can include the nature of the website used with the domain name (whether it is commercial or not) or whether there has been an attempt by the registrant to sell the domain name to the franchisor at an inflated price. Bad faith registration may be shown through a franchise or license agreement that precludes registration.12

2. UDRP Actions Brought by Franchisors Against Franchisees

UDRP panels will find for franchisors in domain name disputes involving a prior franchisor-franchisee license agreement, specifically when the franchisee continues to use the domain name after the franchise relationship terminates.13 In *Dial-A-Mattress Operating Corporation v. ICS*, for example, a franchisee asserted it had a right or legitimate interest in using the marks by merely being a legitimate franchisee; however, the panel rejected its argument and ordered the transfer of the domain name to the franchisor.14 A panel may transfer a domain name where the franchisee registered the do-

---

10. Id. (cybersquatter defaulted in the civil action).
11. See Sizzler USA Franchise, Inc. et al. v. 88DB Hong Kong Limited/Patrick Ng, FA 1479053 (Nat’l Arbitration Forum Feb. 16, 2013).
12. ERA Franchise Sys. LLC v. Era Sierra Props., FA 0812001239255 (Nat’l Arbitration Forum Feb. 18, 2009) (domain name transferred after facts showed that respondent, a former franchisee, was using the confusingly similar domain name to divert business away from the franchisor and to his current business, which was in direct competition with the franchisor, and had registered the domain name in direct contravention of an agreement prohibiting such registrations by franchisees).
13. Id.; see also RE/MAX Int’l Inc. v. NCR Northcoast Realty, FA 0906001266756 (Nat’l Arbitration Forum Aug. 4, 2009) (domain name transferred after facts showed that respondent acquired interest in the domain name after termination of the franchise; even if the domain name had been obtained during the term of the franchise agreement, the trademark manual governing the relationship prohibited registration of domain names by franchisees).
main names just before termination.\textsuperscript{15} Where a registrant is a potential franchisee that never received a license to use the franchisor’s mark(s) in furtherance of its franchise, a UDRP proceeding is an even stronger option.\textsuperscript{16}

Where the rights at issue are not as clear, the UDRP may not be a good forum. For example, a franchisor and owner of the mark CASHIES, for stores that purchase or sell secondhand goods or provide financial services like loan brokerage or pawn brokerage, filed a UDRP complaint against a former franchisee for use of the mark CASH EEZ in its domain name.\textsuperscript{17} Post-termination, the franchisee opened a business offering competitive services to those of the franchisor and had registered the CASH EEZ mark. The UDRP panel denied the transfer of the domain name, reasoning that the respondent-franchisee had a legitimate right or interest in the domain name because it was engaging in a bona fide use of the mark. In particular, the panel noted the following factual issue in which the question of the respondent’s rights or legitimate interest turned:

The issue of whether or not the Respondent’s offering of goods and services in connection with the disputed domain names was bona fide is the subject of strong dispute between the Complainant and the Respondent. In essence, the Complainant contends that the Respondent’s offering of goods and services was not bona fide because it occurred in breach of the restraint clause in the franchise agreement to which the Respondent’s director and company secretary was a covenanter.\textsuperscript{18}

The panelist found that it did not have enough information to resolve this dispute, and the complainant lost because it had the burden of proof on this issue.\textsuperscript{19} Where factual disputes are not clear-cut, panelists find it difficult to rule in favor of complainants because of their limited opportunity to determine facts. This can be the case where the rights of the franchisor and franchisee are not so well-defined that the franchisee’s registration and use of a domain are clearly done in bad faith.\textsuperscript{20}

\begin{footnotesize}
\begin{itemize}
\item[15.] See, e.g., Six Continents Hotels, Inc. v. Triptih doo, WIPO Case No. D2012-1600 (Oct. 12, 2012) (ordering transfer of franchisee’s domain name when it was registered before termination but during the period in which the franchise agreement was being cancelled).
\item[17.] Cash Converters Pty Ltd. v. Casheez Pty Ltd, WIPO Case No. DAU2011-0029 (Nov. 30, 2011).
\item[18.] Id.
\item[19.] Id.
\item[20.] See, e.g., Urbani Tartufi s.n.c. v. Urbani U.S.A., WIPO Case No. D2003-0090 (Apr. 11, 2003) (In consideration of a distributorship agreement, the panel held that the dispute was “not about abusive registration of a domain name within the ambit of the UDRP” but rather “about a business relationship gone wrong.”); Salton, Inc. v. George Foreman Foods, Inc., WIPO Case No. D2004-0777 (Dec. 3, 2004) (holding that respondent still had “some” rights in the context of a license agreement).
\end{itemize}
\end{footnotesize}
Finally, there is a procedure in place to avoid abusive UDRP proceedings brought by franchisors and others that try to use the proceedings as a way of obtaining validly registered domain names.21 There is no appeal procedure for a UDRP proceeding, but a party can file a civil action within ten days of a panel decision that will stop the transfer or cancellation of the domain name during the pendency of that case.22

B. URS Procedures

With the expansion of generic Top-Level Domains (gTLDs),23 ICANN established another form of resolution for domain name disputes: the Uniform Rapid Suspension (URS) System.24 Currently, only two URS service providers are empowered by ICANN to hear URS disputes: the National Arbitration Forum and the Asian Domain Name Dispute Resolution Centre (ADNDRC).25 The URS procedure is designed to deal with trademark violations manifested in domain names in a speedier and cheaper manner than the UDRP. As stated by ICANN, it is meant to complement the UDRP process “by offering a lower-cost, faster path to relief for rights holders experiencing the most clear-cut cases of infringement.”26 In denying relief, one URS examiner noted: “[T]he URS is not intended for use in any proceedings with open questions of fact, but only clear cases of trademark abuse.”27 The URS applies to domain names registered after January 1, 2013.28 Facebook filed the first complaint under the URS system in August 2013.29 There are searchable databases of all URS decisions determined by examiners working for the Forum30 and ADNDRC.31

---

21. See, e.g., Shoeby Franchise B.V. v. Shoebuy.com, Inc./SHOEBUY.COM, WIPO Case No. D2010-2142 (a finding of reverse domain name hijacking against franchisor that resulted in a rejection of its claims in this UDRP proceeding).
22. See UDRP Policy ¶ 4 k.
23. See ICANN’s Generic Names Supporting Organization (ICANN’s explanation of gTLD expansion), http://newgtlds.icann.org/en/about/program.
The URS rules are posted on the ICANN website, and both the Forum and ADNDRC have supplemental rules. There also is a set of URS procedures, which outline the basic means of bringing a complaint, including the following pleading requirements and elements of proof:

1.2.5. The specific trademark/service marks upon which the Complaint is based and pursuant to which the Complaining Parties are asserting their rights to them, for which goods and in connection with what services.

1.2.6. An indication of the grounds upon which the Complaint is based setting forth facts showing that the Complaining Party is entitled to relief, namely:

   1.2.6.1. that the registered domain name is identical or confusingly similar to a word mark: (i) for which the Complainant holds a valid national or regional registration and that is in current use; or (ii) that has been validated through court proceedings; or (iii) that is specifically protected by a statute or treaty in effect at the time the URS complaint is filed.

   a. Use can be shown by demonstrating that evidence of use—which can be a declaration and one specimen of current use in commerce—was submitted to, and validated by, the Trademark Clearinghouse; and

   b. Proof of use may also be submitted directly with the URS Complaint.

   1.2.6.2. that the Registrant has no legitimate right or interest to the domain name; and

   1.2.6.3. that the domain was registered and is being used in bad faith.

There also is essentially no provision under the URS procedure, unlike the UDRP, for protection of unregistered marks because the marks protected must be registered, validated through court proceedings, or specifically protected by statute or treaty, thereby eliminating most unregistered marks. A complainant must show bad faith use of the domain name by the respondent or its URS complaint will fail. This is apart from the need to show bad faith registration. There is a nonexhaustive list of bad faith factors in the URS procedures. The complainant also may submit

32. See ICANN, Uniform Rapid Suspension System, (ICANN’s timeline on appointing administrators for the URS process with links to providers) supra note 24.


35. Id.


38. URS Procedure, supra note 34, at art. 1.2.6.3.

39. Id.
“up to 500 words of explanatory free form text” to support its position, which is clearly a good idea for complainants to include.\textsuperscript{40} The fee to file a URS complaint in the Forum is $375 for one to fourteen domain names.\textsuperscript{41} Thus, the URS is a fairly inexpensive process. Only one panelist, referred to as an examiner, is involved in the initial URS dispute process in comparison to the UDRP where up to three panelists may participate.\textsuperscript{42}

When a mark holder files a URS complaint, the domain name registrar automatically freezes the domain within twenty-four hours.\textsuperscript{43} The domain name holder is then notified and has fourteen days to respond to the complaint.\textsuperscript{44} The response, which cannot exceed 2,500 words, excluding attachments, should include the following:

5.4.1 Confirmation of Registrant data.
5.4.2 Specific admission or denial of each of the grounds upon which the Complaint is based.
5.4.3 Any defense which contradicts the Complainant’s claims.
5.4.4 A statement that the contents are true and accurate.\textsuperscript{45}

The respondent may submit evidence to rebut the claim of bad faith, including a selection of nonexclusive arguments noted in the procedural rules.\textsuperscript{46} There is a fee to respond when fifteen or more domain names are at issue.\textsuperscript{47} Where the respondent puts forth a plausible explanation for its use of the domain name that is not consistent with a bad faith intent, the URS claim is likely to be rejected.\textsuperscript{48} If no response is received, the URS examiner still reviews the complaint on the merits, and if the burden is met by the complainant, the domain name is formally suspended.\textsuperscript{49}

An important consideration in deciding between URS and UDRP procedures is the type of remedy sought. A URS proceeding does not transfer the domain name; it merely suspends the domain name. The domain name cannot be transferred or used in connection with a website during the life of the registration,\textsuperscript{50} and the Whois database is not changed.\textsuperscript{51}
Franchisors have used the URS procedure to suspend cybersquatters’ registration and use of confusingly similar domain names. In *Six Continents Hotels, Inc. v. Beyond the Dot LTD*, the examiner suspended the domain name <holidayinn.tokyo> for the life of the registration because it was confusingly similar to the complainant’s HOLIDAY INN trademark that is used in connection with the Holiday Inn franchise. The panelist noted:

Given the strength and worldwide fame of the HOLIDAY INN Trademark, Respondent’s [sic] cannot have ignored the Complainant’s rights when registering the domain name at issue. It is not possible to conceive of any plausible actual or contemplated active use of the domain name by the Respondent that would not be illegitimate, such as by being a passing off, an infringement of consumer protection legislation, or an infringement of the Complainant’s rights under trademark.

The examiner in that proceeding relied on UDRP precedent. Similarly, in *Moe’s Franchisor LLC v. Gary Cowgill*, the examiner suspended the domain name <moes.catering> for the duration of the registration because it was confusingly similar to the complainant’s MOE’S SOUTHWEST GRILL trademark, which was used in connection with the Moe’s Mexican restaurant chain. In this proceeding, the examiner noted that the respondent admitted to registering the domain name with the complainant in mind and seemed intent on selling it to the complainant for a significant amount.

A losing party may file an appeal within fourteen days after a URS decision is issued. Appeals consist of a de novo review of the examiner’s decision. The appeals panel may consist of three examiners upon request of the appellant and the payment of an extra fee. The appellant need not submit additional evidence to obtain a favorable ruling on appeal. A UDRP proceeding also may be filed in response to a negative URS decision before the Forum, and some fees may be refunded. A losing party also may file a civil action in response to a URS decision in a court of competent jurisdiction.
Although a URS proceeding usually provides fairly quick relief, there may be delays, in addition to an appeal, in reaching a final URS decision if extensions are granted or if relief is sought by a respondent from a default judgment. More specifically, although a URS proceeding from the filing of a complaint to the ultimate resolution is generally about twice as fast as a typical UDRP proceeding, this can change if the decision is challenged. This ability to challenge the result is different from the UDRP, where the only option is filing a civil action to challenge the result.

Another differentiating feature of the URS proceeding is that the complainant must meet a higher burden of proof than in UDRP proceedings. URS proceedings require the establishment of a prima facie case through clear and convincing evidence, rather than the less demanding preponderance of the evidence standard in a UDRP proceeding. This is another reason why the URS is recommended only in clear-cut cases of trademark infringement.

II. Anticybersquatting Consumer Protection Act (ACPA)

A. Background

In passing the ACPA, the U.S. Congress expressed the need for the law as follows:

to protect consumers and American businesses, to promote the growth of online commerce, and to provide clarity in the law for trademark owners by prohibiting the bad faith and abusive registration of distinctive marks as Internet domain names with the intent to profit from the goodwill associated with such marks.

As with any federal court action, it is important to carefully weigh the merits of a potential ACPA suit before filing. This is clearly a remedy to consider if the options noted above are not appropriate or did not lead to a satisfactory resolution. Enforcement efforts typically also include sending a demand letter, which in general should only be sent if the franchisor is committed to taking action if the letter is ignored.

63. Bikoff, supra note 49.
64. See Fan, supra note 50; Bikoff, supra note 49.
65. See Fan, supra note 50; Bikoff, supra note 49.
66. See Fan, supra note 50.
67. See Fan, supra note 50; see also WIPO, WIPO Overview of WIPO Panel Views on Selected UDRP Questions (2d ed.) ¶4.7, http://www.wipo.int/amc/en/domains/search/overview2.0/
68. See Freeman, supra note 50 (arguing that the URS is a “[s]ystem for domains that are clearly instances of cybersquatting, and the use of a centralized Trademark Clearinghouse to ensure that participating marks are included in the mandatory sunrise and trademark notice periods for each new gTLD”).
69. Sporty’s Farm LLC v. Sportsman’s Mkt., Inc., 202 F.3d 489, 495 (2d Cir. 2000) (internal quotations omitted).
B. Proving an ACPA Claim

1. Trademark Rights and Confusion/Dilution

In order to bring a successful ACPA claim, a plaintiff must prove all three elements required under the statute by a preponderance of the evidence: (1) the plaintiff has a mark, either by registration or through common law usage, that is distinctive or famous; (2) the defendant’s domain name is identical or confusingly similar to the plaintiff’s distinctive or famous mark or dilutive of the plaintiff’s famous mark; and (3) the defendant used, registered, or trafficked in the domain name with a bad faith intent to profit from the plaintiff’s mark.\(^\text{70}\)

Courts have not had difficulty determining the first two elements, whether a mark is distinctive or famous, or whether the domain name is identical or confusingly similar to a trademark. The fame or distinctiveness of a mark is an issue at the heart of trademark law and has been addressed in the context of traditional trademark actions for decades. Thus, the courts and the parties are able to argue under established trademark law precedent with which judges are comfortable. The “confusingly similar” standard, however, applies a narrower focus than “likelihood of confusion” by comparing just the mark at issue and the domain name without regard to the goods or services of the parties.\(^\text{71}\)

The cybersquatting cause of action is different in scope from alleging a likelihood of dilution under the Trademark Dilution Revision Act of 2006 (TDRA). Courts have found dilution violations against cybersquatters under both the TDRA and the ACPA.\(^\text{72}\) Establishing a claim that a mark is “dilutive of a famous mark” can be a difficult burden, however, and one that trademark owners may forgo, because a mark need only be distinctive to receive protection under the ACPA.\(^\text{73}\)

2. Registrant’s Bad Faith

The issue of bad faith intent has drawn more attention than the first two requirements and is often more difficult to prove. The ACPA contains a non-exhaustive list of nine factors that a court may consider in determining whether an alleged violator has registered, used, or trafficked in a domain name with a bad faith intent to profit from a plaintiff’s mark.\(^\text{74}\)

A court may weigh these and other indications of good or bad faith displayed by a defendant’s actions. In the end, the court balances all of these factors to decide whether a registrant’s actions truly exhibit bad faith and


fit the classic cybersquatter profile. A court may consider a wide variety of evidence in making a determination as to whether or not the element of bad faith has been proven sufficiently. Bad faith can develop after a registration was obtained, such as when someone later decides to sell the domain name to a trademark owner. In *In re Gharbi*, the court held the defendant, a former franchisee of the plaintiff, was in violation of the ACPA because he continued to use domain names that contained the franchisor’s trademark even after the franchise agreement was terminated.75 The defendant operated a real estate business as a franchisee of Century 21.76 As part of the franchise agreement, Gharbi was granted a license to use the Century 21 marks, including use of the mark within a domain name. Accordingly, Gharbi registered and used the following domain names: <www.texascentury21.com>, <www.century21online.com>, and <www.texasproperties.com/century21capitalteam>. After Gharbi failed to pay his fees mandated under the franchise agreement, Century 21 sent Gharbi a termination notice, leading to the dispute.

3. Jurisdiction

To address the difficulty of obtaining such personal jurisdiction over cybersquatters who live in foreign countries or who supply false contact information in registering their domain names, the ACPA also authorizes *in rem* actions against the domain name itself.77 To bring an *in rem* action, the infringed trademark must be registered with the USPTO. A claim may be brought for cybersquatting or under other provisions of the Trademark Act for infringement, false designation of origin, or dilution.78

A plaintiff must show either that it was unable to establish personal jurisdiction over the domain name owner or unable to find the domain name owner through the exercise of due diligence. Under the statute, due diligence is obtained by sending a notice of the alleged violation and an intent to proceed under the *in rem* provision to the owner of the domain name at the postal and e-mail addresses listed in the registrar’s Whois database and by publishing notice in a newspaper after filing, if the court so directs.79 The publication requirement has been waived when the plaintiff proved that the domain name registrant had actual notice of the lawsuit.80 In all *in rem* actions, the remedy is limited to the forfeiture, cancellation, or transfer of the domain name to the mark holder.81 Transfer is the best option.82

76. Id. at *1.
78. Harrods, Ltd. v. Sixty Internet Domain Names, 302 F.3d 214 (4th Cir. 2002).
plaintiff cannot request damages in an *in rem* action, but may receive costs and attorney fees in exceptional cases.\(^{83}\)

In *Heathmount AE Corp. v. Technodome.com*,\(^{84}\) the court noted in an *in rem* action that a “[p]laintiff would bear the burden of proving the ‘absence’ of personal jurisdiction by a preponderance of the evidence. While such a burden may not be difficult to conceptualize, it is difficult to apply—requiring the plaintiff to ‘prove a negative.’” Courts have discussed the steps necessary to establish *in rem* jurisdiction, including noting with approval an unsuccessful attempt to serve a domain name holder under the Hague Convention.\(^{85}\)

C. Defenses

Like any legal claim, an ACPA claim is also subject to a variety of defenses. For example, under 15 U.S.C. § 1125(d)(1)(B)(ii), a defendant who “believed and had reasonable grounds to believe that the use of the domain name was a fair use or otherwise lawful” may effectively defend himself or herself against a finding of cybersquatting.

D. Damages

The ACPA protects both registered and common law trademarks, service marks, certification, and collective marks constituting or within a domain name.\(^{86}\) The scope of the ACPA is limited to actions involving domain names, but not keywords.\(^{87}\) The ACPA allows a court to order injunctive relief, including the forfeiture or cancellation of the domain name registration or the transfer of the domain name to the mark holder.\(^{88}\) The ACPA also makes available traditional Lanham Act monetary remedies, although not for *in rem* cases as noted above, as well as allowing the trademark owner the option of electing to recover statutory damages ranging from $1,000 to $100,000 per domain name.\(^{89}\)

E. Application of ACPA to Franchisor/Franchisee Cases

For significant disputes with more complicated facts, an ACPA suit may make sense when other options have been considered and rejected or where it is important to take immediate action with the prospect and power of a federal court order. For example, in *In re Gharbi*, the court held that a former franchisee was in violation of the ACPA because he continued to use domain names that contained the franchisor’s trademark after

\(\text{83. See } \text{Agri-Supply Co. v. Agrisupply.com, 457 F. Supp. 2d } 660 \text{ (E.D. Va. 2006).}\)

\(\text{84. 106 F. Supp. 2d 860, 862 (E.D. Va. 2000).}\)


\(\text{86. See Section 45 of the Lanham Act; Spear, Leeds & Kellogg v. Rosado, 122 F. Supp. 2d 403, 403–07 (S.D.N.Y. 2000).}\)


\(\text{88. 15 U.S.C. §§ 1117(d), 1125(d).}\)

\(\text{89. Id.}\)
the franchise agreement was terminated.90 This case was somewhat unusual because the initial registration of the domain names did not violate the ACPA. Instead, based on evidence that Gharbi continued to use the domain names post-termination with the intent of diverting consumers from Century 21’s online websites, the court found that his continued use of the domain names constituted a violation of the ACPA.91 The court held this intentional diversion of consumers was a “bad faith intent to profit from the use of a trademarked name” and therefore in violation of the ACPA.92 The court awarded the plaintiff $25,000 for each of the three domain names in addition to reasonable attorney fees.93

This case highlights an important distinction between the ACPA and the UDRP/URS enforcement options. Under the UDRP/URS options, the complainant must show that the registrant registered and used the domain name in bad faith. Under the ACPA, only bad faith use must be shown along with an “intent to profit.” Therefore, the ACPA may be the only viable option available to franchisors in certain cases.

III. Conclusion

In domain name disputes, a franchisor’s most cost-effective tools for dispute resolution are the UDRP and URS procedures. UDRP procedures are best when a franchisor seeks to transfer the domain name, because this remedy is unavailable in URS proceedings. Because the URS is intended for clear-cut cases, conflicts between franchisors and franchisees are typically best resolved under the UDRP, although the issues must be straightforward in both procedures. Cases with more pronounced factual disputes or where there is no bad faith registration are best left to the ACPA, where a federal court is in a position to hear evidence.

91. Id.
92. Id.
93. Id. at *8.
Franchisors focus on updating their franchise disclosure document (FDD) on an annual basis. But franchisors may overlook the obligation that exists under the Federal Trade Commission (FTC) Rule\(^1\) and various state statutes and regulations to amend their FDD on a more frequent basis upon the occurrence of a material event or material change.\(^2\) The process and timing of creating and possibly registering such an amendment could require the franchisor to stop making sales or “go dark.” Worse, failing to respond at all or within the time period required can create significant liability for a franchisor.

What circumstances would force a franchisor to go dark and amend its FDD? How quickly do franchisors have to respond to such events? What are the consequences, penalties, and possible remedies of failing to do so? What is the lawyer’s role in monitoring these situations?

It is easy enough to imagine a scenario in which a franchisor presents to its prospective franchisees a newly minted FDD, with registration renewed in several states, containing the requisite current information as well as its audited financial statements. Because of its rapid expansion, the franchisor’s cash flow is tight, and midyear it falls behind on one of its bank loans. Unexpectedly, the bank takes an aggressive posture and notices an event of default that will result in a lawsuit if payment is not made. The franchisor
enters into feverish negotiations with the bank, hopeful that disaster can be averted, but in the meantime it continues to sell franchises. However, negotiations fall apart, and a lawsuit is initiated. At that point, the franchisor ceases franchise sales and moves to amend its FDD to reflect the lawsuit. However, after learning of the earlier notice of default, franchisees that purchased their respective franchises just prior to the litigation make a demand upon the franchisor to rescind the franchise agreement. The franchisor takes the position that it has the ability to meet its financial obligations and that the sales were made prior to the litigation and refuses to rescind the sales. The franchisees sue and notify the applicable regulatory authorities of the lawsuit. When should the franchisor have ceased sales and gone dark? Should the franchisor have amended its FDD earlier to describe the change of condition? What is the franchisor’s exposure?

I. Materiality: Statutes, Regulations, and Case Law

A. Statutory and Regulatory Framework

The FTC Rule\(^3\) and various state statutes and regulations\(^4\) require the franchisor to amend its FDD upon an occurrence, which is described in some cases as a material event and in others as a material change. Although some states, such as Minnesota,\(^5\) reference material event and material change as if they are separate and distinguishable concepts, it appears to the author that the two terms are essentially the same concept. But what is the definition of material?

The FTC Rule\(^6\) does not expressly define the term “material event” or “material change.” However, it provides a definitional framework for the application of the concept of materiality. The 2007 Statement of Basis and Purpose (SBP),\(^7\) in which the FTC provides commentary on the underlying rationale for the disclosure obligations contained in the FTC Rule, notes that the FTC regards a representation, omission, or practice to be material if it is likely to affect consumers’ conduct or decisions with respect to the product at issue.\(^8\) Accordingly, “‘materiality’ is determined by the viewpoint of the

---

8. Id. at 15455.
reasonable prospective franchisee.” In practice, the materiality of a fact or an omission of a fact will depend on the particulars of the franchisor and the franchise system, including the number of franchises in operation and the operating history and experience of the franchisor, among other factors.

A majority of state franchise registration statutes do not specifically define the term “material change,” instead relying on a definitional framework similar to that of the FTC. For example, Virginia provides that a “material change” includes a fact, circumstance, or condition that would have a substantial likelihood of influencing a reasonable prospective franchisee in the making of a decision relating to purchase of the franchise.

Six registration states have established detailed examples of events that constitute a material change:

Hawaii provides that a material event or material change may include, but not be limited to, the following:

1. the termination, closing, or failure to renew during any three month period of (a) the greater of one percent or five of all franchises of a franchisor or subfranchisor regardless of location or (b) the lesser of fifteen percent or two of the franchises of a franchisor or subfranchisor located in Hawaii [an identical definition is used in Wisconsin];
2. any change in control, corporate name, or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor or subfranchisor is a subsidiary, is required to file reports under section 12 of the Securities Exchange Act of 1934 [an identical definition is used in Wisconsin and similar definitions are used in Maryland and Minnesota];
3. the purchase by the franchisor in excess of five percent of its existing franchises during any three-month period on a continuous basis [an identical definition is used in Wisconsin]; or
4. the commencement of any new product, service, or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuance or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis [an identical definition is used by Wisconsin].

Illinois provides that a change is material if there is a substantial likelihood that a reasonable prospective purchaser would consider it significant in making a decision to purchase or not purchase the franchisee, including, without limitation:

9. Id. at 15482.
13. Maryland (Md. Code Regs. 02.02.08.01(9)(c),(d) (2015); COMAR 02.02.08.01 (9)(c) (2015), (d)); Minnesota (Minn. R. 2860.2400(B) (2015)); Wisconsin (Wis. Admin. Code § 31.01(2)(b) (2008)).
15. Id.
1. any increase or decrease in the initial or continuing fees charged by the seller [a similar definition is used in New York 17];
2. a change of more than fifteen percent in the number of requests for refund or rescission or other mode of termination or cancellation of business opportunities sold which were received by the seller in the most recent quarter since the effective date of the current disclosure document;
3. a change in the seller’s management;
4. a change in the seller’s or purchaser’s obligations under the contract or agreement of sale or related agreements [as a practice note, it is worth commenting that the third and fourth example here, as some others, are quite broad and may not necessarily be material to a prospective franchisee];
5. a decrease in the seller’s income or net worth of more than twenty-five percent; or
6. additional litigation or a significant change in the status of litigation, including, without limitation (a) the filing of a complaint, or amendment thereto, alleging or involving violations of any business opportunity or franchise law, fraud, embezzlement, fraudulent conversion, restraint of trade, unfair or deceptive practices, misappropriation of property or breach of contract, (b) the entry of any injunctive or restrictive order relating to any business opportunity; or the entry of any injunction under any federal, state, Canadian or Mexican business opportunity, franchise, securities, anti-trust trade regulation or trade practice law, and (c) the entry of a judgment that has or would have any significant financial impact on the seller. Such a judgment is considered to have a significant financial impact if it equals fifteen percent or more of the current assets of the seller and its subsidiaries on a consolidated basis.

Maryland defines a material change, for purposes of the Maryland Franchise Law, 18 to include, but not be limited to:

1. the termination, in any manner, of more than ten percent of the franchises of the franchisor that are located in the State during any three-month period or the termination, in any manner, of more than five percent of all franchises of the franchisor regardless of location during any three-month period [a similar definition is used in Minnesota 19 and New York 20];
2. a reorganization of the franchisor or a change in control, corporate name, or state of incorporation of the franchisor;
3. the commencement of any new product, service, or model line requiring, directly or indirectly, additional investment by any franchisee; or
4. the discontinuation or modification of the marketing plan or system of any product or service of the franchisor which accounts for at least twenty percent of the annual gross sales of the franchisor.

Minnesota 21 defines a material event or material change to include, but not be limited to, the following:

1. the termination, closing, or failure to renew by the franchisor during any consecutive three-month period after registration of ten percent of all

---

18. Md. Code Regs. 02.02.08.01(9) (2015); Comar 02.02.08.01 (9) (2015).
franchises of the franchisor, regardless of location, or ten percent of the
franchises of the franchisor located in the state of Minnesota;
2. any change in control, corporate name, or state of incorporation, or reorga-
nization of the franchisor;
3. the purchase by the franchisor during any consecutive three-month period
after registration of ten percent of its existing franchises, regardless of loca-
tion, or ten percent of its existing franchises in the state of Minnesota;
4. the commencement of any new product, service, or model line involving, di-
rectly or indirectly, an additional investment in excess of twenty percent of
the current average investment made by all franchises or the discontinuation
or modification of the marketing plan or marketing system of any product or
service of the franchisor where the average total sales from such product or
service exceed twenty percent of the average gross sales of the existing fran-
chises on an annual basis;
5. any change in the franchise fees charged by the franchisor; or
6. any significant change in:
a. the obligations of the franchisee to purchase items from the franchisor or
its designated sources;
b. the limitations or restrictions on the goods or services which the franchi-
see may offer to a customer;
c. the obligations to be performed by the franchisor; or
d. the franchise contract or agreement, including all amendments thereto.

New York\textsuperscript{22} provides that the term material change includes, but is not
limited to:

1. the termination, closing, or failure to renew, during a three-month period,
of the lesser of ten or ten percent of the franchises of a franchisor, regardless
of location;
2. a purchase by the franchisor in excess of five percent of its existing franchises
during six consecutive months;
3. a change in the franchise fees charged by the franchisor;
4. any significant adverse change in the business condition of the franchisor or
in any of the following: (a) the obligations of the franchisee to purchase
items from the franchisor or its designated sources; (b) limitations or restric-
tions on the goods or services which the franchisee may offer to its custom-
ers; (c) the obligations to be performed by the franchisor; (d) the franchise
contract or agreements, including amendments thereto; (e) the franchisor’s
accounting system resulting in a five percent or greater change in its net
profit or loss in any six month period; or (f) the service, product, or
model line; or
5. the issuance of audited financial statements of a fiscal year subsequent to the
one in the FDD.

Wisconsin\textsuperscript{23} provides that the material event or material change includes,
but is not limited to:

1. the termination, closing or failure to renew during any three-month period
of (a) the greater of one percent or five of all franchises of a franchisor re-
gardless of location or (b) the lesser of fifteen percent or two of the fran-
chises of a franchisor located in the state of Wisconsin;

\begin{footnotes}
\item[23] W I S. A DMIN. C ODE § 31.01(2)(a)-(e) (2008).
\end{footnotes}
2. any change in control, corporate name or state of incorporation, or reorganization of the franchisor whether or not the franchisor or its parent, if the franchisor is a subsidiary, is required to file reports under Section 12 of the Securities Exchange Act of 1934;
3. the purchase by the franchisor of in excess of five percent of its existing franchises during any three-month period on a running basis;
4. the commencement of any new product, service or model line involving, directly or indirectly, additional investment by any franchisee or the discontinuation or modification of the marketing plan or system of any product or service of the franchisor where the total sales from such product or service exceeds twenty percent of the gross sales of the franchisor on an annual basis; or
5. an adverse financial development involving the franchisor or the franchisor’s parent company, controlling person or guarantor of the franchisor’s obligations. The term adverse financial development includes, but is not limited to (a) the filing of a petition under federal or state bankruptcy or receivership laws or (b) a default in payment of principal, interest, or sinking fund installment on indebtedness that exceeds five percent of total assets which is not cured within thirty days of the default.

B. Case Law

When litigated, the materiality of a fact or omission of a fact generally is determined by using an objective standard of what a reasonable person would consider important in determining whether to purchase a franchise.24 Case law is scarce in applying amendment requirements in connection with the occurrence of a material event. Except for Hanley v. Doctors Express Franchising, LLC, the applicable cases analyze materiality in the context of whether an untrue statement of fact or an omission of fact is material with respect to a franchise offering.

Hanley illustrates the nature of information that would require a material amendment, although the only decision on record in this particular case concerned the defendants’ motion to dismiss the plaintiffs’ claims.25 Doctors Express sold a franchise for the management of an urgent care medical center. In January 2010, Doctors Express provided the plaintiff with a copy of its then-registered FDD and other materials, which described the initial investment required, the average number of patients treated per day at urgent care medical centers, and the average revenue per patient.26 The 2009 FDD initial investment information and financial performance representation were prepared in reliance on the experience and data collected from the franchisor’s affiliate that operated an urgent care center in Maryland. The court noted that Doctors Express knew that the experience of and data from the Maryland affiliate were materially different from that of its actual franchisees and were not a reasonable basis on which to estimate the initial investment
that a new franchisee would be required to make in 2010. The court observed that when it gave the FDD to the plaintiffs, Doctors Express knew that the expected revenues during the initial months of a franchise’s operations were likely to be substantially below those reported in Item 19 of the FDD, because Doctors Express knew that changes to the Medicare enrollment process would mean that a franchisee would not have medical insurance reimbursement contracts in place immediately to pay claims for patient services.27 Those Medicare enrollment policy changes made it difficult, if not impossible, for a franchisee to replicate the Maryland affiliate’s financial experience.28

The plaintiffs opened their Doctors Express DRX center on January 15, 2011. The center allegedly did not do well and closed on July 20, 2011.29 The plaintiffs contended that the 2009 FDD received from Doctors Express and its representatives contained material misrepresentations relating to the estimated initial investment and the expected financial performance due to changes in the law. Doctors Express argued that it was under no duty to update its FDD other than annually, or stated another way, there was no material event that obligated Doctors Express to update its FDD.30 The court was unconvinced by Doctors Express’s argument. Having survived Doctors Express’s motion, the plaintiffs were permitted to proceed with their claims for damages and/or rescission under the Maryland Franchise Law.31 The case suggests that a change in law affecting performance would be a material event necessitating an amendment.

Other cases discuss materiality, although not in the specific context of requiring an amendment. In Morris v. International Yogurt Co., the court determined that it was a material fact that the franchisor’s “unique” yogurt mix was not a trade secret, as the franchisor claimed, because it was available for sale by its manufacturer to third party non-franchisees, and that the omission violated the Washington Franchise Investment Protection Act.32 In Motor City Bagels, L.L.C. v. American Bagel Co.,33 the court determined that information concerning the start-up costs for the franchise was material because it would alter the total mix of information available to the prospective franchisee. Presumably, the emergence of facts such as these during the year would require amending the FDD.

However, in Harb v. Norrell Corp.,34 the court determined that a franchisor was under no duty to disclose what percentage of its franchisees had or had not met their franchise agreement sales quotas because that disclosure

27. Id.
28. Id. at *4.
29. Id.
30. Id.
31. Id.
was not material. This case suggests that certain aspects of ongoing franchisee financial performance would not cumulatively constitute a material event. These cases are instructive of how courts might define material change if there is no applicable state statute or regulation.

II. Amendment Requirements and Effect on Sales

A. Going Dark

As noted above, the FTC Rule and various state registration statutes create a continuing obligation for the franchisor to update its FDD to reflect material changes. The following sections will discuss the timing and manner in which the franchisor must update its FDD. However, an issue of immediate concern for franchisors and franchise counsel is the effect of a material change upon the franchisor’s sales program. In most registration states, applicable statutes mandate that the franchisor must immediately cease the offer and sale of franchises upon the occurrence of a material event.

Under the FTC Rule, which is silent on the issue of going dark upon the occurrence of a material event, the offer and sale of franchises may technically continue, although it would be advisable that the franchisor immediately cease the offer and sale of franchises, given the possible risks inherent with continuing to sell, as discussed later in the Ramifications of a Material Event section. This “going dark” includes the cessation of sales activities relating to prospective franchisees already in the pipeline and may ultimately affect the franchisor’s prospective sales, cash flow, and operations. In states operating under the FTC Rule, it is advisable that the franchisor wait to recommence the offer and sale of franchises until after it has amended its FDD because of the availability of various rights to franchisees under state law, as discussed later.

In registration states, there are varying timing requirements as to when a franchisor may recommence the offer and sale of franchises. In Illinois,

Indiana, Virginia, and Wisconsin, the franchisor may offer and sell franchises as soon as the amendment has been filed with each respective registration state. In the remaining registration states, except California and New York, the franchisor may not offer or sell franchises until its amended FDD has become effective. California and New York allow the franchisor to continue offering franchises pending the effectiveness of an amendment. However, the sale may not close in California until the amendment has been approved. Once the FDD has been approved in California, the franchisor must provide the prospective franchisee with a copy of the amended FDD and proceed with the normal sales procedures.

On the other hand, New York permits the closing of a sale provided that the following procedures are satisfied. The franchisor must provide the prospective franchisee with a copy of its then currently registered FDD and notify the prospective franchisee in writing that an amendment is pending. If a sale closes, the franchisor must segregate the funds collected in a separate trust or escrow account for the benefit of the franchisee. After the amendment has been registered, the franchisor must provide the franchisee with a copy of its now registered amended FDD and wait for the ten-business day disclosure period to lapse. At the end of that period, the franchisee has the options of (1) rescinding the franchise agreement it entered into and have its initial franchise fee returned; (2) cancelling the franchise agreement it entered into and sign the new franchise agreement, if it differs; and (3) continuing the franchise relationship under the franchise agreement it entered into. Due to the complications in New York’s regulatory scheme, it would be far simpler to forego closing the sale of a franchise while an amendment is pending.

B. Timing: When Must the Franchisor Amend its FDD?

Under the FTC Rule, franchisors must prepare revisions to be attached to the FDD within a reasonable time after the close of each fiscal quarter in which a material change occurred. Additionally, if the material change

---

38. Illinois (815 ILL. COMP. STAT. 705/12 (1988)); Indiana (IND. CODE ANN. § 23-2-2.5-17 (2014)); Virginia (VA. ADMIN. CODE tit. 21 § 5-110-60(2015)); Wisconsin (Wis. STAT. ANN. § 553.31(2) (West 2014)).
40. CAL. CORP. CODE § 31107 (1971).
41. CAL. CORP. CODE § 31107.
43. Id.
44. Id.
45. Id.
46. Id.
47. 16 C.F.R. § 436.7(b) (2007).
relates to an Item 19 financial performance representation, the FTC Rule mandates that “when furnishing a disclosure document, the franchise seller shall notify the prospective franchisee of any material changes that the seller knows or should have known occurred in the information contained in any financial performance representation made in Item 19.”

The fact that the FTC Rule specifically sets forth this notification obligation separately from the general obligation to amend within a time period shorter than a reasonable time after the close of the next quarter, implies that material changes to Item 19 financial performance representations are different and more important than other material changes. For that reason, it is also implied that notice of material changes to Item 19 financial performance representations changes must be given to any prospective franchisee sooner rather than within a reasonable time after the close of the following quarter.

Upon the occurrence of a material change, franchise registration states require amendments to be filed, as follows: California (promptly after a material event), Hawaii (before further sales of the franchise are made in Hawaii), Illinois (within thirty days after the close of each quarter of its fiscal year in which a material change occurred), Maryland (promptly), Michigan (promptly), Minnesota (within thirty days after a material change), New York (promptly), North Dakota (promptly), Rhode Island (promptly), Virginia (within thirty days of a material change), Washington (as soon as reasonably possible and before any further sale occurs), and Wisconsin (within thirty days of a material event). South Dakota does not require an amendment to be filed nor does Indiana, unless the commissioner requests additional information. South Dakota has elected to follow the FTC Rule by mandating that the franchisor prepare an amendment to be attached to the disclosure document within a reasonable time after the close of each quarter of the fiscal year. As noted earlier, the franchisor is prohibited from completing franchise sales in California, Hawaii, Illinois, Indiana, Maryland, Minnesota, North Dakota, Rhode Island,

48. 16 C.F.R. § 436.7(d) (2007).
49. 16 C.F.R. § 436.7(b), (d) (2007).
50. Id.
52. HAW. REV. STAT. ANN. § 482-E3(b) (West 2014).
54. MD. CODE ANN. BUS. REG. § 14-220(a) (2014).
62. WIS. STAT. ANN. § 533.31(1) (West 2014).
63. IND. CODE ANN. § 23-2-2.5-10.5 (West 2014).
64. S.D. CODIFIED LAWS § 37-5B-7(2) (2014).
South Dakota, Virginia, Washington, and Wisconsin until the franchisor has amended its FDD and the amendment has become effective, as discussed later.65

C. Effective Date of Amendment

Under the FTC Rule, the FDD is effective immediately upon its issuance.66 Accordingly, an FDD amended to reflect a material change will become effective on the date that it is issued by the franchisor. In Illinois, Indiana, Virginia, and Wisconsin, the amendment will be effective immediately upon filing and the franchisor may recommence the offering of franchises for sale in those states after filing.67 In the following registration states, the amendment will become effective as follows: California (effective upon approval by commissioner), Hawaii (seven days after filing), Maryland (fifteen business days after filing), Minnesota (effective upon issuance of an order by the commissioner), New York (effective upon approval by the department), North Dakota (effective upon approval by the commissioner), Rhode Island (thirty business days after filing), and Washington (fifteen business days after filing).68 As noted above, in South Dakota, no filing is required. Rather, the amendment is effective upon its issuance by the franchisor.69 In each case, the franchisor may resume the offer and sale of franchises after the amendment has become effective.

D. Manner of Disclosure of Amended FDD

After the franchisor amends its FDD to reflect the material change, how should the material change be communicated to prospective franchisees? In registration states, after the FDD is filed and/or registered, where required,
disclosure of the material change is made to prospective franchisees through the provision of the amended FDD. 70 In these states, all required disclosures must be contained within the FDD. 71 On the other hand, the FTC Rule requires the franchisor to prepare revisions to be attached to the disclosure document to reflect any material change to the disclosures included, or required to be included, in the disclosure document. 72 Each prospective franchisee must receive the disclosure document and the revisions attachment.

Additionally, the FTC Rule specifically provides that if the FDD contains an Item 19 financial performance representation and the franchisor knows or should have known that a material change occurred to that information, the franchisor must “notify” the prospective franchisee of the material change. The “notification” requirement obligates the franchisor to inform the prospective franchisee of the material change. Notification may be accomplished outside of the disclosure document. The manner in which the franchisor “notifies” a prospective franchisee is within the sound discretion of the franchisor. Notification can be made in writing, or by telephone call, e-mail, or other electronic transmission, provided that the franchisor can prove that it has informed the prospective franchisee about the material change. 73 Although Section 436.7 of the FTC Rule 74 does not provide a specific time frame for when such notification must be given, notification must be provided to the franchisee prior to the sale of the franchise in accordance with Section 436.2 of the FTC Rule, 75 otherwise material information will have been omitted from the FDD. For those prospective franchisees receiving an FDD after a reasonable period of time after the close of the quarter following the material change, that FDD should contain the necessary revisions to reflect the material change. 76


72. 16 C.F.R. § 436.7(b) (2007).
73. 16 C.F.R. § 436.7(d) (2007).
74. Id.
75. 16 C.F.R. § 436.2 (2007).
76. 16 C.F.R. § 436.7(b) (2007).
III. Ramifications of A Material Change

A. Damages and Rescission Available to Franchisees

A franchisor’s failure to amend its FDD to reflect a material change and its continued offering and selling of franchises exposes the franchisor to potential franchisee claims as well as civil and criminal penalties. Although the FTC Rule does not provide franchisees with a private right of action, various states have enacted Little FTC Acts or business opportunity statutes, which typically provide franchisees with the private right to sue for damages and rescission based on unfair or deceptive practices conducted by the franchisor.77

In California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, and Washington, franchisees have in varying degrees an independent private right of action against the franchisor either (1) for a franchisor’s failure to amend its FDD for a material change and if required, file an amendment reflecting the material change within the time frame and in the manner required by such statute; or (2) for a violation of the statute’s antifraud provision.78

For example, the Illinois Franchise Disclosure Act of 1987 expressly provides that any person who offers or sells a franchise in violation of the Act shall be liable to the franchisee, which may sue.79 In Indiana, which does not create a private right of action for violation of disclosure provisions,


79. 815 ILL. COMP. STAT. 705/26 (2009).
franchisees are afforded a private right of action for acts that constitute fraud, deceit, or misrepresentation.\textsuperscript{80} Thus, franchisees that were sold a franchise in violation of the franchisor’s obligations to amend its FDD for a material change may allege a claim under the antifraud section of the Indiana Franchise Act on the theory that the franchisee was sold a franchise through the use of a disclosure document that contained untrue statements of material facts.\textsuperscript{81}

In Virginia, the civil remedies afforded by the Virginia Retail Franchising Act (VRFA) provide for a private right of action for presale activities in only limited circumstances, i.e., the right to void the franchise agreement within seventy-two hours after discovery of the franchisor’s unlawful sale of the franchise, but in no event more than ninety days after execution of the franchise agreement.\textsuperscript{82} In cases where the misrepresentation of a material fact or an omission of a material fact is discovered after the ninety-day period, the franchisee must base its claim on other legal theories when recourse under the VRFA is unavailable.\textsuperscript{83} In \textit{Bans Pasta, LLC v. Mirko Franchising, LLC},\textsuperscript{84} a Mirko franchisee brought an action against the franchisor in which it alleged that the franchisor violated the VRFA by making presale misrepresentations concerning the expected financial performance of the franchise. The court, noting that the franchisee’s demand to void the franchise agreement was made after the ninety-day period lapsed, dismissed the plaintiff’s claims under the VRFA.\textsuperscript{85} However, the court held that the plaintiff’s claims for fraud in the inducement, constructive fraud, and negligent misrepresentation survived the franchisor’s motion to dismiss.\textsuperscript{86}

In California, Hawaii, Illinois, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Washington, and Wisconsin, a franchisor that offers or sells a franchise without amending the FDD, as required, in violation of such statute shall be liable to the franchisee for damages and in some cases, rescission.\textsuperscript{87} The California and Hawaii statutes specifically provide that rescission is available if the violation is willful, unless (1) the defendant proves that the plaintiff knew the facts concerning the untruth or omission; or (2) the defendant exercised reasonable care and did not know, or, if the defendant exercised reasonable care, would not have known, of

\textsuperscript{80} Hardee’s of Maumelle, Ark, Inc. v. Hardee’s Food Sys., Inc., 31 F.3d 573 (7th Cir. 1994).
\textsuperscript{81} Id.; Indiana (IND. CODE ANN. § 23-2-2.5-27 (West 2014)).
\textsuperscript{84} Id.
\textsuperscript{85} Id. at *7.
\textsuperscript{86} Id. at *11.
the untruth or omission. For illustrative purposes, a violation is willful in California if the act that constitutes the violation was committed knowingly and intentionally, regardless of whether the defendant acted reasonably or in good faith or was ignorant as to whether the law was violated. In Dollar Systems, Inc. v. Avcar Leasing Systems, Inc., at the time of the franchise sale, Dollar Systems was neither registered in California nor exempt from the California registration requirements. The disclosure document provided to franchisees failed to disclose that the franchisor’s principals were subject to a California desist and refrain order that prohibited them from offering or selling franchises in California and failed to disclose the existence of five civil actions involving the franchisor and two criminal convictions for unlawful franchise sale activity. The Ninth Circuit upheld the district court’s grant of rescission and the district court’s finding that the franchisor’s violations were “willful” under the California Franchise Investment Act. Dollar Systems’ violations were determined to be willful because, as the district court noted, Dollar Systems knew it had not registered or filed for an exemption and it knew that it failed to make the required disclosures, even though it was not specifically aware of the laws which it violated in the process.

Rescission as a remedy under Virginia law was discussed in the previously cited Motor City Bagels. There, the franchisees’ claims survived a summary judgment motion, when the court held that the franchisees asserted triable claims of common law fraud and violation of statutory franchise disclosure requirements against a franchisor where there was evidence that the franchisor knew or should have known of information omitted from the FDD that rendered the initial investment cost projections inaccurate and unreliable. The plaintiffs’ case in Motor City Bagels was buttressed by the fact that a later version of the franchisor’s FDD (at that time called a Uniform Franchise Offer Circular, or UFOC), which allegedly was not provided to the franchisees, contained projections significantly different from those in the older UFOC that was provided, and the franchisor knew or should have known the information contained in the later UFOC at the time the franchise agreement was executed. A comparison of the initial investment costs reported in the older UFOC with the initial investment costs disclosed in the more recent UFOC showed an increase in initial investment costs of nearly 20 percent at the low end and 23 percent at the high end. At that phase of the

---

89. 890 F.2d 165 (9th Cir. 1989).
90. Id. at 168.
91. Id.
92. Id. at 176.
93. Id. at 172.
95. Id. at 489.
96. Id. at 469.
97. Id. at 470.
action, the court was satisfied that the plaintiffs could demonstrate that they were harmed by reliance on the defendants’ misrepresentations as they arguably would not have entered into the various contractual obligations with American Bagel had the defendants disclosed the higher initial investment cost estimates and that the plaintiffs could argue that their reliance was reasonable as the franchisors disclosed this information to aid potential franchisees to assess the merits of the business opportunity.98 The court ruled that the franchisee retained the right to rescind the franchise agreement if it could ultimately prove its case against the franchisor.99

B. Administrative Remedies: Imposition of Civil and Criminal Penalties

The FTC is empowered to prevent unfair and deceptive practices.100 If the FTC determines that a franchisor has engaged in unfair or deceptive practices, it has broad latitude in determining the appropriate penalties, which include the issuance of cease and desist orders and the imposition of monetary penalties. In Federal Trade Commission v. Minuteman Press,101 the court held that the defendants’ gross sales misrepresentations and profit misrepresentations violated Section 5(a) of the FTC Act, because such misrepresentations were likely to mislead customers as to a material fact—the economic viability of the franchise. Further, the court determined that a permanent injunction was necessary to prevent a recurrence of the widespread financial misrepresentations and that monetary relief was warranted to redress injuries suffered by the franchisees.102

A franchisor must be cognizant that selling a franchise in a registration state without first amending its FDD to reflect the material change, filing the amended FDD for registration, if required, and disclosing the amended FDD to a prospective franchisee, under the state’s requirements, may subject it to civil and criminal penalties. The statutes of each registration state afford significant powers to their respective regulatory agencies, which typically include the ability to seek injunctive relief as well as to impose civil and criminal penalties.103

98. Id.
99. Id. at 489.
102. Id. at 261, 263.
Violators of New York’s Franchise Sales Act or Washington’s Franchise Investment Protection Act may be offered the opportunity to enter into an assurance of discontinuance. In Maryland, violators of the Franchise Registration and Disclosure Law\textsuperscript{104} may be offered the opportunity to enter into a consent order. In the author’s experience, the assurance of discontinuance and consent order are essentially settlement agreements between the franchisor and the applicable regulatory agency, which impose monetary penalties on the franchisor and require the franchisor to offer rescission to franchisees to whom the franchisor sold franchises in violation of the applicable state statute or regulation.

The format of an assurance of discontinuance and consent order is typically laid out in the following manner: (1) an introductory section identifying how the regulatory agency came to learn of the franchisor’s violations of the applicable statute or regulation, (2) a recitation of the history of the franchisor’s FDD registration and franchise sales within the applicable state, (3) a summary of the franchisor’s violations of the applicable statute or regulation, (4) a promise by the franchisor to refrain from violating the applicable statute or regulation in the future, (5) a requirement that the franchisor offer rescission for franchises sold in violation of the applicable statute or regulation, and (6) the monetary penalties imposed on the franchisor by the regulatory agency.\textsuperscript{105} Although assurances of discontinuance are not made readily available in New York, it may be possible to obtain one through a Freedom of Information Law request. In Maryland, consent orders are available at the Maryland Attorney General’s website.\textsuperscript{106}

In Virginia, EWC Franchise Group, Inc. sold a franchise after it became insolvent without first amending its FDD and filing that FDD with Virginia.\textsuperscript{107} There, the State Corporation Commission’s Division of Securities and Retail Franchising conducted an investigation of the franchisor and determined that the franchisor violated the Commission’s Retail Franchising Act Rules when it failed to amend its FDD to disclose the insolvency.\textsuperscript{108} The Commission entered into a settlement order with the franchisor, in which it assessed monetary penalties against the franchisor in the amount of $10,000, required the franchisor to remit payment of $3,000 for the Commission’s legal fees, and required the franchisor to promise not to violate the Virginia Retail Franchising Act in the future.\textsuperscript{109}

\textsuperscript{104} MD. CODE ANN. BUS. REG. §§ 14-201 to 14-233 (2014).
\textsuperscript{105} Based upon a client’s settlement.
\textsuperscript{106} Office of the Maryland Attorney General, Consent Orders, http://www.oag.state.md.us/ZOOMsearch.asp?zoom_sort=0&zoom_query=Consent+Orders&zoom_per_page=10&zoom_and=0.
\textsuperscript{108} Id. at *1; see VA. ADMIN. CODE tit. 21, § 5-110-40 (2015).
\textsuperscript{109} EWC Franchise Grp., 2013 WL 1512532, at *2.
IV. Practical Advice for Attorneys

We began this article by presenting a rapidly developing scenario in which a typical franchise company could conceivably find itself. Was the receipt of a notice of default from the bank a material event or a material change? The litigation certainly was, but what of the sale made after the notice from the bank but before the litigation? Would it matter if the company’s executives thought in good faith they could settle with the bank? When should they have ceased sales? How could that decision be made in the manner best suited to protect the company?

As noted earlier, the dry statutory and regulatory requirements of what does and does not constitute a material change leave an enormous gray area of events that may or may not meet that definition. In a typical franchise sales company operating in real time, FDDs are being distributed and franchise agreements are being signed all while management or executive-level personnel are evaluating urgent situations and trying to resolve what to do about them. In the meantime, who is evaluating the effect these circumstances should be having on the sales process and the current state of the FDD?

There is not necessarily a bright line of what is and is not material, but there may be little time to make that determination in order to make a decision to go dark before a possibly affected sale takes place. A diligent franchisor counsel would, given the time and resources, set up a mechanism through which ongoing events can be identified and evaluated by knowledgeable personnel for their adverse and potentially material affect.

A franchisor’s counsel could consider doing the following:

• Educate the franchisor’s management as to what may be considered to be a material event so that the legal department or outside counsel can be notified as such events occur. In addition to those examples specifically set forth by the various registration states, franchisors and their counsel should consider any event, fact, or circumstance that might influence a prospective franchisee’s decision to purchase the franchise to be a material change;

• Assist the franchisor with formulating a plan or procedure to address what happens when something that can be identified as a potential material event occurs. The franchisor could circulate a manual and questionnaires to various personnel on a periodic basis for their review concerning the accuracy of the information contained in the FDD;

• Advise the franchisor to have in place periodic auditing and/or monitoring systems of the information contained in the FDD;

• In advance of a material change, identify the specific franchisor’s status legally in terms of what laws will govern their franchise sales practices and how they will be required to react. Identify what rules apply to a particular franchisor, either under the FTC Rule, registration states
and/or other states. The key is to identify what effect the material event will have on the franchisor’s sales given the location of its sales activities and if an amendment is necessary, where it must be filed and/or registered and when will it be effective;

- Prepare executives to participate with counsel immediately to determine if there is a change that requires the FDD to be updated; evaluate quickly on materiality versus non-materiality;
- Cease sales immediately upon the occurrence of a material event; and
- Establish procedures to communicate with sales personnel concerning when sales may resume. There will be different requirements in different jurisdictions. For a national franchisor, the instructions will have to be geographically specific to avoid running afoul of local requirements.
Franchisor Political Speech: The Disclosure Question

Daniel J. Oates

The 2010 U.S. Supreme Court case *Citizens United v. Federal Election Commission*1 has dramatically altered the framework for financing elections. The case and its progeny have made it clear that most restrictions on corporate campaign contributions are unconstitutional.2 In effect, the Court has concluded that the contribution of money to a political cause or campaign is entitled to the same protection as speech under the First Amendment.3

Although the wisdom of the Court’s decision is best addressed by historians, there is no question that it has radically altered the status quo.4 By nearly every estimate, the amount of corporate money that has flowed into political

3. Whether money is speech has long been in debate. J. Skelly Wright, Politics and the Constitution: Is Money Speech?, 85 Yale L.J. 1001, 1005 (1976) (“[N]othing in the First Amendment commits us to the dogma that money is speech.”); Nixon v. Shrink Mo. Gov’t PAC, 528 U.S. 377, 398 (2000) (Stevens, J., concurring) (“Money is property; it is not speech.”). Nonetheless, in Buckley v. Valeo, 424 U.S. 1, 6 (1976), “the Court determined that any regulation of the quantity of money spent on campaigns for office ought to be viewed as a direct regulation of speech itself.” Davis v. Fed. Election Comm’n, 554 U.S. 724, 750 (2008) (Stevens, J., concurring in part and dissenting in part). *Citizens United* has seemingly ended that debate by cementing the idea first articulated in Buckley that money is speech for purposes of the First Amendment. *Citizens United*, 558 U.S. at 314 (“All speakers, including individuals and the media, use money amassed from the economic marketplace to fund their speech, and the First Amendment protects the resulting speech.”); see also McCutcheon, 134 S. Ct. at 1441 (“The right to participate in democracy through political contributions is protected by the First Amendment. . . .”).
4. Jennifer S. Taub, Money Managers in the Middle: Seeing and Sanctioning Political Spending After Citizens United, 15 N.Y.U. J. LEGIS. & PUB. POL’Y 443, 452 (2012) (noting that the Court’s decision in *Citizens United* “reversed two significant Supreme Court decisions, struck down twenty-two state laws, and ended a century-old precedent that state legislatures had consistently relied upon to limit electioneering by corporations”) (footnotes omitted).

Daniel J. Oates (dan.oates@millernash.com) is a partner in the Seattle office of Miller Nash Graham & Dunn LLP. Dan focuses his practice on franchising and distribution litigation.
campaigns has grown exponentially following the Court’s decision.\(^5\) And existing campaign finance laws will not stem the flood of money into political causes and campaigns.\(^6\) To the contrary, viewed through the prism of the majority opinion in *Citizens United*, more money simply means more speech, which the Court views as a positive development.\(^7\)

Most Americans appear to believe that the Court got it wrong.\(^8\) As a result, a variety of organizations are advocating for changes to existing law, including changes to securities\(^9\) and franchise disclosure laws.\(^10\) This article reviews the case for disclosure of franchisor political speech and explains why disclosure is unnecessary. Although there is some anecdotal evidence suggesting that franchisees may be harmed by franchisor political speech, there is no good legal basis for imposing disclosure requirements and little evidence suggesting that additional disclosure would benefit franchisees.

I. *Citizens United* Provokes Activism

Although *Citizens United* effectively precludes any restrictions on political contributions, the Court left open the door for other regulatory measures to combat the influence of money in politics, including disclosure

---

5. Kent Greenfield, *The Third Way*, 37 Seattle U. L. Rev. 749, 757-58 (2014) ("As a result [of *Citizens United*], we saw a massive inflow of money into the mid-term elections in 2010 and then again in 2012, mostly by way of ‘Super-PACs,’ corporate entities organized for the purpose of collecting and spending the money of very rich individuals. So-called ‘independent expenditures’ exploded by a factor of 10, from less than $100 million to over $1 billion."); Monica Youn, *Small-Donor Public Financing in the Post-Citizens United Era*, 44 J. Marshall L. Rev. 619, 622–23 (2011) ("[I]ndependent spending and electioneering in Congressional elections grew to $280.2 million in 2010. This was more than double the $119.9 million spent by outside groups on Congressional elections in 2008, and more than five times the $53.9 million spent by outside groups in 2006."); Richard L. Hasen, *Three Wrong Progressive Approaches (and One Right One) to Campaign Finance Reform*, 8 Harv. L. & Pol’y Rev. 21, 21 (2014) ("Since *Citizens United*, outside spending in federal elections has increased markedly—as much as 245% in presidential elections, 662% in House elections, and 1338% in Senate elections. . . .").

6. The Court’s subsequent decisions have made it clear that a majority of the justices believe that most of the campaign finance laws enacted over the past century violate the First Amendment. See cases cited supra note 3.

7. *Citizens United*, 558 U.S. at 361 ("[I]t is our law and our tradition that more speech, not less, is the governing rule.").

8. *Examining a Constitutional Amendment to Restore Democracy to the American People Before the S. Comm. On the Judiciary*, 112th Cong. 3 (2014) (statement of Jamie Raskin, Professor of Law and Director of the Law and Government Program, American Univ., Washington College of Law) ("80% of Americans—including 82% of Dems, 84% of Independents and 72% of Republicans—oppose *Citizens United* and the practice of unlimited spending in elections.").


10. Robert W. Emerson & Jason R. Parnell, *Franchise Hostages: Fast Food, God, and Politics*, 29 J.L. & Pol’y 353, 387 (2014) ("The FTC could clarify the Franchise Rule by mandating notification to franchise applicants about any franchisor policy, or lack thereof, concerning a corporate employee’s or a franchisee’s prominent, public display of partisan beliefs while associated with the franchised brand.").
requirements. Specifically, eight of the nine justices agreed that disclosure of the “identity of the speaker was a necessary pre-condition for both the general public and shareholders to analyze the merits and weigh the value of the speakers’ messages about candidates for political office.” As a result, campaign finance reform advocates have called for heightened disclosure requirements. Yet efforts to impose more comprehensive disclosure obligations on corporations have stalled in Congress. Stymied in their efforts to impose greater transparency on corporate political donations through congressional action, proponents of campaign finance reform have turned to existing regulatory mechanisms. In 2011, a collection of prominent academics petitioned the SEC, requesting that the Commission commence rulemaking proceedings with the purpose of requiring public companies to disclose to shareholders the use of corporate resources for political activities. Public interest in the petition has been unprecedented.

Proponents of additional disclosure in the securities context need look no further than the text of Citizens United itself. The majority opinion expressly noted that disclosure requirements are an essential component of informed decision-making in a corporate democracy.

11. Citizens United, 558 U.S. at 319 (“The Government may regulate corporate political speech through disclaimer and disclosure requirements, but it may not suppress that speech altogether.”).
12. Taub, supra note 4, at 472.
13. Dan Eggen, More Companies Open Up on Spending, WASH. POST, Sept. 27, 2012, at A15; see also Bradley A. Smith, Separation of Campaign and State, 81 GEO. WASH. L. REV. 2038, 2081 (2013) (“Beginning with legislation in 2000 to require more disclosure of issue advocacy, there has been a steady effort, accelerating since Citizens United was decided in 2010, to increase mandatory disclosure.”) (footnote omitted).
15. See Petition, supra note 9, at 7 (“Disclosure of corporate political spending is necessary not only because shareholders are interested in receiving such information, but also because such information is necessary for corporate accountability and oversight mechanisms to work. . . . [S]hareholders must have information about the company’s political speech; otherwise, shareholders are unable to know whether such speech advances the corporation’s interest in making profits.”) (internal quotation marks omitted).
16. Of the ninety-seven petitions for rulemaking filed with the SEC between the years 2000 and 2012, only thirty-nine received any public comments. The other thirty-eight petitions received on average eighty-one comments. By contrast, the Petition has received more than 750,000 comments. The vast majority of the comments support the Petition. See http://www.sec.gov/comments/4-637/4-637.shtml. “Institutional investors—including a coalition representing investors with more than $3 trillion in assets under management—have sent comment letters to the SEC supporting this petition.” Taub, supra note 4, at 445.
17. Citizens United v. Fed. Election Comm’n, 558 U.S. 310, 370 (2010) (“With the advent of the Internet, prompt disclosure of expenditures can provide shareholders and citizens with the information needed to hold corporations and elected officials accountable for their positions and supporters.”). This assumes, of course, that the procedures of corporate democracy offer a legitimate alternative means of policing corporate conduct, a topic that remains hotly debated. See, e.g., Laurence H. Tribe, What Should Congress Do About Citizens United?, SCOTUSBLOG, (Jan. 24, 2010, 10:30 PM), http://www.scotusblog.com/?p=15469 (“[S]hareholder democracy is largely illusory in a world where there are countless obstacles to vigilant oversight of corporate
is allowed to proceed with no disclosure requirement, then shareholders cannot adequately evaluate their bargain—i.e., their decision to invest or to continue holding stock in any particular company.”18

Past Supreme Court precedent also supports the SEC’s rulemaking authority to regulate the disclosure of corporation political contributions. The Court’s First Amendment analysis has long given the SEC considerable deference in the development of rules that provide investors with information necessary to facilitate the functioning of securities markets.19 So it is likely that, should the SEC choose to act on the petition,20 the restrictions would pass constitutional muster.

II. Franchisor Political Speech May Pose a Threat to the Franchise System

In the wake of the petition, a similar proposal has begun making the rounds in franchising.21 Some anecdotal evidence seems to suggest that reforms might benefit some franchisees because franchisor political activities present at least two potential problems. First, such activities can injure the franchisor’s brand.22 Unsurprisingly, surveys seem to suggest that there is a direct correlation between franchisor political controversies and consumers’ opinions about franchisor brands. For example, after the founder and CEO of the Papa John’s franchised restaurant chain, John Schnatter, claimed...
that the Affordable Care Act (ACA) would add $.20 to the cost of every pizza, Papa John’s reputation among consumers plunged.\textsuperscript{23} Other franchisees who have voiced public opposition to the ACA have faced a similar backlash.\textsuperscript{24} Although franchisees often play no part in a political controversy, they nonetheless feel the damage because a large part of their success is bound to the success of the brand.\textsuperscript{25}

Second, in addition to the threat of reputational injury, political activists are increasingly using economic boycotts as a means of encouraging changes in corporate behavior.\textsuperscript{26} As has been noted by at least one scholar,

\begin{quote}
[i]he economic boycott, which the U.S. Supreme Court has long considered protected First Amendment activity, has increasingly become an effective and popular weapon in the arsenal of dissent to counteract the political influence of individuals, large corporations, special interest groups, and issue-based organizations with access to large accumulations of wealth. . . .
\end{quote}

Moreover, the potential for franchisees to suffer harm from economic boycotts may be exacerbated by the growing political divide along regional boundaries.\textsuperscript{28} In some cases, franchisors may not feel the sting of a political controversy as deeply if the bulk of the franchised locations are in a region of the country that generally agrees with the franchisor’s political speech. One such example involves the Chick-fil-A restaurant chain. In 2012, Chick-fil-A’s president, Dan Cathy, gave an interview in which he attributed the company’s success to its adherence to “biblical values,” including its

\begin{footnotesize}
\begin{itemize}
\item \textsuperscript{23} Ted Marzilli, \textit{Anti-Obamacare Rhetoric and Restaurant Buzz}, \textit{YOGOV} (Nov. 30, 2012) (“Papa John’s CEO John Schnatter’s post-Election Day comments about passing on health care reform costs by reducing worker hours and raising prices coincides with a swift negative reaction among casual food diners. . . .”), \url{http://www.brandindex.com/article/anti-obamacare-rhetoric-buzz}. Indeed, in the immediate aftermath of Schnatter’s comments, polling performed by YouGov, a brand perception and public opinion survey, showed that on a scale of 100 (totally positive) to -100 (totally negative), the company’s reputation dove from a score of 32 to 4.\textit{Id.}
\item \textsuperscript{24} See, e.g., Joe Van Brussel, \textit{Jimmy John’s Franchisee Looks for Ways to Make Obamacare Work}, \textit{HUFFINGTON POST} (Nov. 28, 2012) (noting backlash to comments made by the CEO of franchisor Jimmy John’s regarding the ACA), \textit{available at} \url{http://www.huffingtonpost.com/2012/11/28/jimmy-johns-obamacare_n_2200178.html}.
\item \textsuperscript{25} Emerson & Parnell, supra note 10, at 355–56 (“Franchisees and franchisees can be, in effect, ‘hostage to fortune’—to the attention that any franchise network leader or member garners through words or deeds. Publicity, good or bad, redounds to the benefit or detriment of all.”) (footnote omitted).
\item \textsuperscript{27} Dashev, supra note 26, at 211.
\item \textsuperscript{28} Gerard N. Magliocca, \textit{Don’t Be So Impatient}, 88 \textit{NOTRE DAME L. REV.} 2157, 2161 (2013) (“Years of polling data also suggest that there is something real behind the idea that there are red-state and blue-state voters who are not inclined to renounce their differences.”) (citing Lydia Saad, \textit{In the U.S., Blue States Outnumber Red States, 20 to 12}, \textit{GALLUP} (Jan. 30, 2013), \textit{available at} \url{http://www.gallup.com/poll/160175/blue-states-outnumber-red-states.aspx}).
\end{itemize}
\end{footnotesize}
long-standing tradition of closing outlets on Sundays.\textsuperscript{29} Cathy also espoused his personal support for traditional marriage,\textsuperscript{30} a position advocated by Chick-fil-A’s charitable arm, the WinShape Foundation, which had for years given millions of dollars to organizations fighting same-sex marriage.\textsuperscript{31}

Reactions to the interview and the revelations about the WinShape Foundation’s financial contributions was swift. One group of opponents moved to stop construction of a Chick-fil-A location in California.\textsuperscript{32} Petitions began circulating at the University of Louisville and several other universities nationwide, requesting that the schools close existing Chick-fil-A restaurants on campus.\textsuperscript{33} The mayor of Boston wrote an open letter to Cathy, urging Chick-fil-A to abandon its plans to open a new franchise in that city.\textsuperscript{34} City officials in Chicago, New York, San Francisco, and Washington, D.C., also voiced their opposition to new Chick-fil-A restaurants in their cities.\textsuperscript{35} Even the late Jim Henson’s Muppets joined in the condemnation, withdrawing their support for the restaurant chain.\textsuperscript{36}

Supporters of Cathy’s political position quickly came to Chick-fil-A’s defense. Former Arkansas Governor Mike Huckabee publicly supported Cathy’s remarks and called for like-minded citizens to join him in holding

\textsuperscript{29} K. Allan Blume, ‘Guilty as Charged,’ Cathy Says of Chick-fil-A’s Stand on Biblical & Family Values, \textit{BAPTIST PRESS}, July 16, 2012 (“We know that it might not be popular with everyone, but thank the Lord, we live in a country where we can share our values and operate on biblical principles.”) (internal quotation marks omitted). Cathy’s statement should come as no surprise to franchisees, however, since Chick-fil-A makes no secret of the fact that it is a corporation that is guided by biblical principles and values. Emerson & Parnell, \textit{supra} note 10, at 363–64 (“Chick-fil-A presents itself as a Christian-based corporation. . . . The fact that Chick-fil-A President, Dan Cathy, expressed views opposing same-sex marriage should not have surprised any franchisee.”).

\textsuperscript{30} Blume, \textit{supra} note 29 (“We are very much supportive of the family—the biblical definition of the family unit. We are a family-owned business, a family-led business, and we are married to our first wives.”).

\textsuperscript{31} Kim Severson, Chick-fil-A Thrust Back Into Spotlight on Gay Rights, \textit{N.Y. TIMES}, July 25, 2012, at A13 (“Equality Matters, an online investigative organization dedicated to gay and lesbian issues, last year obtained tax records that showed that the company’s operators, its WinShape Foundation and the Cathy family had given millions of dollars to groups whose work includes defeating same-sex marriage initiatives and providing therapy intended to change people’s sexual orientation.”). It appears that much of the outrage generated by Cathy’s comments was a political tactic, however, since opponents have known for years that the WinShape Foundation was contributing millions of dollars to support groups opposing gay marriage and groups that provide therapy intended to change people’s sexual orientation. \textit{Id}. 

\textsuperscript{32} Jason Green, Opponents Can’t Stomach Chick-fil-A’s Plans in Mountain View, \textit{SAN JOSE MERCURY NEWS}, July 20, 2012.

\textsuperscript{33} Joseph Gerth, University of Louisville to weigh calls for Chick-fil-A shutdown over ‘traditional marriage’ remarks, \textit{COU RIER-J.}, July 28, 2012; Hal Dardick & Annemarie Mannion, Mayor Gets Local Chick-fil-A Invite; Franchise Owner Wants to Meet Amid Gay Marriage Controversy, \textit{CHICAGO TRIB.}, July 27, 2012, at C4 (“Petitions also seek to pressure colleges to evict Chick-fil-A restaurants from seven campuses across the nation, including the University of Illinois at Urbana-Champaign.”).

\textsuperscript{34} Andrew Ryan & Martine Powers, Menino Clarifies Chick-fil-A Stance; View the Same but Admits He Can’t Bar Chain from Boston, \textit{BOSTON GLOBE}, July 27, 2012, at B1.


\textsuperscript{36} Tony Hicks, Muppets Break Ties with Chick-fil-A Over Gay Marriage, \textit{SAN JOSE MERCURY NEWS}, July 23, 2012.

Chick-fil-A is based in Georgia, a reliably conservative state in the heart of the reliably conservative South, and the vast majority of Chick-fil-A’s restaurants are located in politically conservative regions. As a result, the company likely saw an increase in sales and, by extension, franchisee royalties, following Cathy’s interview, as supporters turned out in droves for the Huckabee-championed Chick-fil-A appreciation day. But the remaining minority of franchisees located in less politically conservative regions presumably suffered greatly as a result of the controversy and boycotts. On balance, while Chick-fil-A undoubtedly lost revenue from these outlets, the overall impact on the system was probably negligible due to the increase in sales at other locations. The fact that a franchisor such as Chick-fil-A suffers little injury is small comfort, however, to the franchisee that faces the potential loss of its business.

38. Bennett, supra note 35.
40. As of February 2015, Chick-fil-A boasted 1,141 outlets located in states that have voted for the Republican candidate in at least three out of the last four presidential elections (Idaho, Wyoming, Utah, Arizona, Nebraska, Kansas, Oklahoma, Texas, Missouri, Arkansas, Louisiana, Indiana, Kentucky, Tennessee, Mississippi, Alabama, Georgia, North Carolina, South Carolina, and West Virginia); approximately 313 outlets located in states that voted for the Democratic candidate in at least three out of the last four presidential elections (California, Connecticut, New Mexico, Minnesota, Iowa, Wisconsin, Illinois, Michigan, Pennsylvania, New York, New Hampshire, Massachusetts, New Jersey, Maryland, Delaware, and Rhode Island); and approximately 372 outlets in the four “purple” states that have voted for each party’s candidate twice (Colorado, Ohio, Virginia, and Florida). See http://www.chick-fil-a.com/Locations/Locator.
41. The Chick-fil-Á controversy is only one recent example of a franchisor that has become embroiled in a national debate as a result of the political activities of the franchisor and its representatives. Other examples abound. Liberal political activists protested and sponsored boycotts against franchisors such as Carl’s Junior, Domino’s Pizza, and Curves gyms, after the companies’ respective founders had donated substantial amounts of money to organizations opposing abortion. Lisa Mascaro, NOW Unit Pickets Carl’s Jr. in Irvine on Abortion Issue, L.A. TIMES, Oct. 29, 1989, at B3; Paul Feldman, Pro-Choice Unit Targets Food Outlet, L.A. TIMES, Aug. 31, 1989, at 3; Renee Graham, The Issue for NOW, BOSTON GLOBE, May 6, 1989, at 17; Elaine Mc Ardle, Sweating With the Enemy, BOSTON GLOBE, June 19, 2005, at 18 (“Activists at the March for Women’s Lives, an April 2004 rally in Washington, D.C., in support of abortion rights, handed out fliers calling for a national boycott of Curves. That summer at Curves gyms in Berkeley, California, signs and banners were knocked over or stolen, and in Seattle, anti-Curves fliers were posted on telephone poles.”); Susan Paynter, Curves News Gives Women’s Choices a Workout, SEATTLE POST-INTELLIGENCER, June 28, 2004, at D1. Similarly, conservative activists have called for boycotts of the Ford Motor Company to protest the company’s support for gay rights and advertisements in gay-themed publications. Christine Tierney, Group Backs Off Boycott of Ford; American Family Association, Irked by Support of Gay Issues, Will Meet With Execs, DETROIT NEWS, June 7, 2005, at 1C; David Shepardson, Gay Ads Spur Ford Boycott; Conservative Coalition Says Automaker Reneged on Agreement to Stop Ads in Alternative Media, DETROIT NEWS, Mar. 14,
In short, franchisor political activities can have potentially serious consequences for franchisees and the brand.42 Although these problems are not new, the Court’s decision in Citizens United has drawn an unprecedented level of attention to political speech. In these days of extreme partisanship,43 incidents with franchisors becoming involved in national political controversies will undoubtedly increase in frequency. Franchisees will demand accountability, if not compensation, when the controversies start affecting their bottom line. Given the movement toward increased transparency and disclosure of political contributions in securities regulations, it is not surprising that there are now calls for changes to existing disclosure rules to require franchisors to disclose information about their political activities to prospective franchisees.44 But even though franchise disclosure laws evolved out of existing securities disclosure laws,45 the logic supporting enhanced disclosures in securities laws does not extend to disclosures in the franchise context.

42. Emerson & Parnell, supra note 10, at 354 (“[P]olitical or social commentary can be very costly for both franchisors and franchisees insofar as it impacts how consumers view the franchised trademark or brand.”).
43. “As a number of studies have concluded, political parties today are far more ideologically unified and cohesive than they were in the past.” Yasin Dawood, Democratic Dysfunction and Constitutional Design, 94 B.U. L. REV. 913, 919 (2014) (citing Thomas E. Mann & Norman J. Ornstein, It’s Even Worse Than It Looks: How the American Constitutional System Collided With the New Politics of Extremism 44–45 (2012)).
44. See, e.g., Emerson & Parnell, supra note 10, at 386–87 (“[T]o ensure transparency, the safest course is to reform the disclosure rule . . . by mandating notification to franchise applicants about any franchisor policy, or lack thereof, concerning a corporate employee’s or a franchisee’s prominent, public display of partisan beliefs while associated with the franchised brand.”).
45. David J. Kaufmann & David W. Oppenheim, Selected Business and Legal Issues in the Acquisition of Franchisors or Franchisees, 23 FRANCHISE L.J. 141, 148 (2004) (“Federal and state franchise registration/disclosure laws had their genesis in, and were modeled after, the federal securities laws. Courts determining franchise disclosure disputes or construing the provisions of franchise registration/disclosure statutes frequently cite and rely upon their securities law analogs.”); see Rochelle B. Spandorf, Charting Courses in the Debate Over Mandatory Earnings Claims, 15 FRANCHISE L.J. 1, 36 (1995) (“[G]iven the common policy objectives of franchise and securities regulations, franchise regulators may be criticized if they fail to address the fact that forward-looking disclosures have been demanded from securities issuers for almost twenty years.”).
III. Franchises Are Not Like Securities

Although the regulation of franchise sales was originally based on prior securities laws, the two legal areas have evolved distinctly different standards and requirements. In terms of disclosure of political activities, at least two key differences between securities law and franchise law weigh against requiring such disclosures in franchise sales.

First, one of the primary arguments in favor of requiring disclosure of political activities in securities regulation is that it will provide existing public shareholders with the information that they need to make reasoned decisions in the context of a corporate democracy. But franchises, unlike corporations, are not a democracy, and as such disclosure will not further the same purposes. Second, as a more fundamental matter, the SEC’s authority to regulate securities is far broader than the Federal Trade Commission’s (FTC) authority to regulate franchises.

A. Franchises Are Not a Democracy

Government-imposed disclosure requirements in the securities context pass constitutional muster to the extent that they are narrowly tailored to further the government’s compelling interest in affording shareholders of public corporations access to information that is relevant to their ability to make reasoned decisions in a corporate democracy. This is consistent with one of the main purposes of securities regulations, which are “intended to keep the markets and the investing public informed of the status of a company from quarter to quarter, to enable investors to make decisions about selling securities as well as buying.” But in the context of franchising, the argument makes no sense, because unlike in a corporate democracy, where the shareholders have the ultimate say in how the business conducts itself, franchisees do not have a vote in how the franchisor chooses to run its business. Put simply, “[a] franchise system is not a democracy.”

“[A] franchise is and should be a dictatorship when it comes to overall system direction, including system change. This means that the decision of the franchisor should not be subject to review by a judge, jury, or arbitrator—or franchisee for that matter.” The franchisor’s freedom to control the franchise system is fundamental to the protection of its trademark rights, as well as the franchisor’s ability to innovate over time. Franchisors therefore...
“must be free to take all varieties of risks without a concern that the wisdom of its decision might be second-guessed in a courtroom.”

Moreover, franchisees, unlike shareholders, are locked into long-term contractual arrangements that preclude them from terminating their relationship with the franchisor. They therefore cannot “vote with their feet” by selling their franchise in the same way that an investor may simply sell company stock if it becomes dissatisfied with the manner in which the corporation conducts itself politically. Accordingly, to the extent that franchisees desire ongoing disclosures of franchisor political activities, franchisees simply do not have the same interests as a shareholder in a corporation.

B. FTC Regulatory Authority Is Much Narrower Than SEC Regulatory Authority

Although franchisees do not have the same interests as shareholders in receiving regular updates about franchisors’ political activities, the same cannot be said for prospective franchisees. Much like an investor contemplating purchasing a stock, a prospective franchisee has an interest in receiving information that may be material to its decision to purchase a franchise.

Under the Securities Exchange Act of 1934, the SEC is granted broad authority to regulate securities. Thus, the SEC’s regulation of securities includes disclosure requirements for the benefit of prospective investors who are interested in purchasing stock, existing shareholders so that they may make an informed decision in a corporate democracy or whether to sell their stock altogether, and the general public. The broad scope of the SEC’s regulatory mandate gives the agency virtually unlimited power to change disclosure requirements. Thus, the SEC may modify and extend disclosure requirements simply in response to increased investor interest in receiving a particular type of information, even in the absence of any evidence tending to show that investors have been (or might be) injured in the absence of greater disclosure.
Conversely, the FTC’s regulatory authority is currently limited to addressing the imbalance of information that exists between a franchisor and prospective franchisees before the sale of a franchise. The presale disclosures that are currently required by the FTC’s Disclosure Requirements and Prohibitions Concerning Franchising (Franchise Rule) are further limited “to those areas in which the Commission has found there to be misrepresentations and nondisclosure of information.” This limitation exists because under the Federal Trade Commission Act, the FTC cannot impose new obligations on a franchisor without evidence of specific unfair acts or practices. Thus, unlike the SEC, the FTC is statutorily constrained in its authority to impose regulations only if there is a demonstrated need for additional disclosure obligations to counteract an actual and prevalent pattern of unfair acts or practices. As discussed in more detail below, to the limited extent that securities and franchise regulations share a common purpose of providing relevant information to prospective purchasers, there are insufficient grounds to warrant amending the Franchise Rule.

IV. FTC’s Criteria for Modifying Existing Disclosure Requirements Are Not Satisfied

To impose new limitations on franchisors, the FTC would require evidence demonstrating widespread misconduct that 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.” When the FTC amended the Franchise Rule in 2007,
it applied this standard when considering calls to include, among other things, provisions addressing post-sale relationship issues. Specifically, the FTC noted that

[with regard to the first prerequisite, substantial injury, the record shows that some franchisees in several franchise systems have suffered post-sale harm in the course of operating their franchises, and in some instances this injury may be ascribable to acts or practices of a franchisor. The record, however, leaves open the related questions of whether such franchisor acts or practices are prevalent and whether the injury resulting from acts or practices is substantial, when viewed from the standpoint of the franchising industry as a whole, not from just a particular franchise system.]

Having found that there was no evidence that injuries to franchisees arising out of post-sale misconduct are prevalent in the industry, the FTC declined to impose any post-sale disclosure or other obligations on franchisors.

Because the FTC has not yet addressed the potential implications of disclosures relating to political activities since the Supreme Court’s decision in Citizens United, the question now is whether there is sufficient evidence to suggest that franchisor political activities have caused substantial injury to franchisees and that such injuries are prevalent in the franchise industry. There does not appear to be clear evidence that shows either component.

For example, there does not appear to be any evidence to suggest that franchisees are suffering substantial injuries as a result of the political activities of their franchisor. It also does not appear that the reputational damage associated with any recent political controversies has a permanent or even long-term effect on the value and stability of any brand. Although, in the short term, an economic boycott of franchised businesses may cause some injury to franchisees, the same can be said for nonpolitical controversies that result in the ordinary course of business. The mere fact that a franchisor happens to makes a poor business decision that affects the

65. Id.
66. Id.; see also id. at 15447 n.43 (“There are many factors that influence the success or failure of a franchisee, including downturns in the economy, shifting consumer preferences, or even franchisees’ own conduct. Accordingly, franchisor conduct post-sale may be only one factor that leads to injury to franchisees. The record is inconclusive, with respect to franchising overall, as to whether franchisor acts or practices are a direct and primary cause of poor performance or failure by franchisees.”).
67. Id.
68. Marzilli, supra note 23 (noting that Denny’s reputation score had recovered following statements made by large franchisee); see also Ted Marzilli, Chick-Fil-A Staging Comeback After July Remarks, YOGOV (Oct. 1, 2012) http://www.brandindex.com/article/chick-fil-staging-comeback-after-july-remarks.
69. For example, in 2014, the Chili’s restaurant chain was embroiled in controversy when it implemented a national fund-raising drive to support the National Autism Association, a non-profit organization that has been roundly criticized for claiming that autism is caused by vaccinations. Associated Press, Chili’s Nixes Autism Event After Backlash, CHICAGO SUN-TIMES, Apr. 8, 2014, News at 14 (“Chili’s has canceled a fundraiser for a group that says that autism can be triggered by vaccinations, a position widely discredited by the medical community.”).
brand or results in an economic boycott should not give rise to a claim by a franchisee.70

There also is no evidence to suggest that controversial political speech by franchisors is prevalent in the industry. Although a handful of anecdotal examples demonstrate the potential negative consequences of franchisor’s political activities,71 they are by no means specific to the franchise industry. Moreover, most of the examples involve statements and positions taken personally by the franchisor’s founder and do not appear to reflect the franchisor’s official policy.72 As a result, any injury suffered by a franchisee is not always traceable to the franchisor.73 In light of the absence of the type of compelling evidence that is a prerequisite to amending the Franchise Rule, any calls for such amendments are at best premature.74

70. If anything, it is just as likely that the franchisee will be guilty of tarnishing the brand by becoming involved in political controversies as it is for the franchisor. For example, consumer opinions about the reputation of the Denny’s restaurant chain experienced a similar dip following statements made by a large franchisee about the impact that the ACA would have on the operation of its businesses. Emerson & Parnell, supra note 10, at 374 (“In the wake of Metz’s comments, Denny’s saw a loss of brand value and sales even though Denny’s Corporation attempted to distance itself as much as possible from Metz.”).

71. See sources cited, supra notes 23–25, 29–41.


73. Some may argue that franchisors should be obligated to disclose the political activities of their owners and corporate officers. Such disclosures would not be unprecedented; the current Franchise Rule requires disclosures relating to the franchisor’s principals. 16 C.F.R. § 436.5(b) (requiring disclosure of business experience of franchisor’s directors, trustees, corporate officers, general partners, and individuals with management responsibilities); id. § 436.5(c) (requiring disclosure of litigation history and criminal convictions, if any, of franchisor’s principals); id. § 436.5(d) (requiring disclosure of bankruptcies by franchisor’s principals). But requiring franchisors to disclose the political activities of individuals involved in the management or operation of the franchisor may ultimately be unconstitutional if applied. The Supreme Court has been extremely skeptical of regulations that impose disclosure obligations relating to individuals because they can constitute “an unconstitutional burden since it not only infringes on one’s right to privacy and results in the chilling of speech, but it also triggers acts of retaliation or harassment by those of different ideological or political persuasions.” Dashev, supra note 26, at 214; see also John Doe No. 1 v. Reed, 561 U.S. 186, 201 (2010) (noting that disclosure “would be unconstitutional as applied to an organization if there were a reasonable probability that the group’s members would face threats, harassment, or reprisals if their names were disclosed.”) (internal quotation marks and citations omitted).

74. Although beyond the scope of this article, in addition to the FTC, it is also possible that some states will consider imposing new disclosure obligations on franchisors in addition to those set forth in the Franchise Rule. But it is unlikely that states will do this, given that most defer to the North American Securities Administrators Association (NASAA) in order to improve uniformity and consistency of disclosure requirements. George Lee Flint, Jr., Securities Regulation, 62 SMU L. REV. 1435, 1440 (2009) (“NASAA intends to have many states adopt their guidelines to achieve national uniformity in forms as well as consistency in standards to facilitate nationwide registration.”). Some franchisees might also argue that existing state statutory antifraud laws already require franchisors to disclose the information on the grounds that franchisors have an affirmative duty to disclose all material facts. See, e.g., Abbo v. Wireless Toyz Franchise, LLC, No. 304185, 2014 WL 1978185, at *8 (Mich. Ct. App. May 13, 2014) (holding that the franchisor had “a legal duty to accurately disclose material information concerning the Wireless Toyz franchise”). But that argument is premised on the belief that franchisors have an affirmative duty to disclose information beyond what is required by the Franchise Rule, which is inconsistent with the typical franchise arrangement. Papa John’s Int’l, Inc. v. Dynamic Pizza, Inc., 317 F. Supp. 2d
V. Conclusion

Franchisors already bear the substantial expense of complying with the disclosure requirements in the Franchise Rule.75 The FTC’s reluctance to impose new disclosure obligations in the absence of compelling need is in part an acknowledgment of the significance of those burdens.76 Moreover, while the expense of additional disclosure obligations is substantial, the threat posed by inaction is steadily declining. The current trend among companies, particularly large public companies, appears to be moving toward the voluntary disclosure of political activities, including the imposition of express limitations on political expenditures.77 In a 2012 study,

[the Center for Political Accountability found that nearly sixty percent of leading Fortune 500 companies either disclose their corporate political contributions or have adopted policies refraining from making such donations.78

“Despite the fierce attack on public disclosure policies over the past year, companies continue to adopt disclosure, and it’s going along at a very steady pace . . .”79 The trend includes some prominent franchisors.80 As a result, to

740, 749 (W.D. Ky. 2004) (holding that “[m]any courts hold that a franchisor-franchisee relationship does not give rise to [an affirmative disclosure] duty because [the relationship] is not fiduciary in nature”). The topic is sufficiently broad and debatable, however, to merit its own article.

75. James R. Sims III & Mary Beth Trice, The Inadvertent Franchise and How to Safeguard Against It, 18 FRANCHISE L.J. 54, 54 (1998) (“The process and cost of obtaining audited financial statements, preparing a disclosure document, registering it with appropriate state officials, keeping that document up to date, and ensuring that franchise sales representatives always provide prospective franchisees with the right disclosure package at the right time represent administrative or financial obstacles to quick expansion.”).

76. See, e.g., Disclosure Requirements and Prohibitions Concerning Franchising, 72 Fed. Reg. 15444, 15452–53 (Mar. 30, 2007) (noting that the FTC took all steps to reduce compliance costs when adopting the 2007 amendments to the Franchise Rule, including by refusing to add more disclosure obligations).

77. “[T]hree-fifths of the [100] largest publicly traded companies in the United States[] disclose their direct corporate political spending and have adopted board oversight, or they prohibit spending corporate cash on politics.” Center for Political Accountability, The CPA-Zicklin Index of Corporate Political Accountability and Disclosures, at 5 (2011) (footnote omitted).


79. Eggen, supra note 13, at A15.

80. For example, two of the largest publicly traded franchisors, Yum! Brands, Inc. and the McDonald’s Corporation have adopted company policies requiring disclosure of political contributions. See Yum! Brands, Inc. Political Contributions & U.S. Government Advocacy Policy at 3 (“Any approved corporate political contribution in excess of $150 per year is voluntarily disclosed on an annual basis on the Company’s website.”), available at http://www.yum.com/investors/governance/media/YumPoliticalExpenditurePolicy.pdf; see also McDonald’s Corporation Political Contribution Policy at 3 (“[O]n a semi-annual basis, McDonald’s Corporation will publish the corporate Political Contributions made in the United States pursuant to this Policy. . . .”) available at http://www.aboutmcdonalds.com/content/dam/AboutMcDonalds/Investors/Investor%202014/Political_Contribution_Policy_January_27_2011.pdf.
the extent that a risk remains that franchisees will be injured by the absence of disclosure requirements, that threat is steadily diminishing.

Although political controversies resulting from the activities of the franchisor or one of its principals undoubtedly pose potential problems for franchisees, the solution to those problems is not more disclosure. To impose new disclosure requirements without compelling evidence of harm is precisely the type of knee-jerk reaction that leads to bad policy. Accordingly, the FTC should not even consider imposing additional disclosure obligations on franchisors.
The Legal Relevance of Bargaining Power in U.S. and Canadian Franchise Litigation: A Comparative Perspective North and South of the Border

Adam Ship and Danny McMullen

The paradigm of a “typical” franchise transaction involves a single franchised unit, granted to a relatively unsophisticated franchisee, using the franchisor’s system-uniform franchise agreement without negotiation.1 The common use of system-uniform franchise agreements by franchisors is widely accepted as a necessary requirement of a properly functioning franchise network, facilitating the franchisor’s management and administration of the system and providing for equal treatment

1. See, e.g., Gillian Hadfield, Problematic Relations: Franchising and the Law of Incomplete Contracts, 42 Stan. L. Rev. 927, 961 (1990) (“... the refusal of the franchisor to negotiate—the superior position of the franchisor—is a hallmark of the relationship”); Elizabeth C. Spencer, Consequences of the Interaction of Standard Form and Relational Contracting in Franchising, 29 Franchise L.J. 31, 32 (2009) (“widely accepted within the sector that franchise contracts are not negotiated. Some minor adjustments may be countenanced ...”); Peter C. Lagarias & Edward Kushell, Fair Franchise Agreements from the Franchisee Perspective, 33 Franchise L.J. 3, 6 (2013) (“[m]any franchisors simply do not negotiate franchise agreements. Even in the minority of franchise systems where negotiation occurs, franchisors typically negotiate only a few provisions with limited changes.”); Harold Brown, J. Michael Dady, Jeffer S. Haff & Ronald K. Gardner, Franchising Realities and Remedies § 1.03[4] (2004) (“the franchisor often tells the franchisee, [w]e won’t negotiate any terms. . . . As a result, the franchisee is badly uninformed and will sign anything put in front of him or her by the franchisor without really understanding the documents.”); Kevin Adler, Negotiating Franchise Contracts, franchising Bus. & Law Alert (July 2013) (describing franchisor’s “take-it-or-leave-it attitude about their form contract”); David N. Kornhauser & Michael A. Kleinman, Franchisee Associations in Canada 91 (2011). (“Franchisees rarely have the opportunity to negotiate the terms of franchise agreements.”).
of franchisees. Nevertheless, franchisors’ “take it or leave it” approach to typical franchise transactions has led a number of appellate courts in the United States and Canada to characterize franchise agreements as contracts of adhesion in certain circumstances, with attendant legal implications for the franchisor in the underlying litigation. Although it is an open question as to whether the adhesive characterization in these cases is persuasive, the existing jurisprudence makes this a live issue, warranting special consideration.

In particular, franchise transactions are increasingly falling outside the typical paradigm of a “take it or leave it” negotiation, and the usual justifications supporting characterizing a franchise agreement as adhesive break down in those circumstances. In the United States, franchise transactions in recent years have increasingly involved economically sophisticated franchisees, either private equity investors or wealthy individuals, who will not simply sign the standard form agreement. In addition, negotiation over material business terms is commonplace where the underlying transaction covers multiple units, large exclusive territories, and/or the franchisee’s ability to subfranchise. Further, as many franchise lawyers know, franchisors early in their business lifecycles are much more likely to entertain amendments to their standard form agreements to help establish an initial network of franchisees. In all of these circumstances, the franchisee is much more

2. See, e.g., Ernst Braun, Policy Issues of Franchising, 14 SW. L. REV. 155 (1984) (“[B]argaining freedom . . . appears to be incompatible with maintenance of a franchise system”), cited in James Jordan & Judith Gitterman, Franchise Agreements: Contracts of Adhesion?, 16 FRANCHISE L.J. 14, 42, 45 (1996) (“. . . franchisees benefit from standardization” which is “. . . essential in a franchising system”); Adler, supra note 1 (“Uniform contracts ease management of brand identity, enable franchisors to change the system in a lock-step fashion when necessary, simplify contract administration, provide equal treatment of all franchisees, and can be written to minimize the risk of adverse outcomes in litigation.”); KORNHAUSER & KLEINMAN, supra note 1, at 91 (“Uniformity and consistency of operations is a primary goal.”).

3. See cases cited in infra notes 17 and 18 and accompanying text.

4. See cases cited in infra notes 43 and 44 and accompanying text.

5. See, e.g., Jordan & Gitterman, supra note 2, at 41 (franchising is a “far cry from the circumstances of a true contract of adhesion”); Carmen Caruso, Bethany Appleby & Griffith Towle, Unconscionability and Franchise Litigation, ABA FORUM ON FRANCHISING (2006); Braun, supra note 2, at 244; see also, e.g., Shaffer v. Graybill, 68 F.App’x 374, 377 (3d Cir. 2003).

6. Adler, supra note 1 (“. . . private investment groups and wealthy, experienced business owners have showed increased interest in purchasing franchisees”); BROWN ET AL., supra note 1, §§ 1.03[4], 1-28.5; Caruso et al., supra note 5 (“. . . growing phenomenon of the economically sophisticated franchisee . . .”), citing John Bear et al., Franchising: Distribution Model for the Millennium?, ABA FORUM ON FRANCHISING § 1-4, at 26 (1999).

7. Ronald Gardner, Anne Hurwitz, Francesca Turitto & Larry Weinberg, Key Issues When Advising Master Franchisees and Area Developers (and Franchisors), 11:3 INT’L J. OF FRANCHISING LAW 15 (2013) (“Many master franchisees and area developers are often better capitalized than the franchisor and often represent multiple brands, thus possibly changing the negotiating dynamics”); Frank Zaid, International Franchise Agreements: Research, Risk and Reward, 2:5 INT’L J. OF FRANCHISING L. 6 (2004) (“It is also essential that the franchisor [expanding internationally] understands that virtually all of the terms contained in its current form of domestic franchise agreement will be open to negotiation . . .”); Adler, supra note 1 (discussing “private equity investors . . . seeking to operate many franchise outlets or to control large, exclusive territories . . . [and] individual owner-operates [with] extensive . . . experience [and] management team[s] to operate additional outlets”).
likely to exercise meaningful bargaining power in franchise agreement negotiation because of its economic sophistication relative to the franchisor, the size and scope of the underlying transaction, or both. Although precise statistics as to the prevalence of atypical franchise transactions are difficult to find, at least one source reports that over half of franchised units in the United States are owned by multiunit franchisees.⁸

In other circumstances, although individual franchisees may sign the standard form franchise agreement without negotiating the underlying terms, the franchisor previously elected to engage in meaningful contract negotiations with a representative group of franchisees, i.e., franchisee associations.⁹ Although the overall prevalence of strong franchisee associations may be statistically low,¹⁰ their participation in certain negotiations over franchise agreement terms appears inconsistent with the notion that these particular contracts are adhesive.¹¹ Franchisors may be more willing to negotiate with franchisee associations if the law were prepared to recognize the reality that, in those circumstances, the resulting agreement is anything but adhesive.¹² Recent Quebec case law does precisely this and provides a persuasive framework for other courts to consider when this issue confronts them.¹³

The purpose of this article is to investigate the circumstances in which courts in the United States and Canada have been inclined to characterize franchise agreements as negotiated commercial contracts, rather than as contracts

---

11. See KORNHAUSER & KLEINMAN, supra note 1, at 93–94 (“. . . the leverage [a strong association] enjoys enhances its ability to . . . effect changes to the system”).
12. No positive obligation on franchisors to negotiate with franchisee associations has been recognized by courts in Canada. However, in the five Canadian provinces that have franchise legislation (Ontario, Alberta, Manitoba, New Brunswick, and Prince Edward Island), franchisors are statutorily prohibited from interfering with the right of franchisees to associate with one another: Ontario: Arthur Wishart Act (Franchise Disclosure), 2000, S.O. 2000, c. 3, s. 4 (Can.); Alberta: Franchises Act, R.S.A. 2000, c. F-23, s. 8 (Can.); Manitoba: The Franchises Act, C.C.S.M. c. F156, s. 4 (Can.); New Brunswick: Franchises Act, S.N.B. 2007, s. 4, c. F-23.5 (Can.); Prince Edward Island: Franchises Act, R.S.P.E.I. 1988, c. F-14.1 (Can.).
13. See cases cited at infra note 69 and accompanying text. Quebec is the only Canadian province with a civil (rather than common) law tradition. Moreover, there is no franchise-specific legislation in force in Quebec.
of adhesion, in order to delineate the types of evidence and factors to which franchisors can point to resist the adhesive label in franchise litigation. Rather than enter the current debate as to whether the “take it or leave it” approach found in the typical franchise transaction properly supports the adhesive label, this article reviews the existing case law where courts on both sides of the border have rejected the adhesive characterization, providing an evidentiary framework for future cases. Although not U.S. lawyers, the authors focused on this discrete area of U.S. franchise litigation because the underlying legal principles are substantially similar to those applied in Canada. As described below, the applicable case law in both countries provides a useful evidentiary framework for U.S. and Canadian franchise litigators who face this issue in their practice.

This article is structured into three parts. The first part canvasses the U.S. case law in which franchise agreements have been labelled as adhesive and distills the key legal consequences that have flowed from the label. The second part provides a parallel analysis of similar Canadian case law, including that in Quebec. Finally, the article analyzes cases in both jurisdictions where courts have rejected the adhesive label and identifies the key evidentiary factors that motivated their analyses. The article concludes with a suggested framework for use in subsequent cases.

I. Consequences of Characterizing a Franchise Agreement as Adhesive in the United States

In the United States, the general law of contracts recognizes, through the concept “contract of adhesion,” that certain types of agreements may contain standard-form language imposed by the party with superior bargaining strength. Although the phrase “contract of adhesion” finds its genesis in French civil law, it was first incorporated into the U.S. legal vocabulary through an influential law review article on insurance policies published in 1919.14 The concept is now referred to in leading U.S. treatises on contract law, specifically in relation to the interpretive doctrine, contra proferentem, under which drafting ambiguities are resolved against the drafter.15 A contract is considered adhesive where there is a significant inequality of bargaining power between the contracting parties, such that the stronger party im-

14. This was recognized in Jordan & Gitterman, supra note 2, at 15, citing Edwin W. Patterson, The Delivery of a Life Insurance Policy, 33:2 HARV. L. REV. 198, 222 (1919); see also Michael Furmston, Cheshire, Ffoot & Furmond’s Law of Contract 27 (16th ed. 2012) (“The French, though not the English, . . . have a name for it[:] contract d’adhesion”).
15. WILLISTON ON CONTRACTS § 32:12 (4th ed.) (“Any contract of adhesion, which is a contract entered into without any meaningful negotiation by a party with inferior bargaining power, is particularly susceptible to the rule that ambiguities will be construed against the drafter.”); E. ALLAN FARNWORTH, 2 FARNWORTH ON CONTRACTS § 7:11, at 5 (3d ed.) (“Interpretation of contra proferentem is much favored in the context of standard form contracts, particularly if adhesive” [emphasis added]).
poses the terms and conditions on the weaker party, effectively on a “take it or leave it” basis.\(^\text{16}\)

A number of federal\(^\text{17}\) and state\(^\text{18}\) appellate courts have recognized that franchise agreements may contain the hallmarks of adhesiveness in the sense that they are not subject to meaningful negotiation but instead are imposed by the franchisor on a “take it or leave it” basis. Although U.S. courts are hardly unanimous in this view,\(^\text{19}\) there is sufficient precedent to make this a live issue, the implications of which warrant special consideration. A finding that a particular franchise agreement is adhesive has at least four potential consequences in U.S. franchise litigation:

First, as noted, leading treatises on contract law have recognized that contra proferentem has wider application to contracts of adhesion than to fully negotiated agreements,\(^\text{20}\) likely on the basis that it is easier to identify the drafter of adhesive contracts and thus the party against whom interpretive ambiguities are to be resolved. Indeed, a number of appellate courts have suggested that contra proferentem may apply more strictly to adhesive contracts. In \textit{Abbott v. Amoco Oil Co.}, a nonfranchise case, the Appellate Court of Illinois held that “generally, burdensome clauses in adhesion contracts should be construed against the more powerful party.”\(^\text{21}\) Similarly, in \textit{Semmes Motors v. Ford Motor Co.}, the Second Circuit held that contra proferentem “applies with particular force in cases of standardized contracts and in
cases where the drafting party has the stronger bargaining position.”22 A number of federal and state appellate courts have refused to apply contra proferentem in the insurance context where the insurance policy was not adhesive, i.e., where the insured played a meaningful role in the negotiations.23 Insurance cases may be relevant insofar as they delineate the types of evidence that may persuade a court to reject the adhesive label.

Second, the fact that a contract is adhesive will be relevant, although not dispositive,24 to the court’s analysis of unconscionability, if that issue is raised by the franchisee. For example, in Nagrampa v. Mailcoups Inc., the Ninth Circuit held that the adhesive nature of the franchise agreement effectively satisfied the procedural unconscionability prong of the two-part test for unconscionability under California law.25 The Third Circuit made a similar finding outside the franchise context in Alexander v. Anthony International, L.P., applying Virgin Islands law,26 and the Ninth Circuit did likewise in the franchise case, Ticknor v. Choice Hotels, applying Montana law.27 While there may be persuasive reasons to disagree with this analysis28 and the precise contours of the test for unconscionability vary among U.S. states,29 this case law nonetheless suggests that factual findings supporting the adhesive characterization may be relevant to the unconscionability analysis.30

22. 429 F.2d 1197, 1206–07 (2d Cir. 1970) [internal quotations omitted]. See also Victoria v. Super. Ct., 710 P.2d 833, 837 (Cal. 1985) (the adhesive nature of a contractual clause would support a “stricter construction” of ambiguities “against the party with the stronger bargaining position”).

23. See Barbara O’Donnell, Law and Practice of Insurance Coverage Litigation § 1:12 (June 2014) (available at Westlaw LPINLIT) (“Other courts strive for a middle ground by denying large, commercial insureds the benefits of contra proferentem only where the evidence establishes that they in fact . . . played some role in negotiating . . .”).

24. Caruso et al., supra note 5 (“rarely . . . sufficient to establish unconscionability”); Jordan & Gitterman, supra note 2, at 44–45 (discussing several cases that make this point clear).

25. 469 F.3d 1257, 1281–85 (9th Cir. 2009) (finding that procedural unconscionability was satisfied on the basis that “[franchise] had overwhelming bargaining power, drafted the contract, and presented it to [franchisee] on a take-it-or-leave-it basis”; see also Bridge Fund Capital Corp. v. Fastbucks Franchise Corp., 622 F.3d 996, 1004 (9th Cir. 2010) (finding that an absence of negotiation and inequality of bargaining power per se satisfy the procedural unconscionability prong); Bolter v. Super. Ct., 104 Cal. Rptr. 2d 888, 893 (Cal. Ct. App. 2001) (finding that the adhesive nature of a contract per se satisfies the procedural prong of the two-prong analysis of unconscionability).

26. 341 F.3d 256, 265, 270 (3d Cir. 2003) (finding that procedural unconscionability “is generally satisfied if the agreement constitutes a contract of adhesion”).

27. Ticknor v. Choice Hotels Int’l, Inc., 265 F.3d 931, 939–40 (9th Cir. 2001) (finding that a franchise agreement was adhesive on the basis that it was a “standardized, form agreement that [the franchisee] was forced to accept or reject without negotiation”).

28. Caruso et al., supra note 5 (emphasizing the mandatory delivery of a presale Franchise Disclosure Document as negating the “surprise” element typically present with adhesive contracts and procedural unconscionability); Jordan & Gitterman, supra note 2, at 41 (listing several factors that distinguish franchise agreements from typical contracts of adhesion).


30. Williston on Contracts, supra note 15, § 18:10 (citations suggesting that many U.S. state and federal courts analyze procedural unconscionability by considering facts that would also be relevant to whether the contract is adhesive).
Third, in certain contexts, the bargaining position between the parties at the time of contract formation may be relevant to jurisdictional challenges based on public law grounds. In *Kubis & Perszyk Associates Inc. v. Sun Microsystems*, the New Jersey Supreme Court held that forum selection clauses in franchise agreements were presumptively unenforceable as contrary to public policy, unless the franchisor could offer “evidence of specific negotiations over the inclusion of the . . . clause . . . in exchange for specific concessions to the franchisee . . . [or] proof . . . that the . . . clause was not imposed on the franchisee against its will.” 31 In *Burger King Corp. v. Rudzewicz*, the U.S. Supreme Court considered whether Florida’s arm’s-length jurisdiction statute violated the due process rights of Michigan franchisees, citing with approval lower court findings to the effect that the franchisee meaningfully negotiated the agreement and thus had fair notice of Florida jurisdiction. 32 Other cases to similar effect have been analyzed elsewhere. 33

Fourth, a finding that a franchise agreement is adhesive may lead the court to apply a stricter level of scrutiny to any restrictive covenants found in the agreement, using the same analysis usually reserved for employment agreements. In *Watson v. Waffle House*, the Georgia Supreme Court held that a franchise relationship was analogous to an employment agreement for purposes of determining the level of judicial scrutiny to apply to a disputed restrictive covenant. 34 The court recognized that the case law dealing with the enforceability of restrictive covenants usually arises in the context of the sale of a business on the one hand, or cases involving employment relationships on the other. Since the level of judicial scrutiny—and thus the legal test for enforceability—was stricter in the employment context, the court needed to determine which test to apply to the franchise relationship in *Watson*. According to the court,

the rationale behind the [differential scrutiny] . . . is that a contract of employment . . . is often a contract of adhesion . . . [while] a contract for the sale of a business interest is far more likely [between] . . . parties on equal footing. 35

---


32. 471 U.S. 462, 485 (1985) (“[franchisee] was represented by counsel throughout . . . [the] transactions and . . . conducted negotiations with [franchisor] over the terms of the franchise and lease agreements and . . . [was] able to secure a modest reduction in rent and other concessions . . .”).

33. See Jordan & Gitterman, supra note 2, at 16, 41–42 (fuller discussion of similar cases as well as the lower court decisions in *Burger King*).

34. *Watson v. Waffle House, Inc.*, 324 S.E.2d 175, 177 (Ga. 1985) (“A lease agreement which bears the characteristics of a franchise creates a relationship in which the lessor possesses substantially superior bargaining power. It is for this reason that we adhere to our previous rule that such an agreement is analogous to an employment contract for purposes of analyzing the covenant not to compete”); *Atl. Bread Co. v. Lupton Smith*, 679 S.E.2d 722, 724 (Ga. 2009).

According to the court, since a franchise relationship is characterized by the “substantially superior bargaining power” of the franchisor, it is analogous to an employment contact “for purposes of analyzing the covenant not to compete.”

While this may be a minority and declining approach, it has been followed in part by the Washington Court of Appeal, the Pennsylvania Supreme Court, and the Kansas Supreme Court.

Given these legal consequences that potentially flow from a finding that a franchise agreement is adhesive, it is important to consider the types of evidence that could defend such a characterization.

II. Consequences of Characterizing a Franchise Agreement as Adhesive in Canada

In Canada’s common law provinces (all but Quebec), the concept of contracts of adhesion developed most clearly in insurance litigation, with the Supreme Court of Canada and other appellate courts recognizing early on that such agreements were often imposed by the insurer on a “take it or leave it basis” and interpreting them contra proferentem. As in the United States, leading Canadian treatises on contract law recognize that contracts of adhesion are more likely to be subject to interpretation contra proferentem, likely because in such contexts the drafter is easy to identify. The Canadian common law approach has been influenced by English case law under which contra proferentem continues to resolve ambiguities against the drafter of the contract.

---

36. Id.

37. Peter J. Klarfeld & Mark S. VanderBroek, Law on Covenants Against Competition Shifts Towards Greater Enforceability by Franchisors, 31 FRANCHISE L.J. 76, 77 (2011) (“In recent years . . . courts increasingly have analogized covenants in franchise agreements to covenants in agreements for the sale of a business or have created a test for enforceability that is specific and favorable to franchising.”).

38. Armstrong v. Taco Time Int’l, 635 P.2d 1114, 1117 (Wash. Ct. App. 1981) (“Courts agree a franchise agreement is akin to an employment contract” for purposes of restrictive covenants); Piercing Pagoda, Inc. v. Hoffner, 351 A.2d 207, 211–12 (Pa. 1976) (finding that the policy considerations underlying strict scrutiny of restrictive covenants in employment contracts are “equally important” to franchise agreements); H&R Block, Inc. v. Lovelace, 493 P.2d 205, 211–12 (Kan. 1972) (finding that the franchise agreement at issue was “more akin to [a contract] of employment than to a contract for sale or disposition of a business”).

39. Zürich Life Insurance Co. of Canada v Davies, [1981] 2 SCR 670, 674 (S.C.C.) (“. . . there is every reason to apply a contra proferentem construction to a contract of adhesion such as we have here”); Wagner Brothers Holdings Inc. v Laurier Life Insurance Co. (1992), 36 O.A.C. 365, para 40 (Ont. C.A.) (“This was a contract of adhesion and, therefore, a contra proferentem construction is applicable.”), leave to SCC refused [1992] SCCA No. 455, [1993] 1 SCR vii (SCC); Co-operators Life Insurance Co. v Gibbens, 2009 SCC 59, para 25 (Can.) (“. . . whoever holds the pen creates the ambiguity and must live with the consequences”).

40. JOHN MCCAMUS, THE LAW OF CONTRACT 723 (2005) (“. . . contra proferentem . . . is especially likely to be applied where the author of the document is in a stronger bargaining position than the other party and is able to deal on . . . a ‘take it or leave it’ basis”); GEOFF R. HALL, CANADIAN CONTRACTUAL INTERPRETATION LAW 186 (2d ed. 2012) (“In the case of a contract of adhesion, there is an increased propensity to apply the contra proferentem rule.”).
the contract.41 In Quebec, where the legal tradition can be traced to France (the birthplace of the phrase “contracts d’adhesion”), it is not surprising that the Quebec Civil Code expressly recognizes and provides for differential treatment to adhesive contracts.42 Indeed, as the discussion below illustrates, the Quebec courts have been particularly active in delineating the boundaries between adhesive and nonadhesive franchise agreements, likely because the issue is raised more regularly in franchise litigation in that province given the expressly differential treatment accorded to adhesive agreements under the Quebec Civil Code. All jurisdictions generally share a similar understanding that an adhesive contract is imposed on the weaker party on a “take it or leave it basis.”

Canadian courts have generally accepted that, by their nature, franchise and distribution agreements may be susceptible to being characterized as adhesive. In Hillis Oil & Sales v Wynn’s Canada, the Supreme Court of Canada held that a distribution agreement was adhesive on the basis that it was a standard form agreement drafted by the manufacturer and imposed on the distributor “with no opportunity to modify its wording.”43 Similarly, in numerous other cases, appellate courts across Canada have accepted that franchise agreements may meet the requirements of adhesiveness.44 Several English decisions, which continue to be persuasive in Canada, have also characterized franchise agreements as non-negotiated and standard-form.45 Therefore, it is helpful to consider the potential implications of such a finding under Canadian law, of which there are four.

41. Tam Wing Chuen v Bank of Credit and Commerce Hong Kong Ltd., (1996) 2 BCLC 69 (P.C) [77] (appeal taken from H.K.) (“. . . the basis of the contra proferentem principle is that a person who puts forward the wording of a proposed agreement may be assumed to have looked after his own interests, so that if the words leave room for doubt about whether he is intended to have a particular benefit there is reason to suppose that he is not”); Association of British Travel Agents Ltd v British Airways plc, [2000] 2 All ER (Comm) 204 (C.A.) [219–20] (U.K.); Hawley v Luminar Leisure Ltd., [2006] EWCA Civ 18, [2006] IRLR 817 (C.A.) [100] (U.K.) (adopting the principle that “[i]n the case of ambiguity the construction which is more favourable to the insured should be adopted; this is the contra proferentem rule”).

42. The Civil Code defines a contract of adhesion as “a contract in which the essential stipulations were imposed or drawn up by one of the parties, on his behalf or upon his instructions, and were not negotiable. . . ” CIVIL CODE OF QUEBEC, S.Q. 1991, c. 64, art. 1379 (Can.); see generally Bruno Floriani & Marvin Liebman, Exporting Your Franchise to Canada—Disclosure and Beyond, 4:6 INT’L J. OF FRANCHISING LAW 15 (2008).


44. Aamco Transmissions Inc. v Kunz, (1991) 97 Sask.R. 5 (Sask. C.A.) (“This contract is one which was not in any true sense of the word negotiated, but is a franchise agreement proffered by a large corporation to a franchisee, who was not in an equal bargaining position.”); Shelanu Inc. v Print Three Franchising Corp. (2003), 172 O.A.C. 78, para 58 (Ont. C.A.) (“A franchise agreement is a type of contract of adhesion . . . ”); Provigo Distribution Inc. c. Supermaché A.R.G. Inc., [1997] Q.J. No. 3710, para 48 (Que. C.A.) (“. . . franchise contract . . . is sometimes also a contract of adhesion, because it contains standard clauses that are not open for negotiation”); 405341 Ontario Ltd. v Midas Canada Inc., 2010 ONCA 478, para 38 (Can.); Salah v Timothy’s Coffees of the World Inc., 2010 ONCA 673, para 18 (Can.).

First, as in the United States, the characterization of a contract as adhesive is more likely to result in it being interpreted contra proferentem. In Hillis, the Supreme Court relied in part upon contra proferentem in finding that the distribution agreement did not authorize the distributor’s termination. Similarly, in Salah v Timothy’s Coffees of the World Inc., the Ontario Court of Appeal interpreted a franchise agreement contra proferentem to resolve any ambiguity regarding the scope of a renewal clause against the franchisor. Under the Quebec Civil Code, moreover, contra proferentem is a mandatory tool for the interpretation of adhesive agreements.

Second, similar to the United States, if a Canadian court finds a franchise agreement to have been imposed on the franchisee on an effectively “take it or leave it basis,” this may assist the franchisee to challenge a particular provision under the doctrine of unconscionability. In the nonfranchise case of Birch v Union of Taxation Employees, Local 70030, the Ontario Court of Appeal applied a two-pronged test for unconscionability, holding that the first prong, “inequality of bargaining power,” was per se satisfied because the underlying contract was adhesive. A leading treatise on Canadian contract law recognizes that the recent unconscionability cases consider the “twin criteria . . . [of] inequality of bargaining power . . . [and] inequality of exchange,” which are conceptually similar to procedural and substantive unconscionability, respectively, as applied in certain U.S. states. The Supreme Court of Canada has also observed that contracts of adhesion often give rise to challenges based on unconscionability. Under the Quebec Civil Code, similarly, courts have the jurisdiction to strike out any “abusive clauses” found in contracts of adhesion.

Third, if a franchise agreement is found to be a contract of adhesion, the courts may also be more inclined to review challenged restrictive covenants

---

46. See McCamus, supra note 40; Hall, supra note 40.
49. Hall, supra note 40, at 187 (citing art. 1432 of the Civil Code of Quebec as “mandat[ing] the application of the contra proferentem rule to contracts of adhesion”); Civil Code of Quebec, S.Q. 1991, c. 64, art. 1432 (Can.) (“. . . In all cases, [a contract] is interpreted in favour of the adhering party . . .”).
50. Birch v Union of Taxation Employees, Local 70030, 2008 ONCA 809, paras. 45, 49–51 (Can.) (Unconscionability requires “a finding of inequality of bargaining power and a finding that the terms of an agreement have a high degree of unfairness.” Inequality of bargaining power was satisfied as the adhering parties took the agreement “as they found it with no ability to negotiate or change its term[s].”).
52. See also Domtar Inc. v ABB Inc., 2007 SCC 50, at para 82 (Can.), where the Supreme Court of Canada noted that “the doctrine of unconscionability . . . is generally applied in the context of a consumer contract or contract of adhesion.”
53. Civil Code of Quebec, S.Q. 1991, c. 64, art. 1437 (Can.) (“An abusive clause in a . . . contract of adhesion is null, or the obligation arising from it may be reduced. . . . An abusive clause is a clause which is excessively and unreasonably detrimental to the . . . adhering party . . . in particular, a clause which so departs from the fundamental obligations arising from the rules normally governing the contract that it changes the nature of the contract . . .”).
under the standard usually reserved for employment agreements. The Supreme Court of Canada has explained that the higher scrutiny accorded to restrictive covenants in employment agreements flows from the “imbalance of bargaining power.” In a recent employment decision, the Ontario Court of Appeal noted that the evidence in fact disclosed an inequality in bargaining power when the agreement was negotiated, distinguishing an earlier employment case where a more relaxed standard was applied on the basis that the employee “bargained as an equal.” Similarly, the Supreme Court of Canada, recently applying the Quebec Civil Code, confirmed that evidence as to the bargaining position of the parties at the time the covenant was drafted, and whether they had independent legal advice, will affect the level of scrutiny to be applied to the question of enforceability. These principles suggest that, in the franchise context, the level of scrutiny to be applied to a restrictive covenant may depend in part on whether the franchise agreement is truly a contract of adhesion.

Fourth, in Quebec, the characterization of a franchise agreement as adhesive may have implications for how the franchisor enforces covenants found outside the franchise agreement, for example, in the operating manual. This is because the Quebec Civil Code requires that “external clauses” be expressly brought to an adhering party’s attention in order to be enforceable. Similarly, in a recent English decision that may be persuasive to Canadian courts, the English Court of Queen’s Bench refused to enforce an exclusion clause in a franchise agreement on the basis that the contract was a “standard document” imposed on a franchisee and that the clause “should have been brought to [the franchisee’s] attention” prior to the agreement being signed.

### III. Resisting the Adhesive Characterization: Persuasive Evidence of Bargaining Power

Commentators have long recognized that the analysis supporting the adhesive characterization of a contract breaks down where the true author of the agreement is unclear, where the traditionally understood “weaker

---

56. H.L. Staebler Company Ltd. v Allan et al., 2008 ONCA 576, para. 56 (Can.).
57. Payette v Guay inc., 2013 SCC 45, para. 39, 62 (Can.).
58. CIVIL CODE OF QUEBEC, S.Q. 1991, c. 64, art. 1335 (Can.). (“In a . . . contract of adhesion an external clause is null if, at the time of formation of the contract, it was not expressly brought to the attention of the consumer or adhering party, unless the other party proves that the . . . adhering party otherwise knew of it.”).
60. Kim Lewison, *The Interpretation of Contracts* 363 (5th ed. 2011) (noting that the courts in England will examine which party truly introduced the disputed language into the agreement).
party” is actually economically sophisticated, and where there is actual evidence of negotiations over key covenants in the agreement. Indeed, in U.S. insurance litigation, where the adhesive label has been most prominent, a large body of “criticism about modern contra proferentem . . .” applies to “sophisticated, commercial insureds who are deemed well-informed about the terms and limitations of their policies.” Similarly, there is a significant body of case law in both the United States and Canada where courts have taken a serious look at the evidentiary record to determine whether an insurance or franchise agreement is truly adhesive.

In an early decision of the Ontario Court of Appeal on this issue, the franchisor disputed the franchisee’s right to transfer its interest to a third party. In that case, the court emphasized that the franchisee held the largest number of units in the country (approximately 50 percent) and had exercised “very significant bargaining power in the negotiations which led to the [franchise] agreement.” On this basis, the court held that the franchise agreement was a “negotiated commercial document” and declined to apply contra proferentem. This case suggests that, at a minimum, large, multiunit franchisees with true bargaining power should not be able to advance the adhesive characterization in litigation.

In some cases, the question of adhesiveness turned primarily on the fact that the underlying agreement had been the subject of changes at the franchisee’s behest during the negotiation process. In a number of insurance disputes in the U.S. federal courts, the court, in rejecting the adhesive label, relied upon evidence that certain terms of the policy had been negotiated. Although the insurance context may be distinguishable from franchising, these cases nonetheless shed light on the types of evidence that may per-

61. Caruso et al., supra note 5 (“Franchisors would be well served by introducing evidence . . . concerning the franchisees’ education and experience”).
62. Id. (“. . . franchisees should be prepared to present evidence . . . that their efforts at negotiating the . . . franchise agreement were rebuffed . . .”).
63. See O’DONNELL, supra note 23, § 1:12.
65. See Ticknor v. Choice Hotels International, Inc., 265 F.3d 931, 939–40 (9th Cir. 2001), where the Ninth Circuit rejected the franchisor’s argument that the existence of amending agreements alone disproved adhesion because the franchisor imposed the addenda on a “take it or leave it” basis (relying on this finding to satisfy the test for procedural unconscionability under Montana law).
66. Koch Eng’g Co., Inc. v. Gibraltar Cas. Co., Inc., 878 F. Supp. 1286, 1288 (E.D. Mo. 1995) (“[Insured] negotiated a complex, twenty million dollar policy [with the insurer] . . . called a manuscript policy, the mere title of which indicates that it was not an adhesion, preprinted contract but a policy negotiated by two equal parties on a level playing field”), aff’d, 78 F.3d 1291 (8th Cir. 1996); Rouse Co. v. Fed. Ins. Co., 991 F. Supp. 460, 466 (D. Md. 1998) (“. . . the record suggests that the policy was negotiated and drafted as a joint effort between two sophisticated business entities”); Falmouth Nat. Bank v. Ticor Title Ins. Co., 920 F.2d 1058, 1062 (1st Cir. 1990) (“. . . the sophistication of the [insured] and the fact that it negotiated specific terms of the policy lead us to believe that . . . interpreting ambiguities in favor of the insured does not apply with the same force . . .”); Cooper Cos. v. Transcont’l Ins. Co., 37 Cal. Rptr. 2d 508, 512 (Cal. Ct. App. 1995).
suade a court to reject the adhesive label. For example, in *Falmouth National Bank v. Ticor Title Insurance Co.*, the First Circuit pointed to both the “so-
pophistication of the [insured] and the fact that it negotiated specific terms
of the policy.”\footnote{Falmouth, 920 F.2d at 1062.} Similar factors were considered in an early franchise case in Quebec, where the Quebec Superior Court rejected a franchisee’s adhe-
sive characterization on the basis that she carefully reviewed the agreement,
obtained independent legal advice prior to signing, and secured numerous
amendments both by crossing out selected provisions and making certain
additions.\footnote{Voncorp Inc. c. 147013 Canada Inc., 1997 CarswellQue 4232, para. 60-62 (Que. S.C.).

\footnote{Michael Publishing Company Inc. (Suburban) c. Holand Chrysler Dodge Jeep Ite., 2014 QCCQ 427, para. 28–33 (Can.) (finding that it would have been possible for the franchisee to negotiate the terms of the agreement); 9069-7384 Quebec Inc. c. Superclub Videotron Ite., [2004] R.J.Q. 892, para. 103–105 (Que. S.C.) (court pointing to the fact that franchisee declined to seek independent legal advice when encouraged by the franchisor and refusing to find an impossibility for negotiation); Distribution Stereo Plus inc. c. 140 Greber Holdings, 2012 QCCS 33, para. 37–48 (Can.) (emphasizing the franchisees’s “failure to attempt negotiation”); Asselin c. Groupe pétrolier Olco ULC inc., 2014 QCCQ 2733, para. 51–56 (Can.) (insufficient evidence that the franchisee could not freely negotiate the terms of the agreement).

\footnote{Entreprises MTY Tiki Ming Inc. c. McDuff, 2008 QCCS 4898, para. 189, 198, 202, 205 (Can.). This test was also applied in Michael Publishing, supra note 69, at para 28.

\footnote{Id. at para. 208–14.

\footnote{Id. at para. 216–20.

\footnote{Michael Publishing, supra note 69, at para. 28–33 (finding on the basis of the evidence of one witness that it was possible to negotiate the terms of the agreement).}}}

In another line of cases, courts have been prepared to reject the adhesive
characterization based on evidence that the franchisee could have negotiated
the provisions even though it never availed itself of that opportunity. In this
regard, a common approach in the Quebec case law is for courts to focus on
whether the franchisee attempted to exercise due diligence in the transaction,
with numerous courts refusing to characterize the agreement as adhesive
where the franchisee failed to take any reasonable steps to protect its own
interests.\footnote{Id. at para. 208–14.} In *Entreprises Mty Tiki Ming Inc. c. McDuff*, the Quebec Superior
Court held that in order for a franchise agreement to be adhesive, there must
be evidence both that the franchisor drafted the essential terms and that it
was impossible for the franchisee to negotiate.\footnote{Id. at para. 208–14.} According to the court,
the requirement of impossibility recognizes that franchisees owe themselves
a duty to protect their own business interests, which includes pursuing oppor-
tunities to negotiate.\footnote{Id. at para. 208–14.} On the facts, the court refused to find a contract
of adhesion on the basis that the franchisee rushed to sign the agreement for
her own reasons and failed to inform herself or to make reasonable inquiries
of the franchisor.\footnote{Id. at para. 216–20.} In another Quebec decision, the court again rejected the
adhesive label on the basis that it would have been possible for the franchisee
to negotiate changes had an attempt been made.\footnote{Michael Publishing, supra note 69, at para. 28–33 (finding on the basis of the evidence of one witness that it was possible to negotiate the terms of the agreement).} Applying a similar analysis
in an insurance case, the U.S. District Court for the Southern District of
New York in *Ethicon Inc. v. Aetna Casualty and Surety Co.* refused to charac-
terize an insurance policy as adhesive on the basis that the insured had the market power to negotiate changes, even though it elected not to do so.\textsuperscript{74}

These cases should provide a note of caution to franchisees who assert that their franchise agreements are adhesive in subsequent litigation even though they never bothered to attempt negotiation or to exercise diligence during the initial transaction. However, in the end, every case will turn on its own facts. In an early insurance case, the Second Circuit recognized nuances in the factual record and labelled an insurance policy adhesive even though the insured was a large, sophisticated corporation that had the ability to negotiate certain terms of the policy. The primary factors for the court were that the key provisions of the policy relating to insurance coverage were untouchable during the negotiations and that the insured was bargaining with a consortium of insurers that effectively controlled the entire market for the type of insurance at issue, leaving the insured with nowhere else to turn.\textsuperscript{75} This suggests that where there is no meaningful substitute for the adhering party for the product at issue, the court may find a lack of bargaining power despite the size and experience of the adhering party and the fact that subsidiary clauses were amended.

Another important factor that has persuaded the courts to reject the adhesive label relates to the role of franchisee associations in the negotiation of the franchise agreement. The Quebec Court of Appeal addressed this issue in the context of a franchisee encroachment claim brought against its franchisor.\textsuperscript{76} One of the issues was whether a clause in the franchise agreement that potentially assisted the franchisor was abusive, i.e., unconscionable, within the meaning of the Quebec Civil Code, which required a finding that the agreement, among other things, was adhesive. In examining this issue, the court considered evidence regarding the role of the franchisee association that had negotiated with the franchisor over the version of the franchise agreement at issue. The court relied on this evidence in declining to label the franchise agreement as adhesive, pointing to a number of factors, including intensive negotiations with the association over the precise term at issue in the case.\textsuperscript{77} The court also noted that this particular association

\textsuperscript{74} Ethicon, Inc. v. Aetna Cas. & Sur. Co., 737 F. Supp. 1320, 1327 (S.D.N.Y. 1990) (“The fact that . . . no negotiations actually took place over the details of the terms of the insurance policies at issue . . . has no bearing . . . [as the insured] had the market power to negotiate with its insurers on an even field. The fact that it chose not to do so will not affect that Court’s determination. . . . [The insured] was fully capable of negotiating for terms which it felt to be important for its insurance coverage.”).

\textsuperscript{75} Pan Am. World Airways Inc. v. Aetna Cas. & Sur. Co., 505 F.2d 989, 1003 (2d Cir. 1974) (“The . . . insurers are in effect all of the underwriters in the world who write such [all-risk] insurance. [The insured] had no place else to turn for all risk coverage. The types of risks to be excluded by the . . . policies may have been negotiable . . . but the words describing these risks were not open to negotiation. These words were offered to the insured on a take-it-or-leave-it basis.”) The Second Circuit further explained this in \textit{Schering Corp. v. Home Insurance Co.}, 712 F.2d 4, 10 n.2 (2d Cir. 1983).

\textsuperscript{76} Martineau \textit{c. Societe Canadian Tire ttee, 2011 QCCA 2198 (Can.).}

\textsuperscript{77} \textit{Id.} at para. 35–37.
was independent, well established, and reputable, pointing to the fact that its board of directors was made up of franchisees and that two association representatives were actually members of the franchisor's board of directors.\textsuperscript{78} In the end, the court found the franchise agreement to have been freely negotiated.\textsuperscript{79} While the result in this case may in part be explained by the unusual clout enjoyed by this particular franchisee association,\textsuperscript{80} the court was arguably persuaded by the fact that the franchisor had engaged in meaningful negotiations over the form of franchise agreement.\textsuperscript{81} This legal result may provide an incentive to other franchisors to pursue such negotiations in the future.

\textbf{IV. Conclusion}

At a minimum, courts should be prepared to review the evidentiary record closely before labelling a franchise agreement as adhesive. Where franchisees are economically sophisticated relative to the franchisor and where actual changes have been made to the franchise agreement at the franchisee's request, persuasive authority supports the proposition that the agreement is anything but adhesive. Other courts, particularly in Quebec, have been prepared to go further, emphasizing the duty of franchisees to exercise due diligence and requiring evidence that the franchisees actually attempt to negotiate. Although the differential approach by the courts to this issue makes clear that every case must turn on its own facts,\textsuperscript{82} franchise litigators should be prepared to consider introducing evidence on this issue in any dispute where the adhesive label is at risk of being imposed.\textsuperscript{83}

\begin{thebibliography}{8}
\bibitem{78} Id. at para. 34.
\bibitem{79} Id. at para 44.
\bibitem{80} See Emerson & Benoliel, \emph{supra} note 10 (noting that many franchisors refuse to even negotiate with associations).
\bibitem{81} See \emph{supra} note 12 (Canadian courts have not to date recognized a positive obligation on franchisors to negotiate with franchisee associations).
\bibitem{82} See Bolter v. Super. Ct., 104 Cal. Rptr. 2d 888, 893 (Cal. Ct. App. 2001) (where a franchisee in a preexisting relationship with the franchisor was found to have been under significant pressure to accept the franchise agreement without amendment); see \emph{also} Caruso et al., \emph{supra} note 5 (citing cases that suggest “that a renewing franchisee might potentially fare better than a new franchisee on the issue of procedural unconscionability”).
\bibitem{83} See \emph{generally} Caruso et al., \emph{supra} note 5, for a discussion of the strategic use of evidence in unconscionability cases.
\end{thebibliography}
Immigration Issues: A Basic Guide for Franchise Counsel

Laura Hayes

Franchise systems across the United States confront ever-mounting pressure to win the attention and loyalty of well-capitalized franchisees that can pay the initial and ongoing fees associated with launching a franchised business. As economic pressures within the United States affect the ability of many U.S. citizens and residents to access capital, franchise systems increasingly look to foreign investors as potential franchisees. A study released by the U.S. Small Business Administration Office of Advocacy in 2012 found that immigrants have higher business formation rates than nonimmigrants.1 Approximately, 0.62 percent of immigrant workers in the United States start a business each month.2 Of perhaps even more appeal to franchise systems, immigrant-owned businesses are often better capitalized than their nonimmigrant counterparts. Nearly 20 percent of immigrant-owned businesses start with more than $50,000 in initial capital, while only 15.9 percent of nonimmigrant owned businesses reach such capitalization levels by launch.3 Immigrant-owned businesses employed more than 4.7 billion employees in the United States, according to a 2012 Fiscal Policy Institute report.4 The report also stated that small businesses that are more than half immigrant-owned have an estimated $63 billion in annual earned income, which is 15 percent of the entire $419 billion of annual earned income for business owners in general.5 Consequently, foreign investors represent a huge pool of potential franchisees.

2. Id.
3. Id.
5. Id.

Laura Hayes (laura.bayes@mrlkpc.com) is an attorney with Mullin Russ Kilejian PC in Richardson, Texas.
These are but a few examples of the driving force behind current immigration policy in the United States, which aims in part to encourage certain types of foreign investment through investor class visa opportunities. Yet, immigration issues facing both franchisors and franchisees expand far beyond the scope of attracting new investors. Franchise systems are faced with myriad immigration issues, including employment-based visa applications and the overwhelming task of ensuring that their respective workforces comply with federal regulations.

This article aims to provide franchise counsel with a basic understanding of the legal framework of some of the immigration issues facing the franchise community. Part I summarizes two of the investment-based visas, including the EB-5 Immigrant Investor Program and E-2 Treaty Investors, which often attract potential franchisees. Part II explains the underlying concept of employment-based visas and provides brief examples of two available visa programs. Part III highlights the potential impact of immigration non-compliance in franchise systems.

I. Investment-Based Visas

A. Why a Visa?

In the United States, legal permanent residents, also known as green card holders, have no immigration constraints on their ability to work anywhere within the United States.7 In contrast, other individuals who are not legal permanent residents are required to leave the United States before their visas expire. Depending on the type of visa, expiration periods can vary immensely.8 Moreover, these temporary visa holders may or may not be authorized to work during their stay in the United States.9 Even if a visa holder has a work authorization, a visa might also be subject to certain employment conditions or restrictions, e.g., it may be conditioned on continued employment with a sponsoring employer.10

Because visas are subject to time constraints and possible employment conditions, franchisors must understand the visa status of any franchisee applicant. A franchisee’s immigration status could directly affect his or her ability to operate the franchised business and, more importantly, his or her ability to stay in the United States.11 Franchise systems are likely to encounter two common visa categories—investment-based visas and employment-

---

6. This article in no way, however, aims to replace the necessity of retaining an immigration attorney who specializes in this technical practice area.


8. Id.

9. Id.

10. Id.

11. Id.
based visas. The first part of this article summarizes two widely discussed investment-based visas in the franchise community—the EB-5 visa and E-2 visa.

1. EB-5 Immigrant Investor

During the 1990s, in an effort to stimulate the domestic economy, Congress enacted legislation allowing investors satisfying specific criteria to obtain visas through the EB-5 Immigrant Investor Program.12 This program, which is still in effect, allows investors to obtain permanent status by creating jobs and investing significant capital into the U.S. marketplace. Under the program, qualified applicants enter the United States with conditional permanent resident status. If, after two years, the investor applicant demonstrates to the satisfaction of the U.S. Citizenship and Immigration Services (USCIS) that he or she has satisfied the EB-5 program requirements, the investor and his or her qualified family members will receive legal permanent resident status. This is one of the most attractive investment programs for foreign franchise applicants because it offers them the potential to obtain permanent resident status in the United States.

Although this opportunity to obtain a visa and eventual legal permanent resident status is extremely attractive, the requirements for obtaining this type of visa are arguably the most burdensome in terms of investment requirements and processing time. For example, the processing time to obtain an EB-5 visa is significantly longer than the processing time for E-2 visas. In general, to obtain an EB-5 visa, a foreign investor must:

- invest in a new commercial enterprise;
- invest capital of at least $1 million (in limited circumstances an investment of $500,000 in an area of high unemployment or in a rural area may qualify); and
- create at a minimum ten full-time jobs for U.S. workers (apart from the investor and derivative visa holders) within the first two years that the investor is admitted into the United States as a conditional permanent resident.15

One of the biggest obstacles for foreign investors seeking an EB-5 visa is the required $1 million investment,16 which cannot be borrowed.17 In calculating an applicant’s investment, USCIS considers capital investments beyond cash, including, but not limited to, equipment, inventory, and indebtedness secured by assets such that the investor is primarily and personally liable.18

13. Id.
14. Id.
15. Id.
16. Id.
17. Id.
18. Id.
There are some opportunities for foreign investors to qualify for an EB-5 visa with a lower investment. In some circumstances where the investment area suffers from high unemployment of at least 150 percent of the national average or is considered a rural area, i.e., an area “outside the boundary of any city or town having a population of 20,000 or more according to the decennial census,” a lower investment of $500,000 will satisfy this criterion.\(^{19}\) If a potential franchisee is seeking this type of visa, the initial required investment will be a critical factor.

As stated earlier, an applicant must invest in a new commercial enterprise to be a successful EB-5 candidate.\(^{20}\) The USCIS defines a “commercial enterprise,” including a franchise business, as a “for-profit activity formed for the ongoing conduct of lawful business including, but not limited to: a sole proprietorship, partnership (whether limited or general), holding company, joint venture, corporation, business trust or other entity which may be publicly or privately owned.”\(^ {21}\) To qualify as a “new” commercial enterprise, the target business for the investment must have been established after November 29, 1990. If the target business was established on or before that date, it can still qualify as a new commercial enterprise if (1) it is purchased and restructured in a way that yields a new commercial enterprise, or (2) the investment expands the business by a 40 percent increase in either net worth or number of employees.\(^ {22}\)

The EB-5 visa is also very attractive to potential franchisees because it provides family members of foreign investors the opportunity to obtain legal permanent resident status. Under this visa program, “derivatives,” i.e., qualifying unmarried children under the age of twenty-one and the spouse of the applicant visa holder, typically qualify for the same immigration status—conditional legal permanent resident status—as the visa holder.\(^ {23}\) During the two-year conditional period, spouses and children with derivative status may attend school and work in the United States without limitation.\(^ {24}\) If the USCIS approves the foreign investor’s EB-5 application, family members will also obtain legal permanent resident status.\(^ {25}\)

As previously noted, the application and review period for EB-5 visas is much longer compared to the processing time of other visa applications. Often, the review process can take up to two years.\(^ {26}\) The uncertainty of this application process can pose a problem for franchise systems granting exclusive rights and designated areas to franchisees who may not have been admitted to the country. Potential franchisees are often dissuaded from this type

---

19. Id.
20. Id.
21. Id.
22. Id.
23. Id.
24. Id.
25. Id.
of visa because legal permanent residents of the United States are taxed on worldwide income. Foreign investors should be encouraged to seek experienced tax and immigration assistance in pursuing these types of applications.

The process for obtaining an EB-5 visa is onerous and requires technical expertise. To begin the process, an investor must file an initial I-536 Petition for an Alien Entrepreneur. During the application process the investor must demonstrate several things, including that the investment funds were obtained by lawful means and that the business will create (or preserve, in the troubled business case) at least ten full-time jobs for U.S. positions. To demonstrate that the commercial enterprise will create or preserve the required positions, investors must submit a comprehensive business plan with their visa applications. Within the ninety-day period before expiration of the investor’s second year as a conditional permanent resident, the investor must submit a Form I-829 Petition for Entrepreneur to Remove Conditions. The application to remove conditions will also require evidence that the investor actually invested in the new commercial enterprise and has sustained the investment and that ten full-time positions were created or will be created within a reasonable time. Given the complexity of such an application and subsequent review process, a foreign investor will likely need to engage an immigration attorney for more specific information.

2. E-2 Treaty Investors

Unlike the EB-5 visa for permanent resident status, potential franchisees can also be admitted to the United States through nonimmigrant visas. The E-2 visa is an example of a nonimmigrant visa popular among franchisees. The E-2 classification allows an individual who is a national of a country with which the United States has a treaty of commerce and navigation (Treaty Countries) into the United States for renewable two-year periods if the applicant invests a substantial amount of capital in a U.S. business. Examples of Treaty Countries include Australia, Canada, and Luxembourg. E-2 visa holders are admitted to the United States for a maximum initial stay of two years with potential extensions in increments of two years. To qualify as Treaty Investor, an investor must:

29. Id.
30. Id.
31. Id.
32. Id.
35. Id.
• be a national of a Treaty Country;
• “have invested, or be actively in the process of investing, a substantial amount of capital in a bona fide enterprise in the United States;” and
• be seeking admission to the United States to “develop and direct the investment enterprise.”

For the purposes of obtaining Treaty Investor status, a “substantial amount of capital” is defined as: (1) substantial in relation to the total amount necessary to start or buy the business, (2) sufficient to demonstrate that the investor will be committed to the enterprise’s success, or (3) of a magnitude such that the enterprise is likely to be successfully developed. In terms of actual monetary commitment, investors should plan to invest at least $100,000 of their funds. To that same end, a bona fide enterprise is a business that is actively operating to produce goods or services for a profit and meets the requirements for doing business in the applicable jurisdiction.

Many potential investors prefer E-2 visas because of the faster application process, the lower investment threshold, and the avoidance of the classification as a legal permanent resident for taxation purposes. To apply for the E-2 visa, an investor must submit a Form I-129 with evidence he or she has satisfied all of the visa requirements. Again, obtaining any type of visa is complicated and generally requires the expertise of an experienced immigration attorney.

Several significant limitations and drawbacks accompany an E-2 nonimmigrant visa. Investors must maintain that they intend to leave the country when their status expires or is terminated. In addition, investors may work only for the specified enterprise for which they were granted status. Perhaps even more burdensome to potential franchisees, investors must report any change to the enterprise’s characteristics including, but not limited to, mergers and acquisitions to USCIS and request an extension of stay for such a change. This type of visa, while much quicker to obtain, can pose problems for franchise systems. Situations such as the failure of the franchisee entity or changes in the entity’s ownership structure could potentially force investors and their families to leave the United States. Another drawback of the E-2 visa as compared to the EB-5 is the treatment of derivatives. Although spouses and unmarried children under the age of twenty-one are often granted E-2 nonimmigrant visas, they must apply for a separate

36. E-2 Treaty Investors, supra note 33.
37. Id.
38. Mullin, Kinser & Yu, supra note 7.
40. Id.
41. Id.
42. Id.
43. Mullin, Kinser & Yu, supra note 7.
work authorization if they wish to seek employment in the United States during their stay.44

II. Employment-Based Immigration

Investment-based visas are not a good fit for all franchisees or franchise systems. Moreover, simply forming an entity to employ a foreign franchisee will generally not be a permissible vehicle for a foreign franchisee seeking admission to the United States.45 Aside from investment-based visas, however, there are many opportunities for the employees of franchisees and franchise systems to obtain employment visas through the current immigration system. Accordingly, information regarding the L-1A and EB-1(c)(3) visa may be of interest to franchisee and franchisor counsel.

A. EB-1(c)(3): First Preference EB-1 Visa

The EB-1(c)(3) visa grants permanent authorization for an individual to live and work in the United States. Under this visa program, individuals obtain legal permanent resident status if they (1) have an extraordinary ability, (2) are an outstanding professor or researcher, or (3) are a multinational executive or manager.46 The third category of applicants is likely the most relevant in franchising. Franchisors and franchisees seeking to obtain a visa for the transfer of a foreign manager to a position in the United States might use this visa application. Of more importance for franchise counsel, this type of program is ripe for immigration fraud such as schemes by which individuals abroad are coerced into paying large sums of money in hopes of becoming a legal permanent resident.

To apply for this type of visa, the employer (not the employee) must submit a Form I-140, Petition for Alien Worker, and pay the corresponding legal fees. To qualify for an EB-1(c)(3) immigrant visa as an executive or manager, the individual must be employed as an executive or manager by a qualified company for at least one of the past three years.47 A “qualified company” under the Immigration Code is an U.S. affiliate, parent, or subsidiary of a foreign business.48 In this instance, “executive capacity” means the ability to make decisions over a wide latitude of a company’s affairs without much oversight; “managerial capacity” refers to the management of several

44. E-2 Treaty Investors, supra note 33.
47. Id.
48. Id.
other professional employees as well as the management of an entire sub-
division of the entity, such as an entire department.49 “Managerial capacity” in
some instances refers to the employee’s ability to manage the entity at a high
level without any direct oversight.50 While these visas are desirable, they are
extremely expensive and involve time-intensive applications. Additionally,
sponsoring employers have no assurance that employees will continue to
work for the business upon receiving status.

B. L-1A Intracompany Transferee Executive or Manager

In some instances, employees of franchisors and franchisees may be able
to utilize the L-1A visa program. To obtain a visa under this program, exec-
utives and managers of franchisors or franchisees who have been working for
that same company abroad for at least three years may be able to obtain an
L-1A visa to operate a location for that same franchisee or franchisor in the
United States. This visa is a nonimmigrant classification that allows a U.S.
employer to transfer an executive or manager from an office abroad to an af-
fliate office within the United States.51 Like the EB-5 and E-2 visa, this visa
requires detailed business plans that include business formation documents
that show the ownership of the companies. To obtain this visa, the employer
must have a qualifying relationship with a foreign company and must cur-
rently be, or will be doing, business as an employer in the United States
and one other country for the duration of the visa holder’s stay.52 The indi-
vidual must be working for the organization abroad for one of the past three
years preceding the petition and must be entering the country in an executive
or managerial capacity as an employee of the qualifying organization.53

Like the EB-1(c)(3) visa requirements, a qualified organization is a U.S. af-
fliate, parent, or subsidiary of a foreign business.54 For the purposes of this
application, “doing business” means the “regular, systematic, and continuous
provision of goods and/or services by a qualifying organization and does not
include the mere presence of an agent or office of the qualifying organization
in the United States and abroad.”55 Just as in the EB-1(c)(3) context, the in-
dividual must be employed as an executive or manager of the company as de-
defined by the Immigration Code.56 L-1A visa holders are allowed to stay for
the initial one-year period and may have the opportunity to renew their visa
for two-year terms.57

49. Id.
50. Id.
51. U.S. Citizenship & Immigration Servs., L-1A Intracompany Transferee Executive or
Manager (June 17, 2013), http://www.USCis.gov/working-united-states/temporary-workers/l-
1a-intracompany-transferee-executive-or-manager.
52. Id.
53. Id.
54. Id.
55. Id.
56. Id.
57. Id.
III. Other Concerns—Why Should Franchisors Worry?

The federal government aggressively seeks to enforce immigration compliance and prosecute those who actively commit wrongdoing. The government has pursued companies like the Indian IT company Infosys for immigration fraud after a whistleblower attack.58 In the unfortunate scenario of Infosys, the company allegedly engaged in a pattern of immigration fraud that included coaching employees on statements regarding their work activities during consular interviews.59 It is extremely important that companies continually monitor their recruitment and employment practices to ensure that they comply with federal law.

Similarly, although the immigration status of a franchisee’s employees is generally the responsibility of that franchisee entity, a franchisee’s poor immigration compliance can negatively impact an entire franchise system. Because brand management is an ever-pressing concern for franchise systems, franchisee noncompliance with federal immigration laws can and has affected entire franchise systems, as discussed below. Both franchisors and franchisees must comply with federal immigration regulations, including I-9 requirements. Under the Immigration Reform and Control Act, every employer must hire only employees who are authorized to work in the United States and must not discriminate on the basis of citizenship status or national origin.60 More specifically, it is unlawful for an employer to employ an alien who is not authorized to be employed for a position, and it is unlawful for an employer not to use an employment verification system.61 Accordingly, employers must complete a Form I-9 for each new employee to verify the identity and employment authorization of that employee. It is imperative that franchisors themselves use and also encourage franchisees to also use I-9 verification systems. Noncompliance by one franchisee can trigger I-9 audits of franchisees throughout an entire franchise system.

In a noteworthy example, a 7–Eleven franchisee with several convenience stores was investigated for several counts of immigration fraud.62 The immigration investigation regarding allegations against one set of owners caused 7–Eleven franchisees to be investigated nationwide.63 7–Eleven was subjected to significant negative publicity, and some of the news articles likened

59. Id.
63. Id.
the convenience stores to modern day plantations. As a result, 7–Eleven in-
curred the expense and media scrutiny of an internal review of the immigra-
tion compliance of 5,600 franchisees.64

When confronted with issues regarding franchisee compliance with fed-
eral immigration laws, franchisors must navigate the underlying tension be-
tween ensuring that franchisees comply with federal immigration laws and
the possibility of incurring vicarious or employer liability. Although franchi-
sors traditionally have not been directly responsible for a franchisee’s com-
pliance with federal immigration regulations, recent employment law trends
reveal that the federal government is increasingly eager to impute employer liabil-
ity to franchisors. Particularly when a franchisor exercises significant
control over franchisee operations, the franchisor should consider the poten-
tial for its own criminal liability under federal statutes such as the anti-
harboring statute, 8 U.S.C. § 1324 (a)(1), which criminalizes “any person
who knowing or in reckless disregard of the fact that an alien has come to,
entered, or remains in the United States in violation of law, conceals, har-
bucks, or shields from detection, or attempts to conceal, harbor, or shield
from detection, such alien in any place.”65

Given trends in current employment law cases, it is conceivable that gov-
ernment agencies and courts could one day impute such a responsibility to
the franchisor, particularly in franchise systems where the franchisor is in-
volved in any business dealings tangentially related to a franchisee’s immi-
gration status or compliance, e.g., escrowing money for master franchisees
or area representatives recruiting foreign investors, has knowledge of a pat-
tern of bad immigration conduct, or does not require system-wide I-9 com-
pliance. To help mitigate any potential immigration liability, franchisors
should consider implementing immigration compliance policies, conducting
regular I-9 audits of their company, engaging independent auditors to eval-
uate franchisee compliance, and enforcing employment and immigration
compliance provisions of their franchise agreements.66 To that same end,
at a minimum, franchisors might consider verifying that the managing own-
ers of franchisees have the requisite immigration status to operate the fran-
chised business. The value of these activities, however, must be balanced
with the potential increased risk of liability for issues relating to the franchi-
see’s employees.

64. Aaron Katersky, Susanna Kim & Alyssa Newcomb, 7-Eleven Cracks Down on Franchisees
65. Mary E. Pivec, Brand Protection: The Case for Franchisor Auditing and Enforcement of Fran-
detail.aspx?g=784ad00b-d222-4ff1-9758-aaa1817ac918.
66. Id.
IV. Conclusion

Although immigration may be perceived as Pandora’s box in the current political climate, franchise systems and franchise counsel can significantly benefit from familiarizing themselves with the basic types of visas available to investors and employees, and other immigration issues facing the franchise industry. A basic understanding of immigration opportunities for foreign investors can be a powerful asset in the development and expansion of a franchise system, while ignorance of immigration risks and pitfalls can have lasting negative impacts on a business and franchise system.
Superb Scholarship and Practical Insights

Natalma M. McKnew

Merger and Acquisitions of Franchise Companies (2d ed.)
Leonard D. Vines and Christina M. Noyes, editors
2014, 429 pages, 7 x 10
Includes CD-ROM
$127.95 (Forum on Franchising members)

Merger and Acquisitions of Franchise Companies, the most recent publication of the ABA Forum on Franchising, isn’t just about mergers and acquisitions. Any lawyer, experienced or not, contemplating a client’s merger or acquisition needs this publication. Not only will it provide a comprehensive overview of a franchise merger or acquisition, but it will raise issues that might otherwise go unnoticed. Even if a franchise lawyer’s practice does not include mergers and acquisitions, however, this book is invaluable, addressing a raft of issues across multiple practice areas that affect franchise businesses every day. The 1996 edition of this publication was a first in the industry; this second edition reflects the increased sophistication and complexity of mergers and acquisitions in the franchise space.

Lenny Vines and Christina Noyes have assembled and guided an impressive suite of high-powered legal talent. These are lawyers I’d want to guide me through any significant corporate transaction: Harris Chernow and Chuck Modell on the germ of the idea, motivations, and potential speed bumps; Dawn Newton, Rebekah Prince, and Les Wharton on negotiation strategies and targets; John Baer, Mark Kirsch, and Beata Krakus on the all-important due diligence; Herbert Hedden and Judith Marsh on real estate aspects of combinations; Richard Greenstein and Richard Morey on valuation; Michael DeLaurentis and Will Woods on tax considerations; and Chris Bussert and William Bryner on trademark considerations. In addition to this impressive list of topics, Glenn Moses offers wisdom on acquisitions through bankruptcy, an oft-neglected topic, and Jeff Brimer, Lucie Guyot, and Ken Levinson tackle international issues that confound many lawyers.

Natalma M. McKnew (tami.mcknew@smithmoorelaw.com) is a partner in the Greenville, South Carolina, office of Smith Moore Leatherwood LLP.
A deeper dive into the materials demonstrates the book’s scope and depth of knowledge. Chuck Modell and Harris Chernow appropriately begin with an “Introduction to Practical Problems and Issues” in Chapter 1, addressing the transaction overview and the differing motivations of buyers and sellers, insights that will necessarily inform the entire course of any ensuing transaction. In the franchise industry, of course, there are third parties that are profoundly affected by (and deeply interested in) the franchisor’s transaction. Relationships with franchisees and potential franchisees during the course of the transaction thus receive special attention.

Dawn Newton, Rebekah Prince, and Les Wharton, the authors of Chapter 2, “Negotiating Key Provisions in the Agreement,” observe that mergers and acquisitions involving franchise companies bear a strong resemblance to transactions involving other types of entities. But some issues are unique, and some issues that are common to all mergers and acquisitions assume a different character in the context of franchising. The authors overlook none of these singular twists, most importantly the myriad of issues arising from the impact of multilevel contractual obligations, the impact of franchise specific laws, and limitations that may be imposed by both.

As with unique negotiating considerations, due diligence in a franchise acquisition presents singular challenges. It’s these challenges that John Baer, Mark Kirsch, and Beata Krakus tackle in Chapter 3, “Due Diligence on Franchise Systems.” Franchise assets include intangible rights and contract rights; assets that are held at various business levels; customers of the system (franchisees) have inordinate significance in the business structure. This is not a situation where an accountant’s letter to the franchisee confirming debt will suffice. Overlying this are the extensive state and federal regulations with which the parties must comply and, perhaps more importantly, a seller’s prior compliance with these laws can be a tricky due diligence item. The authors expertly address the complexity of due diligence. It is especially poignant to recognize the excellence of these authors, one of whom (John Baer) the franchise community has so recently lost.

Of particular interest in Mergers and Acquisitions of Franchise Companies are the many chapters that focus on discrete and particularly thorny issues. Real estate in a franchise system may be held by the franchisor, the franchisee, or third parties. As Herbert Hedden and Judith Marsh explain in Chapter 4, “Real Estate Matters in Acquisitions and Mergers,” ownership means must be closely examined and addressed, with the added challenge that a full range of potential encumbrances, leasehold restrictions, and limitations may be problematic, and environmental conditions must be considered. All of these receive the attention of these capable authors.

It is deceptively easy to relate an acquisition price as some multiple of EBITDA. But, as Richard Greenstein and Richard Morey abundantly demonstrate in Chapter 5, “Valuation of Franchise Companies,” the devil is in the details. The authors begin with familiar EBITDA-based pricing, but with a dose of reality—a range of actual EBITDA multipliers in actual
franchise transactions. But that is only the beginning. The authors examine the varying quality and unique factors adding to (and detracting from) the value of a franchise company. How should a buyer approach questions of valuation to achieve an optimal price, what can a seller do to maximize company value, and how might the structure of the entity affect valuation?

Michael DeLaurentis and Will Woods, authors of Chapter 6, “Income Tax Considerations in Acquisitions and Combinations of Franchise Businesses,” succinctly define the critical difference between any corporate merger/acquisition and one involving franchise companies. The federal and state income tax considerations accompanying the purchase or sale of a franchise business are the same as those for any other business, the authors note, but the distinguishing feature of such a transaction in a franchise business is the franchise itself: the bundle of (a) related assets and rights captured in trade names, copyrights, patents, trade secrets, other intellectual property, and agreements with franchisees, and (b) the related obligations to provide ongoing support to franchisees.

It is those features that deserve and receive particular attention from these authors, both as coincident with the transaction itself and as affecting the ongoing business post-transaction.

Intellectual property, especially trademarks, are critical assets of a franchise business and create value in the business. The fate of these assets in a merger or acquisition is one of the most important issues in the transaction, but, as the authors of Chapter 7, “Trademark Considerations in Franchise Transfers,” demonstrate, it’s not as simple as drafting an assignment. Chris Bussert and William Bryner closely examine these issues based on their solid IP backgrounds. They address a wide range of important topics, ranging from pre-transaction analysis of the status of trademarks, potential liens and encumbrances, and ensuring that post-termination, trademarks retain value for the purchaser and the franchise system.

One company’s financial distress sometimes becomes another’s opportunity. That is the case with acquiring a franchise company through bankruptcy, a topic expertly handled by Glenn Moses in Chapter 8, “Acquisition of a Franchisor, or Its Assets, Through a Bankruptcy Proceeding.” The author addresses the advantages of such a path to ownership, e.g., the ability to cherry-pick assets, as well as the challenges imposed by the bankruptcy laws, e.g., assumptions and rejections and extinguishing third party rights.

In Chapter 9, “International Issues,” Jeff Brimer, Lucie Guyot, and Kenneth Levinson travel beyond U.S. borders to address issues that affect cross-border mergers and acquisitions. Among the topics that receive their experienced and invaluable analysis are disclosure obligations, international structural issues, international tax considerations, potential banking and currency restrictions and problems, employment, and even translation issues. Mergers and Acquisitions of Franchise Companies is thus truly an invaluable resource in any franchise transaction.
I would be remiss if I failed to mention the extremely helpful forms and appendices, which include sample transactional contract provisions, due diligence checklists, a lease assignment, an index of potentially applicable environmental laws, a technical tax supplement, trademark practice and search resources, an antitrust checklist, and an index of foreign franchise disclosure and registration laws.

Wisdom comes in two media with this publication. Folks like me who can’t help making notes or writing comments in essential guidebooks will appreciate the 400+ pages with readable print and useful margins. Forms and appendices are also provided on CD: antitrust checklists, defined terms, sample transactional representations and warranties, due diligence checklists, a lease assignment, potential environmental issues, tax supplemental information, trademark forms, and summary charts of foreign disclosure regulations. The accessibility of CD media makes these instantly useful.

In short, the publication offers academic, judicial, and practical wisdom on all aspects of franchise mergers and acquisitions. Kudos to Lenny Vines and Christina Noyes for guiding this impressive and vital publication to such an impressive end. *Mergers and Acquisitions of Franchise Companies* is the standard to which other publications will aspire.
ANTITRUST


Marjam Supply Co., a former distributor of commercial roofing products manufactured by Firestone Building Products Co. and related entities, had thirty-five sales and warehouse facilities throughout the Northeast and Southeast. Its sales of Firestone products increased dramatically between 1997 and 2007, but decreased significantly thereafter. Firestone subsequently terminated Marjam’s distributorship. Marjam sued in the U.S. District Court for the District of New Jersey asserting claims for violation of the Robinson–Patman Act. Marjam contended that its sales of Firestone’s products decreased because other distributors (ABC defendants and New Castle) were able to offer lower prices to its customers as a result of receiving significantly more favorable rebates and incentives.

The ABC defendants filed a Rule 12(b)(6) motion to dismiss, arguing that Marjam did not have antitrust standing because their actions had not resulted in antitrust injury. Noting that the requisite causation element is not “unduly rigorous,” the court found that Marjam’s allegation that the loss of its Firestone distributorship would reduce competition among Firestone distributors was a sufficient allegation of interbrand antitrust injury.
The ABC defendants and New Castle also sought to dismiss Marjam’s cause of action for violations of Section 13(f) of the Robinson-Patman Act, which prohibits any person engaged in commerce from knowingly inducing or receiving “a discrimination in price which is prohibited by this section.” The court noted, however, that Section 13(f) does not prohibit all “discriminatory” prices; the discrimination must be illegal. For purposes of Section 13(f), a plaintiff must allege that the defendant buyer knew that it was receiving a lower price than a competitor and that the seller would have “little likelihood of a defense” for offering such price. Knowledge may be either actual or constructive. With respect to the seller’s likelihood of a defense, the plaintiff must, at a minimum, allege that “a price differential favoring the defendant buyer exceeded any cost savings the seller may have enjoyed in sales to the favored buyer.”

The court reviewed the allegations in Marjam’s complaint and found there was no allegation that ABC defendants and Newcastle had any knowledge about the prices Firestone charged Marjam. The court further found no allegation they had any reason to know the discounts they received were “unjustifiably low.” The court rejected Marjam’s reliance on pre-

Twombly and

Iqbal decisions, which suggested a lesser pleading standard. The court also found that cases cited by Marjam were distinguishable in that there was some factual allegation regarding the buyers, in addition to their size and sophistication, supporting an inference that the buyers knew the prices they received were improper. Thus, the court granted the defendants’ motion to dismiss the Section 13(f) claim.

ARBITRATION


In this case, a federal court considered whether a claim for a permanent injunction could be pursued in court, notwithstanding an arbitration provision in the parties’ distributor agreement. Goulds Pumps, Inc. and DXP Enterprises, Inc. entered into an agreement pursuant to which DXP was granted the right to sell Goulds’ products. The agreement included a broad arbitration clause, as well as a provision providing that “[n]otwithstanding the foregoing, [Goulds] or [DXP] may apply to a court of competent jurisdiction for the imposition of an equitable remedy (such as a Restraining Order or an Injunction) upon a showing of the elements necessary to sustain such a remedy.”

A dispute arose and Goulds initiated an arbitration seeking a declaration that it was entitled to terminate the distributor agreement. In response, DXP sued Goulds in state court seeking a temporary restraining order, as well as a preliminary and permanent injunction, prohibiting Goulds from terminating the parties’ agreement. The state court denied DXP’s request, finding no threat of irreparable harm because Goulds had agreed not to terminate the
distributor agreement until the arbitration had concluded. Goulds removed the case to the U.S. District Court for the Southern District of Texas, which denied DXP’s motion for preliminary injunction for the same reason.

Goulds moved to dismiss or alternatively stay DXP’s claim for a permanent injunction on the ground that the claim was subject to arbitration. The court framed the issue as whether a “provision allowing the parties to pursue an injunction permits DXP to avoid arbitrating its claim for a permanent injunction covering the same issues that Goulds seeks to arbitrate—whether DXP properly terminated the parties’ agreement.” DXP argued that the term “notwithstanding” in the arbitration provision meant that any claim seeking an injunction remedy was excluded from the arbitration requirement.

The court first analyzed a number of cases in which other courts had considered whether the specific language of an arbitration clause permitted a claim for injunctive relief to be pursued in court. The court found that the arbitration provision in the distributor agreement did not “‘clearly evidence an intent’ to allow litigation of claims subject to arbitration by asserting them as claims for permanent injunctive relief.” In reaching this decision, the court concluded that permitting DXP to litigate the appropriateness of the pending termination would require the court to decide the merits of the dispute that was subject to the valid arbitration clause and pending before an arbitrator. The court further concluded that an order from the court would necessarily moot the pending arbitration and deprive Goulds of its rights to have the matter resolved by arbitration. Accordingly, the court found that DXP’s claims for a permanent injunction must also be resolved in arbitration.


Doctor’s Associates entered into three franchise agreements with the defendant, an individual franchisee, for the operation of three Subway sandwich shops. When the franchisee failed to operate the sandwich shops in accordance with the franchise agreement, the franchisor filed two arbitration proceedings against the franchisee and won arbitration awards in both. Doctor’s Associates then filed a complaint in the U.S. District Court for the District of New Jersey, seeking to confirm the arbitration awards against both the individual franchisee and an alleged alter ego corporate entity that was not a party to the arbitrations. When the franchisee and his associated corporate entity failed to timely answer the complaint, the court eventually permitted Doctor’s Associates to move for default judgment.

The court noted that a default judgment was generally inappropriate to confirm an arbitration award against a nonparty to the arbitration, despite the alter ego allegation. However, the court held that rule did not apply because the defendants had failed to appear in the case. Instead, the court found that Doctor’s Associates could pierce the corporate veil based on evidence that the franchisee had created the corporation for the sole purpose of
operating the Subway franchises and that the individual franchisee was hiding behind the corporate entity to avoid paying the arbitration award and judgment. In a footnote, the court also found that enforcement of the arbitration award against the corporate entity would have been appropriate in any event pursuant to the franchise agreements’ corporate assignation provision. Thus, the court pierced the corporate veil and confirmed the arbitration awards as to both defendants.

The plaintiff dealer and the defendant manufacturer entered into a dealer agreement granting the plaintiff a nonexclusive right to sell and market the defendant’s forklifts in a certain geographic territory. Following the alleged termination of the agreement, the dealer demanded that the manufacturer repurchase certain equipment pursuant to the agreement and various state laws. The manufacturer refused, and the dealer filed a lawsuit in the U.S. District Court for the District of Kansas. The manufacturer moved to compel arbitration pursuant to an arbitration provision in the dealer agreement.

The plaintiff argued that “the liberal federal policy favoring arbitration raises a presumption of arbitrability only when evaluating the scope of an arbitration agreement—not when determining whether a valid arbitration agreement exists in the first place.” The court agreed and did not presume a valid arbitration agreement existed, making that determination under Tennessee law instead. In concluding that a valid arbitration agreement existed under Tennessee law, the court analyzed whether the forum-selection clause created a conflict with the purportedly mandatory arbitration clause by referencing proceedings that are brought in Shelby County, Tennessee, or the Western District of Tennessee. The court held that this provision did not present a conflict because it could be harmonized with the arbitration clause. Citing decisions from the Second, Third, Fourth, and Fifth Circuits, the court found that the forum-selection clause language refers to the power of a federal court to enforce an arbitration award or hear any disputes not subject to the arbitration clause and does not preclude arbitration. Finally, the court held that the dealer’s claims fell within the scope of the valid arbitration agreement. As a result, the court compelled arbitration.

RISO, Inc. was a manufacturer and distributor of printing and duplicating hardware and supplies, and Witt Co. was an authorized dealer of RISO’s products. In 2011, RISO and Witt entered into an asset purchase agreement, which included an arbitration clause, under which Witt acquired seven of RISO’s markets in California and Arizona. A dispute later arose regarding
RISO’s alleged obligations to continue to do business with Witt for a certain period of time. Witt sued RISO in the U.S. District Court for the District of Oregon alleging breach of the agreement and breach of the duty of good faith and fair dealing (the Oregon Action). Witt sought to enjoin RISO from terminating Witt’s authorized dealer status and damages. RISO filed a motion to dismiss Witt’s claims with prejudice, which the Oregon court granted.

Thereafter, Witt filed a demand for arbitration before the American Arbitration Association asserting claims against RISO for breach of the agreement. RISO responded by filing a complaint in the U.S. District Court for the Central District of California seeking a declaratory judgment that Witt waived its right to arbitrate by filing the Oregon Action. The California court construed RISO’s action as a motion to compel arbitration.

The court first addressed whether the waiver issue should be decided by the court or the arbitrator. The court, citing Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 72 (2002), held that waiver remained an issue for the court to determine.

The court then turned to the issue of whether Witt had waived its right to arbitration. A party seeking to demonstrate waiver must show: (1) knowledge of the existing right to compel arbitration, (2) facts inconsistent with that existing right, and (3) prejudice to the party opposing arbitration resulting from such inconsistent acts. Witt acknowledged that it knew about the arbitration clause, but argued that its actions were not inconsistent because the clause permitted a party to seek injunctive relief. Witt argued that it was primarily seeking injunctive relief in the Oregon Action and that the damages sought in that action were merely “incidental.” The court disagreed, noting that Witt had sought millions of dollars of damages in the Oregon Action and characterizing Witt’s actions as an attempt to “take two bites at the apple.” The court concluded that RISO was prejudiced by Witt’s approach because RISO was forced to spend time and money defeating Witt in the Oregon Action and then required to spend more time and money in the current action litigating the issue of whether the arbitration provision was enforceable. The court therefore concluded that Witt had waived its right to compel arbitration.

*Everett v. Paul Davis Restoration, Inc.*, Bus. Franchise Guide (CCH) ¶ 15,399, 771 F.3d 380 (7th Cir. 2014)

Matthew Everett and EA Green Bay, LLC (EAGB) entered into a franchise agreement with franchisor Paul Davis Restoration, Inc. (PDRI) for the operation of a furniture restoration franchise. Pursuant to PDRI’s requirements, EAGB was formed solely to operate the franchise. Everett signed the franchise agreement as 100 percent owner of EAGB. However, at some point later, his wife became a fifty percent owner of EAGB. However, at some point later, his wife became a fifty percent owner of EAGB at some point. The franchise agreement required PDRI’s consent before transfer of any ownership and also required owners to sign the agreement in their personal capacity. The Everetts knew of this requirement, but did not
make PDRI aware of Mrs. Everett’s ownership interest and she never signed the franchise agreement.

In 2010, PDRI terminated the franchise agreement for cause. The agreement contained a noncompete provision restricting EAGB and its principals from competing with PDRI for two years. Mr. Everett thereafter assigned forty-five percent of his fifty percent interest in EAGB to his wife. Mrs. Everett continued to operate EAGB in competition with PDRI, including using a PDRI marketing list to send out e-mails. PDRI initiated arbitration under the terms of the franchise agreement. Mrs. Everett filed suit in the U.S. District Court for the Eastern District of Wisconsin seeking a declaratory judgment that, as a nonsignator to the franchise agreement, she was not required to arbitrate. The district court denied the motion, finding “abundant evidence” that she was bound under the direct benefits doctrine. The arbitration panel ultimately entered an award against Mrs. Everett. PDRI returned to the district court and requested confirmation of the arbitration award. The district court thereafter reversed its prior reasoning and vacated the arbitration award on the grounds that the benefits to Mrs. Everett were indirect because they flowed through her ownership interest in EAGB rather than directly from the franchise agreement. PDRI appealed to the Seventh Circuit.

The Seventh Circuit noted the “relative dearth of precedent regarding direct benefits estoppel” but went on to find that the district court’s ruling with respect to the direct benefits doctrine was too narrow. The Seventh Circuit found that EAGB existed solely because of the franchise agreement; that Mrs. Everett through her ownership interest received all the benefits accorded under the franchise agreement; and that if the district court’s analysis was followed to its logical end, direct benefits estoppel would never be available when at least one signatory existed with an ownership interest. The Seventh Circuit also quickly disposed of her other arguments, including that the arbitration clause was unconscionable, her due process rights were violated, and the arbitration panel was biased, finding that they were unsupported by law. Thus, the Seventh Circuit reversed the judgment of the district court and remanded the case.

**BANKRUPTCY**


Navnitlal Zaver had a long history of owning and operating hotels through various business entities, including ownership of a business that was a franchisee of G6 Hospitality Franchising LLC (G6), pursuant to which Zaver operated a Motel 6 location in Pennsylvania. Zaver was a guarantor under the franchise agreement. G6 filed suit against the business entity and Zaver in the U.S. District Court for the Middle District of Pennsylvania, al-
leging breach of the franchise agreement and violations of the Lanham Act for the unauthorized use of the Motel 6 trademark.

On the morning that the matter was scheduled to go to trial, Zaver filed a Chapter 13 bankruptcy petition in the Bankruptcy Court for the Middle District of Pennsylvania. Thus, the automatic stay imposed by the bankruptcy filing enjoined the district court case from going forward. G6 responded by filing a motion in the bankruptcy court to lift the automatic stay to allow the district court case to proceed. The bankruptcy court entered an order to lift the stay. Although the district court case moved forward, Zaver filed his Chapter 13 plan in the bankruptcy case. G6 objected to the plan and sought an order dismissing the bankruptcy case on the grounds that it was filed in bad faith. G6 argued that Zaver had acted in bad faith by filing the bankruptcy case simply to stop the district court case from proceeding, as opposed to having a true need to reorganize his debts, and by filing schedules in the bankruptcy case that significantly overestimated the actual value of certain assets. In addition, G6 argued that Zaver had no actual intent or ability to reorganize his debts in the bankruptcy process.

Acknowledging that filing a case merely to stop litigation can be a sign of bad faith, the bankruptcy court found that Zaver had timed his bankruptcy filing to prevent the district court case from proceeding. Although this weighed in favor of a bad faith filing, the bankruptcy court went on to analyze G6’s other arguments. As to the valuation issues, the court noted that neither party submitted valuation evidence with respect to the assets at issue and, therefore, there was inadequate evidence to support a finding that Zaver purposefully misrepresented the values. As to Zaver’s intent to misuse the bankruptcy process, the bankruptcy court found that the substance of Zaver’s proposed Chapter 13 plan showed a true desire to reorganize his debts with a number of different parties. The court therefore concluded that, on balance, the case was not filed in bad faith and denied G6’s motion.

CHOICE OF FORUM


A supplier of filtration and purification products entered a distribution agreement with an equipment and supplies distributor, which contained a forum-selection clause identifying New York State or federal courts as the exclusive forum. The distributor sued the supplier in the U.S. District Court for the Eastern District of Arkansas, alleging that the supplier violated the Arkansas Franchise Practices Act (AFPA) by terminating the franchise without sufficient notice. The supplier moved to transfer the case to the U.S. District Court for the Eastern District of New York. The distributor argued that its claims arose out of the AFPA rather than the agreement and, therefore, were not subject to the forum-selection clause. The court dis-
agreed, noting that the action arose, either directly or indirectly, from the distributorship and granted the motion to transfer.

The plaintiff, a commercial truck dealer, sued the defendant, a commercial truck manufacturer, in the U.S. District Court for the District of South Dakota, alleging state law claims and violations of the Robinson–Patman Act. The manufacturer moved to dismiss the case for improper venue or to transfer the matter to federal court in Ohio pursuant to the choice-of-law provision and forum-selection clause in the parties’ agreement. Prior to the court’s decision on the motion to dismiss or transfer, the U.S. Supreme Court issued its decision in Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas, 134 S. Ct. 568 (2013), clarifying the proper procedural mechanism for enforcing a forum-selection clause and holding that courts should give such clauses controlling weight in most situations. The court denied the manufacturer’s motion, and the manufacturer then moved for reconsideration in light of Atlantic Marine.

The court denied the motion for reconsideration, reasoning that despite the holding in Atlantic Marine, it had a responsibility to determine whether a particular forum-selection clause was valid before deciding whether to transfer pursuant to 28 U.S.C. § 1404(a). The court determined that, contrary to the forum-selection clause in Atlantic Marine, the forum-selection clause here was unenforceable in light of the strong public policy of South Dakota. The court did, however, grant permission for an interlocutory appeal pursuant to 28 U.S.C. § 1292(b).

IB Agriculture, a distributor of agricultural products, sued Monty’s Plant Food Co., alleging that Monty’s committed fraud and negligence and breached the parties’ agreement by conducting direct sales in the distributor’s territory and raising prices during the term of the agreement. Monty’s moved for summary judgment on IB Agriculture’s claims. In granting the motion for summary judgment, the court found that there was no exclusive distribution agreement between the parties. Furthermore, the court found that the distributorship more closely resembled a UCC Article 2 sale of goods contract than a services contract because there was no evidence of a commission-based relationship and the supplementary services did not predominate over the sale-of-goods portion of the contract. As a result, the court found that, although the parties’ course of dealings could supplement or explain the contract terms under Kentucky’s UCC, the course of dealings could not add an exclusive distributorship as a term of the contract. The
court also concluded that there was no evidence of a price increase in violation of any agreement.

IB Agriculture alleged that Monty’s committed actual and constructive fraud by selling to customers within the distributor’s territory, but the court found no evidence to support that Monty’s agreed to an exclusive distributorship that would create material misrepresentation. Nor did IB Agriculture identify any breach of legal duty to support a constructive fraud claim, which also doomed its negligence and negligent misrepresentation claims. Finally, IB Agriculture’s claim for tortious interference with a prospective business advantage also failed because no evidence existed of an intentional and improper or impermissible motive. The court ultimately dismissed the complaint with prejudice.


Four franchisee entities operated 142 KFC restaurants across various states. The defendant guarantor Kazi guaranteed each of the restaurants’ obligations. When the four franchisees filed bankruptcy, they sold virtually all of their assets pursuant to the Bankruptcy Code. KFC received none of the sale proceeds and filed a lawsuit against Kazi as guarantor. Kazi asserted four affirmative defenses on behalf of the franchisees and sought discovery. In an earlier order, the U.S. District Court for the Western District of Kentucky had found that the guaranties were enforceable. The court then addressed Kazi’s affirmative defenses. The court dismissed the first two affirmative defenses, which inappropriately challenged KFC’s business judgment decision to push “Kentucky Grilled Chicken” and focus on the China market at the expense of U.S. franchisees. The court held it must presume that the company made business decisions on an informed basis, in good faith, and under the belief that those actions were in the best interests of the company. In his third defense, the guarantor alleged that KFC conspired against the franchisee entities and engaged in anticompetitive business practices. In his fourth defense, the guarantor asserted that KFC forced certain restaurants to undergo unreasonable remodeling, thus forcing them into bankruptcy. The court determined that res judicata barred these two affirmative defenses because Kazi could have and should have raised these defenses during the bankruptcy proceedings.


Benjamin Franklin Franchising, LLC (BFF) was a franchisor in the business of licensing plumbing business systems. On Time Plumbers, Inc. (OTP) entered into a franchise agreement with BFF for a location in Las Vegas (the Nevada franchise), which OTP never actually opened.
George Donaldson was the president of OTP, and Clockwork, Inc. was the parent company of BFF. Several other businesses owned by Donaldson were franchisees of Clockwork entities. In October 2013, Clockwork and Donaldson entered into a letter of intent (LOI) to end their franchisor/franchisee relationship for certain locations in Arizona and California. The LOI proposed that Clockwork would purchase the Arizona and California franchises and further provided that the LOI could be terminated if the parties did not enter into a purchase agreement by December 16, 2013. The LOI also provided that certain provisions would remain binding after termination of the LOI, including a provision that Clockwork and Donaldson would “work together” to transfer the Nevada franchise territory. In December 2013, Clockwork advised Donaldson that it did not intend to enter into a purchase agreement. Donaldson responded by de-branding his Arizona and California businesses and began operating them in competition with Clockwork franchises.

Donaldson sued Clockwork in the U.S. District Court for the Central District of California (the California action) seeking a declaratory judgment that his businesses were not in violation of the LOI’s noncompetition clauses. In the meantime, Clockwork and OTP were in negotiations regarding the transfer of the Nevada franchise. BFF subsequently filed an action against OTP in the U.S. District Court for the Middle District of Florida (the Florida action), alleging breaches of the franchise agreement by OTP. Donaldson responded by filing an amended complaint in the California action adding OTP as a plaintiff and BFF as a defendant. OTP then moved to dismiss the Florida action, arguing that the matters in the Florida action should proceed in the California action based on the “first-to-file” rule or on grounds of improper venue.

The court noted that the franchise agreement contained a forum selection clause mandating that actions must be commenced in the U.S. District Court for the Middle District of Florida, which was BFF’s principal place of business. The court concluded that the franchise agreement was controlling over the LOI because neither BFF nor OTP were parties to the LOI and also because the franchise agreement required any change to be: (1) in writing, (2) identified as an amendment to the agreement, and (3) signed by the parties.

The court also noted that the forum selection clauses were presumptively valid and would be enforced unless a plaintiff made a strong showing that enforcement would be unfair or unreasonable under the circumstances. OTP argued that the clause should not be enforced because litigating in California would preserve judicial resources and proceeding in Florida would be expensive and inconvenient. The court held that these reasons were not sufficient to rebut the presumption of validity. The court next analyzed whether it could exercise personal jurisdiction over OTP, concluding that if a forum selection clause is freely negotiated and is not unreasonable and unjust, the minimum contact standard for personal jurisdiction is met. The court held that under that analysis, it could exercise personal jurisdiction over OTP.
Turning to OTP’s first-to-file argument, the court considered: (1) the chronology of the two actions, (2) the similarity of the parties, and (3) the similarity of the issues. The court concluded that the two actions were separate and distinct because neither OTP nor BFF were parties to the LOI and it was clear that the LOI was intended to be a separate agreement from the franchise agreement. The court further concluded that there was no overlap between the two actions that would compel enforcement of the first-to-file rule.

Finally, the court considered OTP’s forum non conveniens argument. The court held that because there was an enforceable forum selection clause, OTP’s forum non conveniens argument would only be considered on public policy grounds such as: (1) the administrative difficulties flowing from court congestion, (2) the local interest in having localized controversies decided at home, and (3) the interest in having the trial of a diversity case in a forum that is at home with the law. The court further noted that, according to U.S. Supreme Court precedent, the factors must demonstrate “unusual” or “extraordinary” circumstances supporting the position that maintaining the action in Florida would constitute a burden on the court system. Thus, the court denied OTP’s motion to dismiss the Florida action.

Pepe’s Franchising, Ltd. and Frango Grille USA, Inc. entered into a master franchise agreement granting Frango the right to operate Pepe’s restaurants in California and recruit additional California franchisees. Pepe’s was both incorporated in and had its principal place of business in the United Kingdom. The agreement contained a forum selection clause stating that proceedings arising out of or in connection with the agreement must be brought in any court of competent jurisdiction in London. However, the franchise disclosure document contained a “California addendum” stating that the forum selection clause may not be enforceable under California law.

Although Frango made preparations to open a Pepe’s restaurant, the restaurant never opened and Frango later sought to rescind the agreement. Frango filed suit against Pepe’s in the U.S. District Court for the Central District of California, alleging various state law claims. Pepe’s filed a motion to dismiss based on the forum selection clause or on forum non conveniens. Frango argued that the forum selection clause was invalidated by the California Franchise Relations Act (CFRA), which provides that a “provision in a franchise agreement restricting venue to a forum outside [California] is void with respect to any claim arising or relating to a franchise agreement involving a franchise business operating within [California].”

Pepe’s argued that the CFRA did not apply. First, Pepe’s argued that Frango was not “operating” a franchise in California because the restaurant never actually opened. The court rejected this argument on the grounds that the CFRA is to be interpreted broadly and that the provision is designed to
apply to all franchise agreements concerning the operation of a franchise business within California. According to the court, the agreement clearly pertained to the operation of a California franchise, even if the restaurant never opened. Pepe’s further argued that the CFRA did not apply because none of Frango’s claims were brought under that statute. The court disagreed again, holding that the CFRA applies to any claim arising under or relating to a franchise agreement involving a franchise business within California. Pepe’s also argued that the CFRA provision should only be applied to forum selection clauses deemed “unfair.” The court rejected this argument on the grounds that it was not supported by the text of the CFRA provision, which makes no mention of fairness.

Pepe’s next argued that the court was required to apply federal law in determining whether a forum selection clause is enforceable based on the Supreme Court’s decision in Atlantic Marine Construction Co., Inc. v. U.S. District Court for Western District of Texas. Although the court acknowledged that it is required to analyze the factors in 28 U.S.C. § 1404 in deciding whether to enforce a forum selection clause, it noted that the analysis applied only to valid forum selection clauses and that the CFRA made the applicable forum selection clause invalid based on California public policy. Therefore, the court found that an analysis of the 28 U.S.C. § 1404 factors was not required.

Finally, the court analyzed the forum non conveniens factors without taking into account the forum selection clause. The court noted that agreement negotiations mainly took place in England, but that Pepe’s sought to do business in California; registered its business there; and, based on the California addendum, clearly knew that the forum selection clause was likely unenforceable. The court therefore concluded that, on balance, the forum non conveniens factors were not met to a degree requiring transfer of the venue.

CLASS ACTIONS

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

CONTRACT ISSUES

Gish Oil Company was a longtime petroleum marketer for Phillips Petroleum and its successor, Phillips 66 Co., in Georgia. Raymon and Helen Gish executed a guaranty for all of Gish Oil’s obligations to Phillips. In 1998, Gish Oil and Phillips entered into an agreement (the NCIP agreement) pursuant to which Gish Oil agreed to make certain improvements to a convenience store selling Phillips gasoline (Baytree Convenience
(the NCIP program). The NCIP agreement required Gish Oil to reimburse Phillips for some or all of the incentive payments under certain conditions, including if the convenience store was no longer branded as a Phillips gas station. The amount that would need to be reimbursed was dependent on when any of the conditions occurred. To fulfill its obligations to improve the Baytree Convenience Store, Gish Oil razed the existing structures and constructed a new building. Phillips ultimately paid $162,000 in incentive payments to Gish Oil under the NCIP agreement.

In October 2004, Phillips and Gish Oil entered into a separate branded marketer agreement (the 2004 agreement) pursuant to which Gish Oil was required to purchase 5 million gallons of gasoline and distillate from Phillips annually. Gish Oil’s annual sales fell below this minimum threshold in 2005 and 2006. In 2007, Phillips informed Gish Oil that it was going to end its marketing agreements with marketers that were not meeting the company’s sales goals. As a result, Gish Oil decided to end its relationship with Phillips and removed the Phillips brand from the Baytree Convenience Store, which was the ninth year that the store had been in the NCIP program. Phillips 66, which by that time had acquired the rights under the NCIP agreement and guaranty, sought to recover some of the incentive payments paid to Gish Oil pursuant to the agreement. Gish Oil refused to pay, and Phillips 66 filed suit in the U.S. District Court for the Middle District of Georgia. After considering the parties’ cross-motions for summary judgment, the court granted Phillips 66’s motion and denied the defendants’ motion.

The court quickly concluded that Gish Oil had breached the NCIP agreement by not repaying some of the incentive payments and then addressed Gish Oil’s affirmative defenses. The defendants argued that the requirement that it repay some or all of the incentive payments was a penalty “in the guise of liquidated damages.” The court disagreed, finding that the provision requiring the reimbursement of the incentive payments was not a liquidated damages provision because (1) the NCIP agreement did not prohibit Gish Oil from removing the Phillips brand, and (2) Gish Oil was obligated to repay the incentive payments even if Phillips had caused at least one of the conditions to occur. The district court also rejected the defendants’ argument that the 2004 agreement had superseded the NCIP agreement, finding that they dealt with different subject matters.

The court then turned to the defendants’ arguments that there were disputed issues of material fact that warranted denying Phillips 66’s motion. The court rejected the defendants’ claim that Phillips 66 had not established that it had suffered damages from the breach of the agreement or the amount of damages, concluding that Phillips 66 was not required to show that it or its predecessor had actually lost sales as a result of Gish Oil’s breaches. The court was similarly unpersuaded by the defendants’ claim that there was a
genuine factual dispute as to whether the NCIP agreement failed for a lack of consideration, finding that the parties had initially performed as agreed. The court also found no evidence to support the defendants’ claim that Phillips had either waived its rights or that it had repudiated the agreement such that Gish Oil’s performance was excused.

Saletech, LLC, a Ukrainian company, entered into a distribution agreement with East Balt Ukraine (EB Ukraine), also a Ukrainian company, to be the exclusive distributor of bakery products. East Balt, Inc. (EB Inc.) is a Delaware corporation and the parent company of East Balt of Eastern Europe, LLC (EB Europe), an Illinois limited liability company that owns EB Ukraine. Saletech alleged that shortly after entering into the distribution agreement, EB Ukraine breached the agreement. Saletech filed a series of complaints against the defendants, all of which were dismissed with leave to amend. In its third amended complaint, Saletech asserted claims for (1) breach of contract against EB Ukraine, (2) breach of contract by ratification against EB Inc. and EB Europe, (3) breach of contract by actual or apparent agency against EB Inc., (4) breach of contract against EB Europe as the alter ego of EB Ukraine, (5) a promissory estoppel claim against EB Inc., and (6) unjust enrichment against EB Inc. and EB Europe. Saletech did not serve the third amended complaint on EB Ukraine, and the other defendants moved to dismiss.

The court first considered Saletech’s claim for breach of contract against EB Inc. based on an agency theory. The court found that Saletech had failed to allege that EB Inc. gave EB Ukraine authority to enter into the distribution agreement on its behalf and that there was no other evidence that its words or acts (rather than those of EB Ukraine) established the alleged actual authority. The court also found that Saletech had failed to plead any apparent authority showing that (1) EB Inc. had consented to or otherwise knew that EB Ukraine had entered into the agreement on its behalf, (2) that Saletech had a good faith belief that EB Ukraine had authority to bind EB Inc., or (3) that EB Inc. had relied on EB Ukraine’s authority to its detriment.

The court then considered Saletech’s claims against EB Inc. and EB Europe for breach of contract based on the theory that they had ratified the agreement by allegedly telling Saletech that if it assisted in the investigation of claimed improprieties by EB Ukraine’s management, the distribution agreement would be honored. The court first noted that there was no evidence that EB Ukraine was acting as an agent for either EB Inc. or EB Europe. The court then found that there were no allegations in the third amended complaint that would support the conclusion that EB Inc. and EB Europe retained any benefits under the distribution agreement or took any steps to be bound by it.

The court also dismissed Saletech’s claim for breach of contract against EB Europe on an alter ego theory. The court held that, although Saletech
alleged the parties had commingled funds as a means for defrauding creditors and had a unity of interest and the same address, the complaint lacked any factual support for the allegation that the funds had been commingled as a means of defrauding the creditors.

The court rejected Saletech’s promissory estoppel theory, holding that such a claim only applies in the absence of a contract. Finally, the court dismissed Saletech’s unjust enrichment claim, finding that Saletech had failed to explain what benefit the defendants had obtained that was to Saletech’s detriment.


Pursuant to the parties’ distribution agreement, GLM agreed to purchase stolen vehicle recovery units (SVRUs) from LoJack in order to resell and install them. LoJack had the right to terminate the distribution agreement if GLM breached any of the provisions in the agreement and either party could terminate the agreement for no cause upon written notice. In the event that the distribution agreement was terminated without cause, LoJack agreed to credit GLM the price of any uninstalled SVRUs and pay a fee for any units sold by LoJack to a dealer in GLM’s market for a period of 180 days. The distribution agreement included standard waiver, integration, and no modification-without-a-writing clauses.

At some point, either before or after the parties entered into the distribution agreement, the parties discussed GLM being guaranteed LoJack’s “best price” for the SVRUs. For purposes of considering the parties’ motions for summary judgment, the court assumed that the discussions occurred after the agreement was entered. GLM also claimed that a third party, George Wafer, president of Vehicle Manufacturer Services (VMS), told GLM’s president that GLM would receive the best price from LoJack and that GLM would be paid $2 for each LoJack unit purchased by a distributor that GLM helped VMS to recruit. Wafer entered into a separate agreement with LoJack regarding VMS’s obligation to recruit distributors of LoJack products in exchange for compensation.

When GLM fell behind in its payments, LoJack issued a notice of default. In response, GLM sent a letter to LoJack giving notice of its intent to terminate the distribution agreement for no cause. Thereafter, LoJack sent a letter terminating the distribution agreement as a result of GLM’s failure to pay the outstanding arrearages. GLM filed suit asserting a variety of claims, including breach of contract, breach of the duty of good faith and
fair dealing, and a statutory claim under Massachusetts law. LoJack asserted counterclaims based on GLM’s failure to pay for goods and services.

The court first addressed LoJack’s motion for summary judgment on GLM’s claims, which were all based on GLM’s allegation that it was promised the best price on LoJack’s products. Although the distribution agreement included a provision requiring that any amendment or modification of the agreement be in writing, the court noted that such provisions do not automatically bar an oral modification of the agreement. The court further noted, however, that the presence of such a provision does increase a party’s burden of establishing an oral modification. After considering GLM’s evidence, the court found that it was not “sufficiently clear and convincing” to overcome the “deference” to which a provision requiring all modifications be in writing was entitled. Among other things, the court found that the evidence did not support GLM’s claim that Wafer had the authority to bind LoJack to a best price promise and there was no evidence that LoJack acted in any manner which supported that an oral modification had occurred. The court similarly found that there was no evidence to support GLM’s claim that LoJack, rather than Wafer, had agreed to pay a commission to GLM for SVRUs sold by distributors that GLM had helped to recruit.

The court then turned to GLM’s claims that LoJack had breached the distribution agreement by (1) requiring that GLM pay for products in advance, (2) not crediting GLM’s account for returned products, (3) not paying GLM for units sold to dealers in its territory, and (4) not crediting GLM for unclaimed incentive payments. With respect to the first claim, the court found that there was no provision prohibiting LoJack from requiring prepayment. The court found that GLM’s claim that it was entitled to various post-termination payments failed because LoJack had terminated the distribution agreement for cause and, therefore, was under no obligation to make such payments. Finally, the court found that GLM’s claim that it was owed prepaid incentive monies was contrary to LoJack’s written policy, and GLM had acknowledged the policy.

The district court then addressed GLM’s breach of duty and good faith and fair dealing claim, finding that such a claim may not “be invoked to create rights and duties that were not otherwise provided for in the existing contractual relationship” and that the distribution agreement had not been orally modified to require LoJack to provide GLM with its best price. GLM’s unfair competition claim, also based on the alleged best price agreement, fared no better because the court had found that there was no such agreement. Moreover, the court concluded that even if LoJack had hidden the fact that it was offering better prices to other dealers and misled GLM, LoJack’s conduct did not rise to the level necessary to sustain an unfair competition claim under Massachusetts law.

The court then turned to LoJack’s counterclaims for breach of contract and breach of good faith and fair dealing. The court quickly found that
GLM had breached the distribution agreement by failing to pay amounts owed and granted summary judgment in favor of LoJack on this claim. However, the court denied LoJack’s claim for breach of good faith and fair dealing, which was based on two theories. The court rejected the first theory, finding that it was duplicative of LoJack’s breach of contract claim that GLM had failed to pay for goods and services. The court found that the second theory—that the best price issue was contrived and only intended to improve GLM’s negotiating position with respect to the outstanding balance—was unsupported by any evidence of GLM’s motive.


John LeCompte was the principal and sole shareholder of an entity that operated two Popeyes restaurants in Louisiana pursuant to two franchise agreements entered into with AFC Enterprises, Inc. In response to the plaintiffs’ efforts to acquire additional Popeyes franchises in Louisiana, AFC advised them that “it did not want to grow with LeCompte with a new store.” Subsequently, another Popeyes franchisee offered to sell his Popeyes franchises to the plaintiffs. AFC again told LeCompte that it was not interested in “growing” with the plaintiffs.

The plaintiffs filed a lawsuit in Louisiana state court against AFC and the franchisee who offered to sell his franchises to the plaintiffs, alleging violations of Louisiana’s Unfair Trade Practices Act (LUTPA) and a violation of the abusive rights doctrine. In response, AFC filed an exception of no right of action and a motion for summary judgment. The trial court granted AFC’s motions and the plaintiffs appealed. The appellate court affirmed the judgment.

The court first considered the defendants’ exception of no right of action. The court found there was no evidence to support the plaintiffs’ theory that they were a party to the contract between AFC and the selling franchisee and, thus, had no standing to assert a claim that AFC had unreasonably refused to approve the sale.

The court next addressed AFC’s motion for summary judgment. The plaintiffs’ unfair trade practices claim was based upon AFC’s purported “intentional retribution” due to prior litigation between the parties. AFC asserted that because there was no development agreement with the plaintiffs, AFC was under no obligation to permit the plaintiffs to acquire additional franchises. In order to prevail on a LUTPA claim, a plaintiff must provide evidence of fraud, misrepresentation, deception, or unethical conduct. The court found that the plaintiffs’ evidence failed to rise to this level.

The court found that the plaintiffs’ abuse of rights claim was similarly deficient. Abuse of rights claims under Louisiana law are “invoked sparingly” and applied only when either “(1) the predominant motive for exercise of the right was to cause harm; (2) there was no serious or legitimate motive for exercise of the right; (3) the exercise of the right violates moral rules,
good faith, or elementary fairness; or (4) the exercise of the right was for a purpose other than that for which it was granted.” The court held that the plaintiffs had presented no evidence that AFC’s unwillingness to grow with them was a result of any motivation to cause harm to the plaintiffs, illegitimate, or in bad faith.


Plaintiff Westgate Ford Truck Sales, a Ford medium- and heavy-duty truck dealer, brought a class action against Ford Motor Co., alleging that Ford’s competitive price assistance program (CPA) violated the standard franchise agreement between Ford and its dealers. The CPA permitted dealers to petition Ford for competitive, individual discounts off wholesale prices. Westgate complained that Ford did not inform other dealers of the discounts given to individual dealers that petition for relief under the CPA. It argued that this violated a provision of the franchising agreement stating that sales would be made according to published price schedules.

The trial court originally granted summary judgment in Westgate’s favor and entered a jury verdict for class-wide damages totaling nearly $2 billion. Ford appealed the summary judgment decision and verdict, and the Ohio Court of Appeals reversed, holding that the relevant language in the agreement was ambiguous, and that Ford’s interpretation was reasonable. On remand, the trial court conducted a second jury trial on Westgate’s breach of contract claim, which resulted in a complete defense verdict for Ford. Westgate then moved for judgment notwithstanding the verdict, which the trial court granted. The trial court entered a judgment in Westgate’s favor on liability but based on a breach unrelated to the relevant language in the franchise agreement previously found ambiguous.

Ford again appealed to the Ohio Court of Appeals, arguing that the trial court’s grant of Westgate’s motion for judgment notwithstanding the verdict contradicted the law of the case because the only provision at issue was the one determined, as a matter of law, to be ambiguous. The appellate court agreed, holding that the trial court erred in determining that Ford breached the contract and, thus, the appellate court reversed the judgment and reinstated the jury verdict in Ford’s favor.


Englewood Auto Group, LLC (EAG) was an authorized dealer of Chevrolets and Buicks in New Jersey pursuant to dealer agreements between EAG and General Motors Corp. EAG sublet the Buick dealership facility from Argonaut Holdings, Inc., a GM Corp. affiliate.

In 2002, in conjunction with EAG becoming a Buick dealer, EAG and GM Corp. entered into a “business plan agreement” providing that, among other things, EAG had the right at some point in the future to oper-
ate a Pontiac franchise at its Buick dealership facility. The business plan agreement also required GM Corp. to pay EAG a subsidy for rent at EAG’s Buick facility (the Pontiac rent subsidy) until GM Corp. appointed EAG as a Pontiac franchisee.

In 2004, GM Corp. appointed EAG as a Pontiac franchisee and the parties amended the business plan agreement such that the Pontiac rent subsidy would end on December 31, 2004. In 2009, GM Corp. filed Chapter 11 bankruptcy. As part of the bankruptcy, GM Corp. discontinued the Pontiac and Saturn brands. General Motors, LLC (GM) was the entity that emerged from the bankruptcy case. Following the bankruptcy case, GM granted certain dealerships the opportunity to perform Saturn warranty work going forward. EAG was not granted this right.

GM and EAG entered into “participation agreements” allowing EAG to continue as a Chevrolet and Buick dealer following the bankruptcy case. The participation agreements included a sale performance metric called the retail sales index. GM alleged that EAG did not meet the required retail sales index for several years. In 2013, GM filed a complaint in the U.S. District Court for the District of New Jersey seeking a declaratory judgment that GM could terminate its contractual relationship with EAG. EAG responded by filing counterclaims against GM and Argonaut. GM filed a motion to dismiss EAG’s counterclaims, which the court granted.

The first set of counterclaims involved EAG’s allegation that GM breached the dealer agreements by failing to prevent other dealers from engaging in brokered sales of cars to end users and also by failing to grant EAG the opportunity to perform Saturn warranty work. The court found that EAG had not identified any specific contractual obligation by GM to prevent the brokered sales. The language that EAG pointed to was merely “general and aspirational” and did not impose any actual obligations. EAG also alleged that it was a third party beneficiary of GM’s agreements with other dealers and that GM owed a duty to EAG to police its dealership networks and prevent brokered sales. The court again pointed to the fact that GM was not contractually obligated to preclude such sales. The court also noted that the dealer agreements with EAG and the other dealers specifically precluded the enforcement of third party beneficiary obligations asserted by EAG. As to the Saturn warranty work, the court determined that the dealer agreements did not obligate GM to name EAG as a Saturn warranty center.

The court next addressed EAG’s claim that GM was obligated to reinstate the Pontiac rent subsidy once it became clear that the Pontiac brand would be discontinued as part of the bankruptcy. EAG alleged that GM was unjustly enriched by the higher rent payments made by EAG following the discontinuing of the Pontiac brand. The court determined that nothing in the relevant agreements indicated that EAG was entitled to receive rent subsidies in the event the Pontiac brand was discontinued. The court also noted that unjust enrichment was appropriate only in the absence of a valid and binding
contract between the parties. Because the parties had a contract, the court ruled that EAG could not bring an unjust enrichment claim.

EAG also claimed that Argonaut breached the sublease by failing to agree to a modification of the rent after the Pontiac brand was discontinued. The court ruled that Argonaut had no such obligation under the sublease. EAG also alleged that the sublease should be “reformed” to provide for a rent subsidy or rent reduction. The court noted that under New Jersey law, an agreement can be reformed only upon a showing of mutual mistake or unilateral mistake accompanied by fraud or unconscionable conduct. The court held that the sublease specifically contemplated the possibility of EAG losing its right to distribute a particular brand and that, therefore, there was no mutual or unilateral mistake and no fraud or unconscionable conduct.

Finally, EAG asserted that GM breached the covenant of good faith and fair dealing by failing to prevent brokered sales and denying EAG’s right to perform Saturn warranty service. The court determined that under Michigan law, the duty of good faith and fair dealing arises only in connection with specific contractual obligations. Because GM had no such obligations, EAG had no claim.


Tom Spiece, through his company Richard I. Spiece Sales Co., Inc., became an authorized retailer of Levi’s jeans in 1978. Throughout the 1980s and 1990s, Spiece worked closely with Levi’s to grow his business and promote the brand. The jeans were purchased by Spiece on a purchase order and acceptance basis. The purchase orders included Levi’s terms of sale. In 2000, Spiece sought and was granted permission to sell Levi’s on his company’s website. Levi’s provided Spiece with its written Internet sales policy, which stated that it would periodically be amended. In 2008, Levi’s amended the policy to prohibit the practice of “key word stuffing,” which is adding words and phrases in an attempt to manipulate Internet search engines so that the website is more prominently featured in web searches. Levi’s knew that Google disapproved of this practice and often punished businesses engaged in it. In 2008, Levi’s discovered that Spiece’s website was using key word stuffing and other practices prohibited under the policy. Levi’s sent Spiece a letter demanding that he come into compliance with the policy. Over the next few years, Spiece addressed some, but not all, of Levi’s concerns. In 2011, Levi’s revoked Spiece’s right to sell Levi’s jeans on his website. Spiece had made a large 2010 year-end purchase, and Levi’s made a one-time offer to repurchase that inventory. Spiece refused to return the inventory and refused to pay for the inventory in full.

Levi’s subsequently filed a lawsuit in Indiana state court seeking to collect $321,778 owed for the inventory. Spiece filed a counterclaim, alleging breach of contract and violations of the Indiana Deceptive Franchise Practices Act. The trial court ruled in Levi’s favor and Spiece appealed.
As to the breach of contract issue, Spiece argued that the letters from Levi’s authorizing Spiece to sell Levi’s products were enforceable contracts. Levi’s responded that there was never a contract between the parties and that the products were always sold pursuant to purchase orders. The appellate court affirmed the trial’s courts holding that there was no contract. Rather, the purchaser orders provided that Levi’s acceptance of each of Specie’s purchase orders was conditioned on his agreeing to comply with Levi’s policies. The court found that this conditional acceptance in a purchase order did not give rise to any contractual obligation on Levi’s part.

Spiece also argued that his business was a franchisee under the Act because he was granted the right to sell Levi’s branded products and was subject to Levi’s policies. The trial court held that Spiece’s business was not a franchisee because (1) there was no contract between the parties, (2) Levi’s had no control over who Spiece hired or what he sold to customers, and (3) Levi’s did not require Spiece to purchase new product to sell to customers. On appeal, the court affirmed this decision, noting that Spiece provided no evidence suggesting that the trial court’s ruling was in error.

CORPORATE VEIL PIERCING


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

**DAMAGES**


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


Plaintiff Gutter Topper Ltd. (GTL) is a manufacturer of gutter covers for personal residences throughout the United States. Defendant Sigman & Sigman Gutters, Inc. (SSGI) entered into a series of dealer agreements with GTL pursuant to which it was granted the right to sell Gutter Topper covers in portions of the United States. The agreements were guaranteed by William Sigman, the president and owner of SSGI. The dealer agreements prohibited SSGI from distributing, promoting, or designing any competitive products; restricted SSGI’s rights to use the Gutter Topper trademark; and gave GTL the right to terminate the agreements if SSGI failed to pay the required royalties.

GTL ultimately terminated the dealer agreements due to SSGI’s failure to pay royalties. Unbeknown to GTL, prior to the termination of the parties’
agreements, SSGI developed and offered for sale a competitive gutter cover product. Notwithstanding the termination, SSGI continued to advertise GTL’s product and use its trademark for at least six weeks after the termination. GTL filed a complaint in the U.S. District Court for the Southern District of Ohio, asserting claims under the Lanham Act and seeking injunctive relief and damages. GTL successfully moved for summary judgment on the issue of liability with respect to several of its claims. A trial was set on damages issues, but was vacated when SSGI and Sigman filed for bankruptcy. The case was ultimately reopened as to Sigman only and GTL moved forward with its damages case. In lieu of a trial, the parties agreed to resolve the matter on written briefs. GTL requested that the court issue findings that Sigman had willfully engaged in infringement and unfair competition and also sought a finding that Sigman’s conduct was committed “willfully and maliciously to cause injury.”

After considering the evidence submitted by GTL, the court concluded that Sigman’s infringing use of the Gutter Topper trademark was “willful, deliberate, and fraudulent.” In reaching its decision, the court found that Sigman understood he was not permitted to use the Gutter Topper trademark to promote any product other than Gutter Topper because he said as much in a letter to the company, but nonetheless developed and sold a competitive product. The court also noted that Sigman falsely told GTL that his product was only for the commercial/industrial marketplace. Additionally, the court noted that SSGI sales representatives offered the competitive product to consumers as an alternative to and usually at a cheaper price than the Gutter Topper product. The court further found that Sigman had taken no steps to remove the Gutter Topper trademark from SSGI’s website for several months after the agreements were terminated and continued to affirmatively use the trademark, even after the lawsuit was filed, in invoices and agreements suggesting that SSGI was installing a Gutter Topper system. Based on this evidence, the court also found that Sigman intended to injure GTL or at least should have known that injury was “substantially certain.” Thus, the court also found that Sigman had acted with the intent to cause willful and malicious injury.

A child care center franchisee indicated its intent to end its franchise relationship with the franchisor Legacy Academy, effective January 1, 2011, approximately eight and one-half years into the agreed upon twenty-year term. The franchisee continued to use the name and trademarks through December 31, 2010, but ceased paying royalties in the last three months. Legacy terminated the agreement based on the franchisee’s breach of the franchise agreement. Legacy then sued the franchisee, alleging breach of contract and seeking to collect royalties and advertising fees through December 31, 2010, as well as future lost profits. The trial court granted summary judgment to Legacy, but, following a bench trial on damages, the trial court awarded damages only for
accrued royalty fees during the two months prior to de-identification, with no royalty fees awarded for the balance of the franchise agreement’s term.

On appeal, the Georgia Court of Appeals reversed and, under traditional contract principles, held Legacy was entitled to lost future royalty payments through the end of the franchise agreement term, but only if it could prove those lost profits. On the record from the trial court, the appellate court did not find definite, certain, and reasonable data to ascertain Legacy’s anticipated profits.

DEFINITION OF FRANCHISE


Kinsley Group, Inc. entered into a distribution agreement with a German company (MWM) that manufactured power generators under the MWM brand. Pursuant to this agreement, Kinsley Group was granted the exclusive right to market, sell, install, and provide repair and maintenance services for power generators manufactured by MWM in the Northeast and Mid-Atlantic regions in the United States. The agreement prohibited Kinsley Group from marketing, selling, purchasing, or distributing any products that competed with MWM’s products while the agreement was in effect and for a twelve-month period thereafter. However, the agreement permitted Kinsley Group to market and distribute products for Kohler, whose products did not compete with MWM. The distribution agreement expressly disclaimed a franchise relationship and included a standard integration clause.

After the parties entered into the distribution agreement, Kinsley Group formed Kinsley Energy Systems, LLC (KES) for purposes of selling and supporting the MWM products. Although a draft assignment of the agreement to KES was prepared, it was never finalized or signed. Several years after the parties entered into the distribution agreement, MWM and its affiliates were acquired by Caterpillar, which has its own distribution network in the United States. The plaintiffs claim that as a result of this acquisition, MWM “began to find alleged fault with Kinsley’s performance.” MWM subsequently terminated the distribution agreement, and Kinsley Group and KES filed suit in the U.S. District Court for the District of Connecticut. MWM and the other defendants filed a motion for judgment on the pleadings that the court analyzed under summary judgment standards.

The central issue in the motion was whether Kinsley Group was a franchisee subject to the protections of the CFA. In order to be a franchisee under the CFA, a party must establish that (1) there was an oral or written franchise agreement, (2) it was “substantially associated” with the claimed franchisor and its trademark, and (3) the claimed franchisor “substantially prescribed” the putative franchisee’s business pursuant to a marketing plan or system. After considering the evidence, the district court concluded that
the plaintiffs were not a franchisee and granted the defendants’ motion for judgment on the pleadings.

The court first addressed whether there was an oral or written franchise agreement by analyzing “whether the parties’ conduct in addition to their words, constitutes an agreement or arrangement.” The court found that although the express no-franchise disclaimer in the agreement was not dispositive given the remedial nature of the CFA, it did “cut against the finding of a franchise relationship.”

The court then turned to the “substantially associated” factor. The defendants argued that Kinsley Group was not substantially associated with MWM or its trademark because less than 10 percent of its revenues came from the sale of MWM products. The court noted that other courts had applied a “most or all” standard and required that at least 50 percent of a claimed franchisee’s business be derived from its relationship with the claimed franchisor. The plaintiffs argued that a “substantial portion of its business was dedicated to work being performed” under the agreement and that all of KES’s revenues came from sales and services under the agreement. The plaintiffs further argued that they had made a substantial investment in the MWM business as part of a long-term strategy. The court was not persuaded by this argument, noting that the plaintiffs cited no cases in which a court has relied upon investment rather than sales and revenue to find a substantial association. The court then considered the limited connection between the plaintiffs’ business and the MWM trademark, noting that this factor is “considered in combination with” the sales. The court then found that only a small portion of Kinsley Group’s revenue was derived from the MWM business, the parties’ relationship was relatively short-lived, Kinsley Group made minimal use of MWM’s trademarks, and the majority of its sales were derived from the sale of Kohler products. Accordingly, the court found that the plaintiffs had not established that Kinsley Group was substantially associated with MWM.

Although not required to, the court also considered whether the plaintiffs were operating under a marketing plan or system “prescribed in substantial part” by MWM. The Connecticut Supreme Court has identified a number of factors relevant to making this determination, one of the most significant of which is whether the putative franchisor “possesses power over pricing.” Here, MWM had no involvement in the prices that Kinsley Group and KES charged their customers. Although MWM unilaterally set the “wholesale prices” at which they sold the MWM product to the plaintiffs, the court agreed with other cases holding that this fact does not support a finding of substantial control.

Kinsley Group also attempted to establish control based on the requirement that it submit a business plan to MWM and meet certain benchmarks. The court found that although a business plan in which the manufacturer was involved in setting sales targets evidences some control, it did not demonstrate the “requisite degree of control” because the plaintiffs had not
shown that the business plan prevented them from “exercising independent judgment over their business.” Finally, Kinsley Group argued that MWM exercised undue control because the plaintiffs were required to hire somebody to service a preexisting MWM customer and their personnel had to undergo training in MWM products. The court held that while this may evidence some form of control, it did not amount to a “usurpation” of the claimed franchisee’s independent judgment. The court further noted that MWM did not dictate the level of training and that Kinsley rejected MWM’s initial proposal for the amount of training that was required.


Plaintiff Watchung Spring Water Co., a bottled water distributor, and defendant Nestle Waters North America Inc., a bottled water manufacturer, entered an exclusive distributorship agreement in 1994 for a territory in New Jersey. In 2014, Nestle sent a termination notice and later proposed a nonexclusive distributorship agreement in the same geographic area. In response, Watchung sued Nestle in the U.S. District Court for the District of New Jersey, seeking a declaratory judgment and injunctive relief and alleging violations of the New Jersey Franchise Practices Act (NJFPA), breach of contract, breach of the implied covenant of good faith and fair dealing, and tortious interference with economic advantage.

On Watchung’s motion for a preliminary injunction, the court considered its likelihood of success on the merits of its claims. Watchung argued that it had a high likelihood of success on its claims because the distributorship agreement created a franchise, thereby triggering the application of the NJFPA, which precluded termination of the agreement without sufficient cause. The court held that it was not clear whether a “franchise” existed under the NJFPA. To show that a franchise exists, a plaintiff must establish, among other things, that the plaintiff maintains a “place of business” in New Jersey. The court noted that significant outstanding factual issues existed about whether Watchung’s facility constituted a “place of business” under the NJFPA, considering the facility operated predominantly as a warehouse. For this reason, the court could not agree that the distributor had a high likelihood of success and thus declined to grant the preliminary injunction.

At the same time, the court considered Nestle’s motion to dismiss. The court concluded without further explanation that the allegations with respect to the NJFPA, breach of contract, breach of the implied covenant of good faith and fair dealing, injunctive relief, and damages were sufficiently well-pled to withstand a motion to dismiss. The court held, however, that Watchung’s claim for tortious interference with business advantage failed to allege any conduct corroborating or suggesting malice. Moreover, the court found that granting leave to amend this deficiency would be futile.

Volvo Trucks North America and Andy Mohr entered into a Volvo dealer sales and service agreement. Mohr alleged that during their negotiations, Volvo represented that if Mohr entered into the dealer agreement, Volvo would grant a Mack Truck dealership to Mohr as soon as Volvo was able to terminate an agreement with a local Mack Truck dealer that had fallen out of favor with Volvo. Mohr later learned that Volvo did not have the right to terminate the dealership agreement with the other dealer. Volvo advised Mohr that in order to become a Mack Truck dealer, he would have to purchase the dealership from the other dealer. The other dealer ultimately later sold the Mack Truck dealership to someone else.

Volvo asserted that Mohr did not perform under the dealer agreement, causing Volvo to lose market presence, and filed suit against Mohr in the U.S. District Court for the Southern District of Indiana. Mohr separately sued Volvo, alleging that Volvo misrepresented the Mack Truck dealership issue and that Volvo failed to provide him with sufficient support as a Volvo dealer. The two cases were consolidated.

The court took up several motions, including: (1) Mohr’s motion to file an amended complaint, (2) Volvo’s motion for reconsideration of a prior ruling by the court, (3) motions for summary judgment filed by Volvo, and (4) Volvo’s motion to limit certain expert testimony.

Volvo argued that Mohr’s motion to file an amended complaint should be denied because the amended complaint included a claim for price discrimination under the Indiana Unfair Practices Act (IUPA) and the Indiana Deceptive Franchise Practices Act (IDFPA) and Volvo asserted that Mohr had failed to include such a claim in his original complaint. The court ruled that Mohr was not required to plead every legal theory in his complaint and that the original complaint was broad enough to include price discrimination claims. Volvo also sought to prevent Mohr from adding a bad faith termination claim under the Automobile Dealers Day in Court Act, the IUPA, and the IDFPA. Mohr argued that the claim should be permitted because of newly discovered evidence from the deposition of Volvo’s CEO. The court denied this aspect of Mohr’s motion to amend his complaint on the grounds that the deposition testimony relied upon by Mohr was taken out of context and did not support the requested amendment.

The motion to reconsider dealt with the court’s prior decision finding that Mohr’s business entity (Mohr Truck) was a franchise under the Indiana Franchise Act. The issue came down to the “experienced franchise exclusion” under Indiana law, which excludes an entity from the definition of a franchise if the entity has been in the same or similar business as the franchised business for two years prior to entering into the franchise agreement. The court held that this exclusion did not apply under the IDFPA definition of franchise and, therefore, denied Volvo’s motion to reconsider.
As to the summary judgment motions, Volvo argued that it was entitled to a declaratory judgment that good cause existed to terminate the dealer agreement. Although Volvo relied on the Indiana Declaratory Judgment Act, the court determined that the federal Declaratory Judgment Act applied. Volvo argued that Mohr’s failure to build a new facility was a good faith basis for termination. The court found, however, that the dealer agreement did not include such an obligation, and the integration clause prohibited the court from looking outside the terms of the agreement.

Volvo also argued that it was entitled to summary judgment on Mohr’s deceptive practices claim under the IUPA and the IDFPA that were based on Volvo’s alleged misrepresentations to Mohr. The court granted Volvo’s motion as to these claims, finding that the alleged misrepresentations occurred prior to the formation of the franchise relationship.

Volvo further sought to dispose of Mohr’s claim under the Crime Victims Act (CVA), which was based on Mohr’s allegation that Volvo’s alleged misrepresentation was an unauthorized exercise of control over Mohr’s property. The court dismissed Mohr’s CVA claim on the grounds that the CVA was not intended to cover breach of contract disputes.

Finally, the court addressed Volvo’s motion to exclude the testimony of Mohr’s expert. The expert issued a report on the damages related to the alleged misrepresentation and further reserved the right to opine on matters that remained subject to ongoing discovery. Volvo argued that the expert should be precluded from testifying beyond what was in the report. The court denied Volvo’s motion, stating that Volvo was essentially seeking an advisory opinion on what the expert might say in a further report and that Volvo was not entitled to such a ruling.

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

FRAUD

In this case, the California Court of Appeal affirmed a trial court’s grant of summary judgment in favor of Nissan North America, Inc. on a dealer’s claims. Leo Boese entered into an agreement to purchase a Nissan dealership in southern California from another dealer. At the same time, an entity that Boese apparently owned or controlled entered into a dealership agreement with Nissan for the location. Shortly after the transactions closed, Nissan received the preliminary results of a market study recommending that the dealership be relocated. Nissan subsequently adopted the market study and notified Boese of the results, including the recommendation that the dealership
be relocated. Nissan did not, however, tell Boese that he was required to move the dealership.

Boese and related entities filed an action in California Superior Court against Nissan and others alleging intentional and negligent misrepresentation, concealment, negligence, and unfair business practices. Nissan filed a motion for summary judgment, which the trial court granted. The plaintiffs appealed.

The plaintiffs’ causes of action for intentional and negligent misrepresentation alleged that Nissan falsely represented that the dealership’s facilities met or exceeded all of Nissan’s requirements and that the dealership had been unprofitable because of “poor management.” The plaintiffs’ concealment claim alleged that Nissan had disclosed these “facts,” but did not disclose that there were prior market studies concluding the dealership location was not “appropriate” and that there was a pending market study. The plaintiffs’ negligence claim alleged that Nissan breached a duty of care to the plaintiffs when it sent a letter to the seller of the dealership (prior to the plaintiffs’ purchase) advising that the market study was being conducted. The plaintiffs alleged that the notice was defective or had not been properly sent to the seller. The plaintiffs’ cause of action for unfair business practices was derivative of their misrepresentation and concealment claims.

With respect to the plaintiffs’ misrepresentation claims, Nissan argued that there were no triable issues of material fact whether the representations were false. The plaintiffs argued that an addendum to the dealership agreement addressed the appropriateness of the dealer location and was false. The court disagreed, finding that the addendum dealt only with Nissan’s square footage guidelines, not whether the location was appropriate for a dealership, and there was no evidence that it was false. The court also found that the evidence was undisputed, and Boese agreed, that the prior operation of the dealership was subpar. Given this, the court held that an isolated report showing a temporary increase in the prior dealer’s sales did not disprove the representation that the dealership was unprofitable due to prior management, noting that there was considerable other evidence establishing that the dealer had sustained net losses.

Under California law, a concealment claim requires a fiduciary duty or other duty to disclose. Nissan argued that it did not have a contractual relationship with the plaintiffs prior to entering into the distributor agreement and that it owed no duty to disclose. The court assumed that there was no fiduciary duty relationship between the parties and analyzed whether the plaintiffs had established a triable issue of fact whether Nissan had a duty to disclose because it had exclusive knowledge of material facts unknown to the plaintiffs, had actively concealed those facts, and had made partial representations but suppressed other material facts. The court found that there was no evidence supporting any of these circumstances and, therefore, there was no duty to disclose.
The court then turned to the plaintiffs’ negligence claim. The court found that the plaintiffs had failed to allege a duty of care and that the only duty the plaintiff had actually alleged was a duty to disclose, which the court had rejected. Thus, the court also upheld summary judgment on this claim.

Finally, the court disposed of the plaintiffs’ unfair business practice claim on the ground that it was predicated on the plaintiffs’ other causes of action, all of which the court had found were barred.


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

*Fresno Motors, LLC v. Mercedes Benz USA, LLC*, Bus. Franchise Guide (CCH) ¶ 15,396, 771 F.3d 1119 (9th Cir. 2014)

This case is discussed under the topic heading “Tortious Interference.”


Meat House Franchising, LLC (MHF) was established for the purpose of selling franchises for high-end butcheries. Thomas Brown was an officer and managing member of MHF and a co-founder of related entities. Cary Tober was a low-level employee in the Meat House franchise organization. Arnold Schwartz was a surgeon and Tober’s uncle. In 2010, Brown and other MHF personnel allegedly leveraged their relationship with Tober to encourage Schwartz to purchase MHF franchise and area developer rights. After a series of communications with Schwartz and an in-person meeting discussing the MHF franchise opportunity, MHF forwarded a franchise disclosure document to Schwartz, who ultimately invested more than $2 million. The only Meat House location that Schwartz’s entity opened was in Roslyn, New York, which closed less than ten months after opening.

Schwartz and his related entities first invoked the alternative dispute provisions in the related MHF agreements by sending letters to MHF, Brown, and other MHF-related officers and entities. None of the defendants complied with the provisions. The plaintiffs then filed suit against the defendants in the U.S. District Court for the Eastern District of New York. All of the defendants defaulted, with the exception of Brown, who filed a motion to dismiss the plaintiffs’ complaint under Federal Rule of Civil Procedure 9(b) for failure to plead with the requisite particularity. The plaintiffs responded by filing a motion seeking to amend the complaint. The complaint, as amended, alleged twenty-one causes of action, none of which were directed solely against Brown. Rather, the allegations were made against all of the defendants as a “group pleading.”

In considering the motion to dismiss, the court first found that the plaintiffs were required to plead causes of action involving fraud with particularity under Rule 9(b), although the other causes of action could be pled more
broadly under Rule 8(a). The court also noted that group pleading is permitted under Rule 9(b), but not under Rule 8(a). The court then analyzed each of the causes of action alleged against Brown.

The plaintiffs asserted causes of action for fraud and fraudulent inducement under New York state law. The court found that the plaintiffs’ allegations addressed the “who, what, and when” of the alleged scheme, but did not address the “how” or the “why.” The court held that the plaintiffs’ “kitchen sink” pleading did not “explain the ways [the financial] figures touted by defendants were inflated or distorted” to a degree that met the particularity standard of Rule 9(b). The court further noted that the allegations were primarily made “upon information and belief.” The court recognized that a plaintiff often does have access to certain information prior to discovery, but that “this ineluctability in fraud cases does not relieve a plaintiff from complying with the heightened pleading requirements of Rule 9(b).” The court therefore dismissed the fraud and fraudulent inducement causes of action.

The court next turned to the negligent misrepresentation claim. The court noted that courts in other jurisdictions disagree on whether to apply the Rule 9(b) standard to such a claim, but that the issue was settled in the Second Circuit in favor of Rule 9(b) scrutiny. The court further noted that a negligent misrepresentation claim requires a special relationship between the parties and that such a relationship is more likely to exist if the misrepresented facts were peculiarly within the defendant’s knowledge. The court held that that was the case with respect to Brown’s knowledge and therefore denied the motion to dismiss the negligent misrepresentation claim.

The court also applied the Rule 9(b) standard to the plaintiffs’ breach of fiduciary duty claim because it sounded in fraud. The court noted that Brown was not a signatory to any of the written agreements at issue and that there was no authority that a non-signatory to a contract may be liable for breach of a fiduciary duty arising out of the contract. The court further held that a fiduciary duty is a higher standard than the special relationship discussed above. The court therefore dismissed the breach of fiduciary duty claim. The court also dismissed the plaintiffs’ civil conspiracy/fraud claim because they failed to adequately plead the underlying fraud cause of action. The court dismissed the plaintiffs’ breach of duty of care claim on the grounds that the plaintiffs were unable to show a duty of care by a non-signatory to the agreement such as Brown. The court also dismissed the plaintiffs’ breach of duty of good faith and fair dealing claim on the basis that Brown, a non-signatory, was not in privity with any of the plaintiffs.

The court next analyzed and dismissed the plaintiffs’ gross negligence claim on the ground that it failed to sufficiently allege facts against Brown supporting the claim. Specifically, unlike causes of action based on fraud subject to the heightened pleading standard of Rule 9(b), a gross negligence claim is subject to the general pleading standard under Rule 8(a). For this reason, the court held, the plaintiffs were not permitted to rely on “group” pleading.
The court next analyzed the plaintiffs’ claims under the New York Franchise Sales Act (NYFSA). Under the pleading standard set forth in either Rule 9(b) or 8(a), the court found that the plaintiffs had adequately pled a claim against Brown under NYFSA Section 683 for failure to make proper disclosures. The court also held that the plaintiffs’ allegations stated a claim under NYFSA Section 687 for making false or materially misleading oral and written misrepresentations. The court noted that the law was unclear whether group pleading was permitted to state a claim under the NYFSA, but did not rule on that specific issue.

The court then analyzed the plaintiffs’ claim that Brown’s acts or practices were materially misleading under the New York Consumer Protection Act. The court held that the Rule 8(a) general pleading standard applied. However, the court found that the plaintiffs had failed to state a claim because they had not shown that Brown’s alleged bad acts injured the public generally, rather than simply caused the plaintiffs’ injury in a private contract dispute.

Finally, the court analyzed the plaintiffs’ claim that Brown’s actions were unfair or deceptive under the New Hampshire Consumer Protection Act (NHCPA). The court dismissed the claim on the grounds that the false and misleading actions alleged against Brown were not the specific types of actions giving rise to a claim under the NHCPA.


James and Teresa Klemes entered into a franchise agreement with franchisor ProShred Franchising Corp. to operate a paper shredding business in North Carolina. The business was unsuccessful, and the Klemes filed a complaint against ProShred in the U.S. District Court for the Southern District of New York alleging fraudulent and negligent misrepresentation, violations of the North Carolina Business Opportunities Sales Act, violations of the North Carolina Deceptive Trade Practices Act, breach of contract, and breach of implied covenant of good faith and fair dealing. The claims were based on various statements made by a ProShred representative prior to the execution of the franchise agreement. These statements included representations on how many franchises the program would have in the future; that ProShred would provide sufficient financing to its franchisees; that ProShred franchisees could expect positive return on their investment in eighteen months; that the ProShred system was “proven and perfected”; that ProShred imposed a minimum performance level on franchisees, which the Klemes in this case interpreted to mean that that level was attainable; that the Klemes would be debt-free in forty-eight months; and that the Klemes could expect to have thirty sales a month per salesperson.

The court analyzed each of these statements and concluded that none of them supported a claim under any of the causes of action alleged by the Klemes. The court held that the statements were either predictions of
the future or “puffery.” As to the predictions, the court found that future predictions could not form the basis for either fraudulent or negligent misrepresentation claims that could arise from future predictions. Rather, such claims had to be based on the misrepresentation of current or past facts. The court held that because the common law claims were not viable, the North Carolina statutory claims also were not supported by the facts alleged.

GOOD FAITH AND FAIR DEALING


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


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

INJUNCTIVE RELIEF


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


Liberty Tax Service sent a termination notice to a franchisee for insolvency and failure to pay certain amounts owed. The franchisee defaulted on its promissory notes, and Liberty initiated a lawsuit, alleging three counts of breach of contract and seeking (1) certain advertising and royalty fees, (2) an injunction prohibiting the franchisee from using Liberty’s marks, (3) enforcement of a noncompete clause, (4) damages in the amount currently due on the unpaid promissory notes and accounts receivable, and (5) attorney fees. The franchisee failed to timely answer or respond to the franchisor’s complaint or motion for default judgment. Thus, the court granted default judgment, the requested damages (with the exception of attorney fees, on which the court deferred ruling pending receipt of an accounting), and a permanent injunction based on the four-factor test set forth in *eBay, Inc. v. MercExchange, L.L.C.*, 547 U.S. 388 (2006).


Romper Room, Inc. entered into franchise agreements with Windmark Corporation to operate two Once Upon A Child (OUAC) stores in Wisconsin.
Pursuant to the terms of the agreements, Windmark had the right to terminate the agreements in the event that the franchisee or any of its managers, directors, officers, or majority shareholders were convicted of or pled guilty to a crime “which adversely impacts upon the reputation of the franchise business” or the franchisee was “involved in any act or conduct which materially impairs the goodwill associated with the name Once Upon A Child or any of the Marks or the Business System.” After operating the OUAC stores for more than ten years, Greg Gering, one of the principals of Romper Room, was convicted of three counts of misdemeanor theft in connection with collecting government subsidized health insurance funds to which he was not entitled. Gering was sentenced to thirty days in jail and ordered to pay $30,000 in fines. Gering’s conviction was reported in the newspaper, and several days later Windmark served a notice of termination for cause without an opportunity to cure.

The plaintiffs filed suit in the U.S. District Court for the Eastern District of Wisconsin seeking to enjoin the termination of the franchise agreements. The plaintiffs claimed that the pending termination violated the Wisconsin Fair Dealership Law (WFDL) because it was not based on good cause and, even if good cause existed for the termination, Windmark had violated the WFDL by failing to provide sixty days’ opportunity to cure as required by the statute. The court granted the plaintiffs’ motion.

The court first addressed the irreparable harm factor, finding that the plaintiffs would suffer irreparable harm absent an injunction because they would be compelled to close their business, would be bound by a covenant not to compete, had long-term leases for both stores, had no other source of income, and would likely be unable to pay the attorney fees and costs required to pursue their claims. The court further found that it would be difficult to determine the nature or amount of the losses that the plaintiffs would suffer in the absence of an injunction, thereby “mak[ing] it difficult, if not impossible” to determine damages in the event the plaintiffs were to prevail. Thus, the court also found that the plaintiffs would have no adequate remedy at law.

The court then considered whether the plaintiffs were likely to succeed on their claims, concluding that they had established at least “some likelihood on the success of the merits.” Notwithstanding some news media articles and social media regarding Gering’s conviction, the court found that Windmark had provided no evidence establishing that Gering’s conviction had “materially” impaired the reputation of its business or the goodwill associated with the OUAC name or trademark. Although it was not required to reach the issue given its finding that it could not conclude based on the record before it that the termination was for good cause, the court further found that the notice of termination violated the WFDL because it did not provide the plaintiffs with a sixty-day opportunity to cure. Although Windmark argued that the breach was incurable, the court disagreed and suggested that Gering could have cured the default by transferring his interest in the franchises to his wife or another family member.
Finally, the court analyzed the nature and degree of the plaintiffs’ injuries and the likelihood of the prevailing on the merits against the possible harm to Windmark. The court was persuaded that the harm to the plaintiffs was significant, including the likely loss of their other ongoing business and that the thirty-two employees who worked at the plaintiffs’ OUAC stores would lose their jobs. The court concluded that Windmark had already sustained whatever harm it was going to sustain, because the publicity regarding Gering’s conviction had passed and no additional damage to Windmark’s name or trademarks was likely to occur. Additionally, the plaintiffs were continuing to pay amounts owed under the franchise agreements and otherwise comply with their contractual obligations.

Derma Pen, LLC v. 4EverYoung Ltd., Bus. Franchise Guide (CCH) ¶ 15,413, 773 F.3d 1117 (10th Cir. Dec. 9, 2014)

In this case, the Tenth Circuit reversed an order by the U.S. District Court of the District of Utah, which had denied a motion for preliminary injunction. Derma Pen, LLC and 4EverYoung Limited entered into a distribution agreement regarding the sale of a micro-needling device. Pursuant to the agreement, Derma Pen had the exclusive right to use the Derma Pen trademark in the United States and 4EverYoung had the right to use the trademark in the rest of the world. The distribution agreement also provided 4EverYoung with a right of first refusal to purchase Derma Pen’s trademark rights in the event the agreement was terminated.

Derma Pen terminated the agreement and 4EverYoung attempted to exercise its right to purchase Derma Pen’s trademark rights. 4EverYoung sought financial information from Derma Pen in order to determine the value of the trademark, but Derma Pen refused to provide the requested information. As a result, “no money ever exchanged hands.” Nevertheless, 4EverYoung started using the Derma Pen trademark to sell the micro-needling device in the United States.

Derma Pen filed suit asserting claims for trademark infringement and unfair competition under the Lanham Act. Derma Pen sought a preliminary injunction, which the district court denied on the ground that Derma Pen was not likely to prevail on the merits. On appeal, the Tenth Circuit, reviewing the district court’s rulings de novo, reversed.

The parties agreed that Derma Pen owned the rights to the trademark while the agreement was in place. 4EverYoung argued, however, that Derma Pen’s rights had terminated upon termination of the agreement or, alternatively, that 4EverYoung had a concurrent right to use the trademark in the United States. The Tenth Circuit quickly dispensed with 4EverYoung’s first argument, finding that Derma Pen continued to have an interest in the trademark after termination of the agreement. The court concluded that the provision requiring Derma Pen to offer to sell the trademark to 4EverYoung upon termination of the agreement made sense only if Derma Pen remained the owner of the trademark after termination because a trademark could only
be sold by its owner. Because no sale had occurred, the court found that Derma Pen likely remained the owner of the U.S. trademark rights.

The court was also unpersuaded by 4EverYoung’s alternative argument that it had concurrent rights to use the trademark in the United States. 4EverYoung argued that a provision in the agreement providing that “[t]he parties agree that the Distributors of the U.S. ‘Derma Pen’ trademark will not infringe with 4EverYoung’s use of the ‘Derma Pen’ trademark, and vice versa” permitted such concurrent uses. The court found, however, that 4EverYoung’s interpretation of this provision was at odds with other provisions in the agreement, including the provisions dividing up the territorial restrictions on the use of the trademark and requiring Derma Pen to offer to sell 4EverYoung the right to use the trademark in the United States upon termination of the agreement. The court found that these provisions would not make sense if, as 4EverYoung argued, it had concurrent rights to use the trademark.

Finally, 4EverYoung claimed that Derma Pen had breached the distribution agreement by not selling the U.S. trademark rights. The court held that such a breach, even if true, did not result in Derma Pen losing its property interest in the trademark.

Having concluded that Derma Pen was likely to prevail on the merits of its Lanham Act claims, the court remanded the matter to the district court to consider the other preliminary injunction factors.


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


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


The primary issue in this case was whether, under the Petroleum Marketing Practices Act (PMPA), the defendant New York Fuel Distributors, LLC (NYFD) could terminate its agreement with the plaintiff Yonkers Central Avenue Snack Mart after Yonkers fell into arrears. Yonkers moved the district court for a preliminary injunction under the PMPA barring the termination of its agreement with NYFD. The U.S. District Court for the Southern District of New York denied Yonkers’ motion for a preliminary injunction, and Yonkers appealed to the Second Circuit.

Under the PMPA, the court “shall” grant a preliminary injunction if the franchisee shows: (1) “the franchise of which he is a party has been terminated”; (2) “there exist sufficiently serious questions going to the merits to make such questions a fair ground for litigation”; and (3) “the court deter-
mines that, on balance, the hardships imposed upon the franchisor by the issuance of such preliminary injunction will be less than the hardship which would be imposed upon such franchisee if such preliminary injunctive relief were not granted.” Reviewing these factors, the Second Circuit held that the district court did not abuse its discretion in denying Yonkers’ motion for a preliminary injunction because it was undisputed that Yonkers was in arrears on payments owed to NYFD.


ITS Financial was the franchisor of a tax preparation franchise that the IRS contended violated Section 6701 of the Internal Revenue Code, which prohibits causing the understatement of tax liability. The government sought an injunction against ITS and its affiliated entities. Initially, the government and ITS negotiated and stipulated to a preliminary injunction against filing tax returns using pay stubs, charging certain fees for tax preparation, and offering direct refund anticipation loans. At trial, the U.S. District Court for the Southern District of Ohio issued a permanent injunction against ITS and its co-defendant affiliates enjoining them from operating or being involved in any way with the preparation of tax returns. Section 7402 of the Internal Revenue Code authorizes the issuance of such injunctive relief. ITS appealed the injunction on the ground that Section 7402 does not authorize the court to enjoin a tax preparation franchisor not directly involved in the preparation of tax returns.

The Sixth Circuit held that the permanent injunction was appropriate because the district court specifically found that ITS, as franchisor (along with the ITS founder Ogbazion), intentionally and explicitly trained franchisees to charge customers deceptive and exorbitant fees, lure low-income customers with unavailable tax refund anticipation loans, and file tax returns without customers’ permission. The Sixth Circuit also relied on the district court’s finding that ITS obstructed and circumvented tax laws through fraudulent applications for and use of electronic filer identification numbers.

The court also held that the injunction was not overly broad, unprecedented, or ambiguous. On the other hand, the court agreed that defendant Tax Tree was not a “tax preparer,” so it could not be enjoined as a tax preparer under Section 7402. In summary, the court agreed with the district court that the permanent injunction was appropriate because ITS was likely to violate the federal tax laws again.


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


A terminated beer distributor sued a beer manufacturer, alleging claims under the Ohio Alcoholic Beverages Franchise Act and seeking a declaration of its rights and responsibilities under the Act. The trial court granted summary judgment in favor of the distributor but did not address any of the specific questions about the distributor’s rights. The Ohio Court of Appeals held that, although the trial court apparently made some legal determinations, its failure to state the rights and responsibilities of the parties involved in a declaratory judgment action meant the trial court’s judgment was not an appealable final order.


Anton Nader controlled nine corporate entities, each of which was a Dunkin’ Donuts franchisee. Dunkin’ Donuts filed a lawsuit against Nader and these entities in the U.S. District Court for the District of Massachusetts alleging violations of the Lanham Act. Following the filing of the lawsuit, Dunkin’ Donuts alleged that it learned during a review of corporate documents that Nader transferred interests in the corporate entities—and thus the Dunkin’ Donuts franchises owned by them—to an individual named Leonard Tallo without Dunkin’ Donuts’ knowledge or consent. Dunkin’ thereafter filed a motion seeking to amend its complaint to add twenty-four more corporate defendants, each purportedly controlled by Nader and associated with other Dunkin’ Donuts franchise locations. Dunkin’ Donuts alleged that Tallo was a minority interest holder in each of the additional corporate defendants.

The defendants opposed the amendment on several grounds. First, they argued that the attempted amendment was untimely because it was filed after a deadline in the joint discovery plan and pretrial schedule filed by the parties. Holding that the deadline was not adopted by the court, the court allowed the amendment because the parties had not embarked on any significant discovery and the court had discretion under Federal Rule of Civil Procedure 15(a) to freely grant leave to amend.

The defendants next argued that the amendment was futile because the New Jersey Franchise Practices Act (NJFPA) mandated that any attempt to terminate a New Jersey franchise had to be filed in New Jersey. The court held that the NJFPA does not include such a requirement.

Next, the defendants attempted to invoke the first-to-file rule based on a case filed by the defendants in New Jersey state court. The court noted that the first-to-file rule applies to two proceedings pending in federal court. The court also noted that the defendants actually filed the New Jersey case after the original complaint filed by Dunkin’ Donuts.
Finally, the defendants asserted statute of limitations arguments based on an allegation that Dunkin’ Donuts knew about Tallo’s interests in 2008 when Dunkin’ Donuts invoked its right to review documents pertaining to twenty-nine Dunkin’ Donut shops owned by entities controlled by Nader. Dunkin’ Donuts responded that it did not learn of Tallo’s interests until 2012. The court determined that it needed more facts related to the 2008 review before it could decide this issue. The court therefore held that the statute of limitation arguments were premature and also did not provide a basis for denying Dunkin’ Donuts’ motion to amend.


Eddy Torres, who was a franchisee of cleaning service franchisor CleanNet U.S.A., Inc., alleged that CleanNet failed to provide him with the amount of billings required under the franchise agreement. When Torres sought a refund of the franchise fee, CleanNet refused. Torres subsequently brought a class action suit against CleanNet and several of its area operators under Pennsylvania statutory and common law, alleging that CleanNet improperly classified its franchisees as independent contractors while simultaneously asserting an allegedly significant amount of control over all aspects of the franchisee’s business. CleanNet removed the case to the U.S. District Court for the Eastern District of Pennsylvania based on the Class Action Fairness Act of 2005 (CAFA). CleanNet also filed a motion before the Judicial Panel of Multidistrict Litigation (MDL Panel) seeking to transfer the case and centralize it with cases brought by franchisees pending in the U.S. District Court for the Northern District of Illinois and in the U.S. District Court for the Northern District of California. The MDL Panel denied the motion to transfer on the grounds that, although the cases involved similar claims by franchisees, they also involved different CleanNet area operator defendants and different causes of action under state law. The MDL Panel also noted that duplicative discovery would be minimized because the parties in the various actions had agreed to coordinate discovery.

Torres subsequently filed a motion seeking to remand the matter to state court based on two exceptions to subject matter jurisdiction under CAFA: (1) the home state exception and (2) the local controversy exception. The home state exception requires a federal court to decline the exercise of subject matter jurisdiction under CAFA where “two-thirds or more of the members of all proposed plaintiff classes in the aggregate, and the primary defendants, are citizens of the State in which the action was originally filed.” The parties disputed whether CleanNet was a “primary” defendant. Torres argued that the area operators were primary defendants and that CleanNet was a secondary defendant. In deciding this issue, the court considered the following factors, whether CleanNet: (1) was the “real target” of Torres’ allegations; (2) had potential exposure to a significant portion of the class; and (3) would sustain a substantial loss as compared to other defendants if found
liable. The court noted that Torres named CleanNet as a defendant in every count of his complaint and sought to hold CleanNet directly liable for every alleged violation. The court further noted that, if Torres prevailed, CleanNet would sustain the greatest loss because it would be deemed the “mastermind of the scheme and a joint employer of all defendants.” Therefore, the court held that CleanNet was a primary defendant and that the home state exception was inapplicable.

The local controversy exception requires a district court to refrain from asserting subject matter jurisdiction under CAFA where, among other factors, no other class action asserting the same or similar allegations against any of the defendants has been filed in the preceding in three years. CleanNet argued that the exception was not met because of the other class actions pending in Illinois and California. The court determined that “no other class action” was to be defined narrowly solely to further the purpose of the exception, which is to ensure that defendants did not face copycat, or near copycat, suits in multiple jurisdictions. The court concluded that the other cases qualified as “other class actions” because in all three cases the plaintiffs asserted that CleanNet controlled the operations of its franchisees nationwide and improperly classified them as independent contractors, even though the actual causes of action in the various cases were based in different state statutory and common laws. Therefore, the court held that the local controversy exception was also not met and denied the motion to remand.

LABOR AND EMPLOYMENT

The plaintiffs, who worked as limousine service drivers pursuant to franchise agreements, sued the defendants, limousine service franchisors and their affiliates, alleging violations of the Fair Labor Standards Act (FLSA) and the New York Labor Law (NYLL). The plaintiffs complained that the defendants failed to pay them overtime as required by the statutes. The U.S. District Court for the Southern District of New York conditionally certified a collective action under the FLSA, but denied class certification under NYLL. On the parties’ cross-motions for summary judgment, the district court analyzed whether the drivers were “employees” or “independent contractors” under the multifactor tests applicable to each statute, considering the economic reality of the employment relationship and “whether the worker (1) worked at his own convenience, (2) was free to engage in other employment, (3) received fringe benefits, (4) was on the employer’s payroll, and (5) was on a fixed schedule.”

With respect to the FLSA claims, the court found that the defendants exercised limited control over the drivers, who were free to work for other car services or independently, despite the dress code and limited monitoring and discipline of drivers. Moreover, the court held that the drivers had the op-
portunity for profit or loss and investment in each of their franchisees and that the franchise agreements governed the terms of the respective relationships. Accordingly, the court dismissed the FLSA claims because the totality of circumstances weighed in favor of classifying the plaintiffs as independent contractors, not employees.

In its analysis of the NYLL, the court acknowledged that a finding of whether a person is an employee or an independent contractor under the NYLL has never been inconsistent with a determination under the FLSA. However, the court analyzed each statute separately. As with the FLSA claims, the court primarily focused on the degree of control (or lack thereof) the purported employer exercised and found in favor of independent contractor status. Under both analyses, the court weighted heavily the fact that the franchisors and affiliates may have had the right to exert more control and restrict competition but did not exercise that right. Thus, the court granted the defendants’ motion for summary judgment and denied the plaintiffs’ partial motion for summary judgment. The court amended the order to restrict the application of the dismissal of the NYLL claim only to the named plaintiffs, specifically excluding the opt-in plaintiffs based on the language of the opt-in consent-to-join form.

NONCOMPETE AGREEMENTS

*Everett v. Paul Davis Restoration, Inc.*, Bus. Franchise Guide (CCH) ¶ 15,399, 771 F.3d 380 (7th Cir. 2014)

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

ORAL AGREEMENTS


The plaintiffs, who worked as delivery drivers for the defendants’ package delivery companies, brought a lawsuit against the defendants alleging violations of the Fair Labor Standards Act (FLSA), Federal Insurance Contributions Act (FICA), New York Labor Law (NYLL), and New York Franchise Sales Act (FSA), in addition to other contract-related claims. The plaintiffs alleged that the defendants orally agreed to pay them a 60 percent commission per delivery, which the defendants denied. The plaintiffs further alleged that, despite the defendants’ attempt to categorize them as independent contractors for tax and labor law purposes, the defendants treated them as employees and should have categorized them as such under the FLSA and NYLL.

On the defendants’ motion, the U.S. District Court for the Southern District of New York granted summary judgment in favor of the defendants on the FLSA, FICA, NYLL, and breach of contract claims. The FSA claims remained. Specifically, the plaintiffs alleged that the defendants violated FSA Section 683(1), which prohibits a franchisor from selling a franchise without
first registering an offering prospectus, and Section 687(2), which prohibits fraud in connection with the offer or sale of a franchise. Following a trial on the FSA claims, a jury awarded damages to the plaintiffs.

On cross-appeals, the Second Circuit considered, among other things, whether the FSA’s statute of limitations barred the plaintiffs’ claims and whether the court erred in granting summary judgment on the plaintiffs’ breach of contract and NYLL claims. The appellate court held that the statute of limitations barred six of the eight plaintiffs’ FSA claims, noting that the FSA statute of limitations runs from the inception of plaintiffs’ franchise relationship with defendants, regardless of the purported transfer of the relationship. It affirmed the verdict on the remaining two plaintiffs’ FSA claims, stating that the jury’s finding reflected its implicit factual findings concerning the calculation of those plaintiffs’ net profits and losses.

In addition, the court held that the statute of frauds did not bar the plaintiffs’ NYLL and breach of contract claims because New York courts generally view oral employment agreements without a fixed duration, like the one here, as outside of the statute of frauds because they could be terminated within one year. The court also determined that the plaintiff-drivers raised a genuine issue of fact regarding whether they voluntarily and intentionally abandoned their right to collect 60 percent commissions. As a result, the Second Circuit vacated and remanded to the district court the breach of contract and violation of NYLL claims.

PETROLEUM MARKETING PRACTICES ACT


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

STATE DISCLOSURE/REGISTRATION LAWS


Franchisor Maoz Vegetarian USA, Inc. and franchisee A Love of Food I, LLC (ALOF) entered into a franchise agreement whereby ALOF was authorized to open a vegetarian restaurant in Washington, D.C. ALOF opened the restaurant in 2009, but went out of business less than two years later. ALOF alleged that it sustained losses in excess of $900,000 related to the venture. ALOF sued Maoz in the U.S. District Court for the District of Maryland. The Maryland district court subsequently transferred the case to the U.S. District Court for the District of Columbia on the ground that the Maryland district court did not have personal jurisdiction over Maoz.

ALOF alleged that Maoz had violated Maryland and New York franchise laws by: (1) failing to register the franchise offering statement in either state; (2) failing to provide the statement to ALOF in a timely manner; (3) making
statements about ALOF’s future earnings, despite disclaiming the use of such statements; and (4) making materially false statements regarding initial start-up expenses for the restaurant.

The court addressed each of these claims in connection with the parties’ cross-motions for summary judgment. The court performed a detailed analysis of the background facts, noting that the parties disputed almost every fact. However, it was undisputed that Maoz did not register in either Maryland or New York.

The court concluded that the Maryland Franchise Registration and Disclosure Law (MFRDL) applied because ALOF’s principal place of business was in Maryland and also because ALOF’s principal, who signed the franchise agreement on its behalf, was a Maryland resident. The court also concluded that the New York Franchise Sales Act (NYFSA) applied because Maoz’s principal was in New York when he e-mailed the offering prospectus and proposed franchise agreement to ALOF’s principal.

The court then turned to analyzing each of ALOF’s claims under the MFRDL. First, the court concluded that Maoz was in violation of the MFRDL for failing to register. Maoz argued that the MFRDL could not apply because ALOF had not been formed as of the offer to sell the franchise. However, because ALOF was in existence at the time the parties executed the franchise agreement, the court concluded that Moaz violated the MFRDL for failing to register. The court went on to note that ALOF did not show any harm related to the failure to register. Rather, it was clear from the record that ALOF was aware of the information in the unregistered offering prospectus. Moreover, the record showed that ALOF was responsible for much of the damages it sustained by, for example, picking a location that required substantial build-out and historical building permits and involved costly disputes with the landlord. Therefore, the court concluded that Maoz was in “technical” violation of the MFRDL for failing to register, but that ALOF was not entitled to damages. For the same reasons, the court refused to rescind the franchise or otherwise award restitution to ALOF.

The court next turned to ALOF’s arguments that Maoz was in violation of the MFRDL for the untimely disclosure of the offering prospectus. While the parties disputed the timeline of events, the court noted that even if the disclosure was untimely, the MFRDL does not provide private litigants with a cause of action based on untimely disclosure.

The court then addressed ALOF’s assertions that Maoz violated the MFRDL by making materially false assertions regarding the start-up cost estimates. The court held that it was an issue of fact for the jury to determine whether the estimated initial start-up costs set forth in the offering prospectus were false and whether ALOF actually relied upon the false statements. There was also an issue of fact regarding a subsequent offering prospectus showing higher start-up costs that was never provided to ALOF.

ALOF also alleged that Maoz made statements of future earnings but then disclaimed in the offering prospectus that any such statements were made in
violation of the MFRDL. The court held that this assertion was based on fraud and that ALOF had failed to plead the purported fraud with sufficient particularity as required by Federal Rule of Civil Procedure 9(b).

The court next focused on each of ALOF’s claims under the NYFSA, which mirrored the MFRDL claims. The court reached the same conclusion with the exception of ALOF’s allegation that Maoz violated the NYFSA for making an untimely disclosure. Unlike the MFRDL, the NYFSA does allow for a private right to sue for the violation. The court granted summary judgment in favor of ALOF on this point, but found that ALOF had not shown any damages related to that claim.

The court also addressed whether Maoz’s failure to register in New York was excused by the “isolated sales exception,” which excuses a franchisor from registering if the sale of a single franchise pursuant to an offer is directed by the franchisor to not more than two people. The court concluded that the exception did not apply because Maoz had plans to expand the franchise concept well beyond the one offered to ALOF. Again, however, the court ruled that ALOF failed to show any damages related to this “technical” violation.

Finally, the court addressed ALOF’s common law fraud claim based on the alleged false estimate of start-up costs provided by Maoz to ALOF. The court determined that under District of Columbia common law, there remained issues of fact on this claim as well.

STATUTE OF LIMITATIONS


This case is discussed under the topic heading “Oral Agreements.”

STATUTORY CLAIMS


Plaintiffs Tri County Wholesale Distributors, Inc. and Bellas Company entered into distribution agreements with Labatt USA Operating Co., LLC pursuant to which they were granted an exclusive and indefinite right to distribute certain brands of beer and alcohol in their respective territories. Unrelated entities manufacture the Labatt USA brands on behalf of Labatt USA, which does not own or operate brewing facilities and does not brew any alcoholic beverages. Labatt USA was wholly owned by North American Breweries Holdings, LLC (NAB Holdings). In turn, NAB Holdings was owned by three related entities (the KPS entities). In 2012, Cerveceria Costa Rica, S.A. (CCR) acquired 100 percent of the KPS entities’ membership interests in NAB Holdings (KPS/CCR transaction). As part of that
transaction, all of the KPS entities’ assets were transferred to CCR or one of its affiliates. One of CCR’s affiliates was subsequently merged into NAB Holdings, with NAB Holdings being the surviving entity. Below the level of NAB Holdings, the various operating entities did not change. Further, the agreements between the plaintiffs and Labatt USA remained in effect, and the plaintiffs continued to order products from Labatt USA and were invoiced by Labatt USA.

In 2013, CCR gave written notice to the plaintiffs of its intent to terminate its distribution agreements pursuant to the “successor manufacturer” provision in the Ohio Alcoholic Beverages Franchise Act. The plaintiffs filed an action in the U.S. District Court for the Southern District of Ohio alleging breach of contract and seeking a declaration that (1) the defendants were prohibited from terminating the plaintiffs’ agreements with Labatt USA; or (2) to the extent the Act permitted such termination, it would constitute an unconstitutional taking as applied to their circumstances. The plaintiffs filed a motion for preliminary injunction seeking to enjoin the termination of their agreements. The court granted the motion on the limited basis that the question of whether a successor manufacturer could terminate a written franchise agreement (rather than just an oral franchise agreement) had been accepted for review by the Ohio Supreme Court. Otherwise, the court found that the plaintiffs were unlikely to succeed on the merits of their claims. The Ohio Supreme Court subsequently issued an opinion finding that a “successor manufacturer” may terminate a written franchise agreement without cause. The court then vacated its preliminary injunction order and the parties filed cross-motions for summary judgment.

The parties’ motions turned on the issue of whether CCR was a “successor manufacturer” within the meaning of the Act. Pursuant to Section 1333.85(D), a successor manufacturer is permitted to terminate a franchise without just cause if it provides notice of the termination within ninety days of an acquisition pursuant to which it acquired “all or substantially all of the stock or assets of another manufacturer.” The Act does not, however, define successor manufacturer. The plaintiffs argued that CCR was not a successor manufacturer and, therefore, could not terminate the distribution agreements without cause. CCR argued that the plaintiffs’ claims should be rejected under the law-of-the-case doctrine or, alternatively, that CCR should be found to be a successor manufacturer. The court ultimately found that CCR was a successor manufacturer and, therefore, granted CCR’s motion for summary judgment and denied the plaintiffs’ motion.

The defendants argued that because of the court’s prior determination that the plaintiffs did not have a likelihood of success on the merits, summary judgment should be granted in the defendants’ favor. The court disagreed, noting that the law-of-the-case doctrine typically does not apply to preliminary injunction decisions and that the court was not bound by its prior findings.
The court then proceeded to address whether CCR was a successor manufacturer. The plaintiffs argued that CCR was not a “successor” because the KPS/CCR transaction was a “remote, parent-holding company stock transaction” and Labatt USA remained the licensed manufacturer. The plaintiffs also argued that CCR was not a “manufacturer” because it does not “manufacture” or “supply” any alcoholic beverages, is not registered to manufacture or supply alcoholic beverages as required by Ohio law, and is not the entity that enters into agreements with the Ohio distributors subsequent to the transaction. The defendants argued that CCR was a “successor manufacturer” under the Act based on a plain reading of the statute and because it had acquired “all of the stock” in Labatt USA.

The court first addressed the plaintiffs’ argument that CCR was not a “successor” because the franchise agreements between Labatt USA and the plaintiffs remained in place after the KPS/CCR transaction. Relying on the Ohio Supreme Court’s recent decision in *Esber Beverage Co. v. Labatt USA Operating Co.*, the court found that continuation of a written distribution agreement does not ipso facto disqualify CCR from being a successor manufacturer under the Act. The court also carefully considered the legislative history of the Act, finding that the “evolution of the statute” supported the interpretation that a successor manufacturer is permitted to “terminate” a franchise agreement even if the agreement “carries over” as a result of the transaction. Next, relying on the Ohio appellate court’s ruling in *Esber*, the court rejected the plaintiffs’ argument that because Labatt USA’s corporate structure had not changed after the KPS/CCR transaction, CCR was not a “successor.”

Finally, the court turned to the plaintiffs’ argument that CCR was not a “manufacturer” because CCR did not actually “manufacture” alcoholic beverages. Again relying on the Ohio appellate court’s decision in *Esber*, the court disagreed with the plaintiffs and found that a manufacturer is one that “manufactures or supplies” or is in the “business of manufacturing or supplying” alcoholic beverages to distributors. This, according to the court, was broad enough to cover CCR. In reaching this decision, the court was persuaded by the unrebutted testimony of one of Labatt USA’s key employees, who (1) confirmed that CCR had ultimate “business making decisions” and had taken “tangible steps” to exercise to such authority, including hiring a third-party consultant to evaluate the business and develop business plans; and (2) cited Labatt USA’s management reports to CCR’s management.


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

Clyde/West, Inc. entered into a dealer agreement with Volvo Construction Equipment of North America, LLC to sell heavy construction equipment. The parties’ relationship soured and Volvo terminated the dealer agreement. Volvo brought suit in the U.S. District Court for the Western District of Washington seeking a declaratory judgment that the termination did not violate the Washington Manufacturers’ and Dealers’ Franchise Agreements Act, the Washington Franchise Investment Protection Act (FIPA), the Federal Dealer Suits Against Manufacturers Act, or any covenant of good faith and fair dealing.

Shortly after the parties exchanged their initial disclosures and long before discovery was to be completed, Volvo filed a motion for summary judgment on all of its claims. Volvo agreed to extend Clyde’s deadline to oppose Volvo’s motion and also agreed to make its Rule 30(b)(6) corporate designee and all of its employees who submitted declarations in support of its motion available for deposition before Clyde’s opposition was due. Notwithstanding, Clyde sought to continue the motion in order to conduct discovery relevant to its opposition pursuant to Federal Rule of Civil Procedure 56(d).

The court started its analysis by noting that a continuance is appropriate if the application is timely and identifies relevant information as to which there is some basis to believe actually exists. Provided that the moving party can make this showing, a continuance is required. The court then considered Clyde’s motion with respect to each of Volvo’s claims.

Clyde argued that it needed to depose various personnel and obtain documents from the Washington Department of Licensing with respect to the Washington Dealer Act claim. Volvo argued that the Act did not apply because the equipment that Clyde sold is not required to be registered and titled in the State of Washington and, therefore, Clyde did not qualify as a “new motor vehicle dealer” under the Act. Volvo further argued that the issue was purely a matter of law and could be decided without discovery. The court rejected these arguments, noting that Volvo had supported its motion with respect to this claim with factual declarations and exhibits.

The court also granted Clyde’s request for continuance as to its FIPA claim, which provides that a franchisee can only be terminated for “good cause.” Although FIPA does not include a remedy, a violation of FIPA may constitute an unfair, deceptive act or practice that is actionable under the Washington Consumer Protection Act (CPA) if, among other things, the alleged violation impacts the public interest. Clyde indicated that it intended to seek discovery from the Department of Licensing and municipalities that purchase Volvo construction equipment in order to establish that the public’s interest “in maintaining and building safe roads and infrastructure” impacts disputes between dealers and manufacturers of such equipment. Volvo argued that a breach of a private contract did not affect the public interest. The court rejected this argument, holding that whether the public has an interest in an action is typically a question of fact.
The court denied, however, Clyde’s request for continuance with respect to the Federal Dealer Act claim. The federal act applies to an “automobile dealer,” which is defined as a person or entity “engaged in the sale or distribution of passenger cars, trucks, or station wagons.” Volvo argued that its construction equipment did not fit within the definition of covered vehicles. The court found that any evidence that Clyde would need with respect to this claim would be within its knowledge or could be obtained from Volvo’s declarants and its corporate designee.

Finally, the court considered whether a continuance was appropriate with respect to the breach of the duty of good faith and fair dealing claim. Volvo argued that there was no applicable duty of good faith because Volvo terminated Clyde pursuant to a specific section of the parties’ agreement. Clyde argued, however, that Volvo’s decision to terminate was motivated by different reasons than those stated for the termination. The court agreed with Volvo that the issue of whether a duty of good faith existed could be decided as a matter of law and that Clyde had not established that it was unable to oppose this issue without the requested discovery.


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


Tesla Motors MA, Inc., a wholly owned subsidiary of Tesla Motors, Inc., incorporated to operate sales and service centers for the sale and service of Tesla vehicles, operated an automobile showroom in Massachusetts. The Massachusetts State Automobile Dealers Association, Inc. (MSADA), representing automobile and truck franchised dealerships, sued Tesla MA and Tesla Motors, alleging they were operating an automobile dealership without a license and in violation of a Massachusetts statute prohibiting a manufacturer from owning a dealership. Both defendants moved to dismiss the claims for lack of standing and failure to state a claim on which relief could be granted. After a hearing on the motion to dismiss and MSADA’s request for an injunction, the trial court denied the requested injunctive relief and granted the motion to dismiss based on MSADA’s lack of standing. On appeal, the Supreme Judicial Court of Massachusetts affirmed that MSADA lacked standing to sue Tesla under the Massachusetts Motor Vehicle Dealer Law because the law was aimed at protecting automobile dealers from unfair and deceptive trade practices directed at them by their own brand manufacturers and distributors. Because MSADA was not affiliated with Tesla, the court concluded that MSADA did not have standing to sue Tesla under the Act.
This case is discussed under the topic heading “Labor and Employment.”

This case is discussed under the topic heading “Oral Agreements.”

Plaintiff Southern Motors Chevrolet attempted to purchase a Chevrolet dealership in Georgia. General Motors did not approve the plaintiff’s application but did approve the application of a minority-owned business. The plaintiff sued GM under the Federal Civil Rights Act, 42 U.S.C. § 1981, alleging racial discrimination. GM moved to dismiss and stay discovery pending the outcome of the motion to dismiss. While the motion to dismiss was pending, a magistrate judge denied the motion to stay discovery. Recognizing the court’s discretion to manage the process and ensure that parties are not subjected to unnecessary and burdensome discovery, the magistrate judge nonetheless held that although the motion to dismiss was not “wholly insubstantial,” it was also “not so clearly meritorious as to warrant a stay of discovery.” GM argued that the plaintiff’s speculation as to whether GM went too far in its minority applicant preferential treatment was insufficient to meet the standard to survive a motion to dismiss under Bell-Atlantic Corp. v. Twombly. The magistrate judge, however, held that “[j]ust as a plaintiff should not be able to embark on unfettered discovery by filing a defective complaint, neither should a defendant be able to halt resolution of a case every time it conceives of a Rule 12 motion.”

CMS Volkswagen Holdings, LLC, a Volkswagen dealer in New York, sued Volkswagen Group of America, Inc. in the U.S. District Court for the Southern District of New York alleging that certain of Volkswagen’s practices with respect to its dealers violated the New York Franchised Motor Vehicle Act. The court entered an order dismissing CMS’s claims and CMS filed a motion to reconsider.

The court analyzed the motion to reconsider under the “strict” standard of Federal Rule of Civil Procedure 60(b), which requires showing either controlling contrary decisions or a clear error that must be corrected to prevent injustice. After addressing each of CMS’s claims under this standard, the court denied the motion to reconsider.

First, the court considered CMS’s claims related to Volkswagen’s Variable Bonus Program, which provided bonuses to dealers that met certain
sales objectives, which were determined based on a set formula that applied to all dealers. Volkswagen argued that the program fell within the safe harbor provision of Section 463(2)(g) of the Dealer Act, which permits incentives or discounts that “are reasonably available to all franchised motor vehicles in this state on a proportionately equal basis.” CMS argued that the incentives were not proportionally equal for two reasons. First, the program used a market share variable that was measured at the regional level. CMS argued that this did not adequately account for consumer preferences that differed within the same region. Second, the program’s sales objectives were determined in reference to a dealer’s assigned territory, but also allowed dealers to account for sales from customers in territories that have no assigned dealers (open points). CMS argued that this impermissibly favored dealers that were located close to unassigned territories. The court noted that most of the arguments made by CMS were raised and fully considered prior to the dismissal order being entered. The court also held that no clear error was present and affirmed its prior decision that requiring customer preferences to be taken into consideration would defeat the safe harbor’s objective standard.

The court next addressed CMS’s argument that the court incorrectly applied the “functional availability doctrine” with respect to Volkswagen’s application of the program. The court noted that its analysis was derived from a Sixth Circuit decision that held that an incentive program is functionally available to all participants if it is applied evenhandedly and available to everyone on the same qualification terms. The court concluded that Volkswagen had applied the program evenhandedly and offered all dealers the same qualification terms.

The court also addressed certain modifications to the franchise agreement that concerned CMS’s ownership structure. Volkswagen permitted the modifications on the condition that CMS sign certain additional agreements. CMS argued that Volkswagen’s actions were unfair and therefore unlawful under the Dealership Act. CMS based its argument on Section 263(2)(ff), which prohibits a franchisor’s unilateral modification to franchise agreements without ninety days’ written notice. Subsection (3) permits a franchisee to demand a review for fairness once the franchisee receives the notice. CMS argued that Subsection (3) makes “unfair” franchise modifications unlawful. The court disagreed, stating that Subsection (3) deals with review of unilateral decisions under Section 263(2)(ff) and does not address bargained-for franchise modifications, which were at issue in this case.

**TERMINATION AND NONRENEWAL**


In this case, a U.S. District Court for the District of New Jersey entered a default judgment in favor of Jackson Hewitt Inc. and against its former fran-
chisee, Larson & Savage, Inc. (L&S). Jackson Hewitt terminated its franchise agreement with L&S for transferring the franchise business without Jackson Hewitt’s consent and failing to maintain the confidentiality of its proprietary information. Jackson Hewitt subsequently filed a complaint alleging that L&S had breached its post-termination obligations and asserting various claims under the Lanham Act. The defendants defied specific court orders and were warned that their continued failure to comply would result in sanctions. Nonetheless, the defendants failed to attend two mandatory status conferences. As a result, Jackson Hewitt filed an unopposed motion to strike L&S’s answer and counterclaim and enter a default. The court granted Jackson Hewitt’s motion and a default was entered. Thereafter, Jackson Hewitt brought an unopposed motion for a default judgment.

In order to impose a default judgment, a district court must make specific factual findings regarding: (1) whether the party subject to default has a meritorious defense, (2) the prejudice suffered by the party seeking default, and (3) the “culpability” of the party subject to the default. The court had previously concluded that L&S was the culpable party and that Jackson Hewitt had been prejudiced by L&S’s conduct. Thus, the only remaining issue was whether the defendants had a meritorious defense to Jackson Hewitt’s request for damages and a permanent injunction. The court quickly concluded that the defendants owed Jackson Hewitt amounts due under the parties’ franchise agreement and awarded Jackson Hewitt in excess of $180,000 in past-due fees and other items, as well as attorney fees and costs. The court also found that Jackson Hewitt was entitled to a permanent injunction and enjoined the defendants from engaging in a competitive business within the geographic territory set forth in the franchise agreement for a two-year period; compelled the defendants to return all franchise client files, trade secrets, and similar items to Jackson Hewitt; and ordered the transfer of their telephone numbers to Jackson Hewitt.


This case is discussed under the topic heading “Statutory Claims.”


Clyde/West, Inc. entered into a dealer agreement with Volvo Construction of North America, LLC to sell heavy construction equipment. The parties’ relationship deteriorated and Volvo terminated the dealer agreement. Clyde brought suit in the U.S. District Court for the Western District of Washington, alleging violations of the covenant of good faith and fair dealing, the Federal Dealer Suits Against Manufacturers Act (Federal Dealer Act), and other statutes. Volvo filed a motion for summary judgment as to all of
Clyde’s claims. In this case, the court addressed Clyde’s good faith and fair dealing and Federal Dealer Suits claims and granted Volvo’s motion.

Pursuant to Section 7.1 of the dealer agreement, either party had the right to terminate the agreement upon 180 days’ advance written notice. Additionally, pursuant to Section 22.1, in the event either party breached the agreement, the nonbreaching party had the right to give the breaching party written notice of default and sixty days to cure. Certain breaches, however, were exempt from Section 22.1, including the dealer’s failure to “achieve and maintain” specific market share requirements and to cure any such default within 180 days (Section 22.2).

Volvo sent Clyde a notice of termination pursuant to Section 7.1. Clyde argued, however, that Volvo’s subjective reason for terminating the agreement was its belief that Clyde was underperforming and, therefore, the duty of good faith and fair dealing required Volvo to terminate the agreement under Section 22.2. The court disagreed, noting that the implied duty of good faith is “derivative” and, therefore, applies to the performance of specific contract obligations. Further, if there is no such obligation, nothing must be performed in good faith. The court found that the agreement did not limit Volvo’s right to terminate the agreement with 180 days’ advance notice and Section 22.2 was optional. Thus, the court held that there was no applicable “contractual duty” that Volvo was required to perform in good faith. Clyde further argued that because Volvo had “discretion” to choose which termination provision to use, it had a duty to exercise that discretion in good faith. The court also rejected this theory, finding that under Washington law, a party cannot breach the duty of good faith when it “simply stands on its rights to require performance of a contract according to its terms.” Finally, Clyde argued that the termination provisions rendered the parties’ agreement “illusory.” The court disagreed, noting that a termination provision does not render a contract illusory where the option to terminate can only be exercised in the event of certain conditions.

The court then turned to Clyde’s Federal Dealer Act claim. The Federal Dealer Act permits an “automobile dealer” to file suit against an “automobile manufacturer” that fails to act in good faith when terminating the parties’ relationship. An automobile dealer is defined as a person or entity “engaged in the sale or distribution of passenger cars, trucks or station wagons.” An “automobile manufacturer” is defined as any person or business entity “engaged in the manufacturing or assembling of passenger cars, trucks, or station wagons.” The statute does not, however, define “passenger cars, trucks or station wagons.” Accordingly, the court was required to determine whether the heavy construction equipment manufactured by Volvo and distributed by Clyde fit within the phrase “passenger cars, trucks, or station wagons.”

The court started its analysis by reviewing the Federal Dealer Act’s legislative history and noting that the original version of the statute included the
phrase “and other automotive vehicles.” This phrase was specifically deleted and the legislature stated that the statute “excludes transactions involving buses, tractors, motorcycles, and other transportation vehicles propelled by power.” The court found that the heavy construction equipment at issue was more “closely analogous” to a tractor than to a passenger car or truck. The court then went on to consider the language of the statute and found that the plain and ordinary understanding of “passenger car and station wagon” would be vehicles seating “a limited number of people . . . for transportation of a small amounts of cargo over established roadways.” The court contrasted this with Volvo’s heavy construction equipment that was “designed to haul massive amounts of cargo at off-road construction sites.” Thus, based on both the legislative history and the plain language of the statute, the court found that the equipment at issue did not come within the scope of the Federal Dealer Act.

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

Ditto, Inc., which owned and operated a chain of clothing stores in Kansas City, entered into a joint venture agreement with the defendant-operators to operate a clothing store. The parties were unsatisfied with the joint venture and attempted to negotiate an early termination of the agreement. Unable to reach an agreement, the defendants unilaterally terminated the agreement and renamed their store. Ditto then sued the operators, alleging breach of the joint venture agreement and breach of fiduciary duty. In response, the operators contended that the agreement was terminable at will because it contained no fixed duration. The parties filed cross-motions for summary judgment. The court granted summary judgment in favor of the operators, finding that the joint venture agreement was indeed terminable at will because it did not contain a fixed duration.

The Missouri Court of Appeals reversed the trial court’s decision because, although the joint venture agreement did not contain a fixed duration on its face, the agreement had to be read and construed in conjunction with the accompanying lease, which did contain a fixed duration. Thus, the agreement was not terminable at will, and the defendant-operators were not entitled to summary judgment.

The court also addressed and rejected the operators’ affirmative equitable estoppel defense. The operators claimed Ditto had represented that the agreement was of unlimited duration and thus would be terminable at will. The court held, however, that the alleged representation did not estop Ditto from claiming that the joint venture agreement was not terminable at will because the representation, which Ditto expressly disclaimed, was a
conclusion of law and not a statement of an existing material fact. Accordingly, the appellate court reversed the trial court’s grant of summary judgment on the equitable estoppel defense and remanded.


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

**TORTIOUS INTERFERENCE**

*Fresno Motors, LLC v. Mercedes Benz USA, LLC*, Bus. Franchise Guide (CCH) ¶ 15,396, 771 F.3d 1119 (9th Cir. 2014)

Ashbury Fresno Imports, LLC owned a Mercedes-Benz dealership in Fresno, California. Ashbury operated the dealership on premises leased from CAR AAG CA, L.L.C. Seeking to purchase the dealership, Selma Motors, Inc. worked with Mercedes-Benz USA, LLC (MB) to provide the necessary information to qualify as a dealer. Selma’s owner subsequently formed Fresno Motors, LLC for the sole purpose of acquiring the dealership. This required additional documentation providing that the relevant asset purchase agreement rights were transferred from Selma to Fresno. Eventually, Ashbury and Fresno entered into an asset purchase agreement for the sale. MB subsequently exercised its contractual right of first refusal (ROFR) by sending notice to Ashbury in various formats, including mail and e-mail. The effect of the ROFR was that MB became the purchasing party under the terms of the Fresno Motors asset purchase agreement.

A few days after sending the notice, MB and Ashbury entered into an acknowledgment agreement providing that, if MB assigned the Fresno Motors asset purchase agreement and related agreements, including the lease of the premises, MB would remain primarily responsible under those agreements. MB subsequently tried to assign the Fresno Motors asset purchase agreement and the lease to a third party, but those efforts failed. MB then attempted to mediate its dispute with Fresno. The negotiations broke down when MB refused to provide the landlord with a guaranty of Fresno’s obligations under the lease. Fresno, which at the time was unaware of the acknowledgment agreement between MB and Ashbury, negotiated directly with the landlord in an attempt to assume the lease or to enter into a new lease with an option to purchase. Those negotiations failed as well.

Thereafter, Fresno and Selma filed suit against MB in the U.S. District Court for the Eastern District of California asserting several claims under California law, including tortious interference, fraudulent concealment, violation of California Vehicle Code Section 11713.3(t)(6), and violation of the California Unfair Competition Law. The district court granted summary judgment in favor of MB on all claims and plaintiffs appealed to the Ninth Circuit.
The Ninth Circuit first addressed the tortious interference claim. The plaintiffs asserted that by exercising its ROFR in an untimely manner, MB tortuously interfered with their contractual relationship with Ashbury. The district court dismissed this argument, finding that, under California law, tortious interference claims may only be made by “strangers” or “interlopers” who do not have a direct and significant interest in the applicable contractual relationship. The Ninth Circuit analyzed California law on this issue and determined that it was in a “state of flux” with no indication that the California Supreme Court would clarify the situation any time soon. The Ninth Circuit affirmed the dismissal, however, on the grounds that MB’s ROFR notice was timely and legally correct. MB was required to provide written notice. The e-mails sent by MB qualified as written notice under applicable law, including Section 1633.7 of the California Electronic Transfer Act. Further, nothing in the California Vehicle Code or otherwise required MB to provide notice to the plaintiffs, in addition to the notice that was provided to Ashbury.

The Ninth Circuit next addressed the plaintiffs’ claim that MB fraudulently concealed the existence of the acknowledgment agreement, which caused them to waste time and effort negotiating directly with the landlord because they would not have had those negotiations has they known about the agreement. The Ninth Circuit affirmed the district court’s dismissal of this claim, holding that the plaintiffs misinterpreted the agreement. Although the agreement required MB to remain obligated to Ashbury in the event of an assignment of the Fresno Motors asset purchase agreement, it did not impose any obligations on MB to Fresno. Therefore, there was nothing for MB to fraudulently conceal from the plaintiffs.

The Ninth Circuit then turned to MB’s arguments that the plaintiffs had no standing to bring a claim for reimbursement of expenses under the California Vehicle Code. The district court held that the plaintiffs lacked standing because the statute did not explicitly provide for such standing. The Ninth Circuit reversed the dismissal on the grounds that a proposed transferee clearly had the right to be reimbursed under the statute and that denying the transferee standing would preclude the transferee from enforcing that right.

Finally, the Ninth Circuit affirmed the dismissal of the plaintiffs’ unfair competition claims on the grounds that the remedy for a violation under the statute is injunctive relief or restitution, neither of which the plaintiffs sought.

**TRADEMARK INFRINGEMENT**

*Derma Pen, LLC v. 4EverYoung Ltd.*, Bus. Franchise Guide (CCH) ¶ 15,413, 773 F.3d 1117 (10th Cir. Dec. 9, 2014)

This case is discussed under the topic heading “Injunctive Relief.”
Grewal Corp., which was owned by Mohinder and Mann Grewel, entered into a franchise agreement with 7-Eleven Corp. for the operation of a 7-Eleven convenience store in Massachusetts. Although the Grewals successfully operated the store for several years, 7-Eleven found out in 2014 that unusual register activity was occurring. After conducting an investigation that included reviewing many hours of store security camera footage, 7-Eleven ultimately concluded that the Grewals were manipulating register transactions in order to pocket extra money and sent them a noncurable notice of material breach and termination. The Grewals continued to operate the store after the date of termination.

7-Eleven filed suit in the U.S. District Court for the District of Massachusetts seeking a preliminary injunction enjoining the Grewals from using 7-Eleven’s trademarks and to enforce the franchise agreement’s noncompetition clause. The Grewals responded by filing their own motion for preliminary injunction seeking an order requiring 7-Eleven to reinstate the franchise agreement.

The court analyzed 7-Eleven’s motion under the well-accepted test: (1) whether 7-Eleven was likely to succeed on the merits, (2) whether 7-Eleven was likely to suffer irreparable harm in the absence of a preliminary injunction, (3) whether the injury incurred by 7-Eleven if an injunction were not granted would outweigh the harm which granting the injunction would impose on the Grewals, and (4) how the injunction would affect the public interest.

As to the first prong, the court found that 7-Eleven’s investigation demonstrated that it was likely to succeed on its claims because it had the right to terminate the franchise agreement. In addition to the contractual rights under the agreement, the court noted that the Lanham Act gave 7-Eleven the right to enjoin the unauthorized use of its trademark. As to the second prong, the court determined that 7-Eleven would suffer significant harm related to confusion in the marketplace if the Grewals were permitted to use 7-Eleven’s trademark post-termination. As to the third prong, the court noted that, while the Grewals had put eight years of hard work into the store, their efforts were outweighed by the significant time and money 7-Eleven had invested in promoting and refining its brand around the world. Finally, as to the fourth prong, the court found that preventing customer confusion in the marketplace was in the public’s interest. The court therefore granted 7-Eleven’s motion to enjoin the Grewals’ use of the company’s trademark.

The court then considered the same four factors to determine whether 7-Eleven was entitled to a preliminary injunction with respect to the noncompete provision. As to the first prong, the court found that 7-Eleven was likely to succeed on enjoining this part of the franchise agreement. As to the second prong, the court concluded that 7-Eleven was not able to
show irreparable harm because the harm of having the Grewals compete during the period it would take for 7-Eleven to fully litigate the matter would be “miniscule” for a company of 7-Eleven’s size. As to the third prong, the court found that the balance of harms favored the Grewals because they risked being put out of business versus the fairly small harm risked by 7-Eleven. Finally, as to the fourth prong, the court found that the public interest weighed in favor of granting 7-Eleven’s request to enforce the non-compete provision. The court concluded on the balance of these factors that 7-Eleven was not entitled to a preliminary injunction with respect to the noncompete provision.

The court also held that the Grewals were not entitled to a preliminary injunction against 7-Eleven because 7-Eleven had demonstrated that it likely was justified in terminating the franchise agreement.

TRANSFERS


The plaintiffs entered into a number of separate franchise agreements with Wyndham Worldwide Corp., Super 8 Worldwide, Inc., Travelodge Hotels, Inc. and Days Inn Worldwide, Inc. The plaintiffs filed suit in the U.S. District Court for the District of Minnesota, alleging violations of the Minnesota Franchise Act, breach of contract and the implied covenant of good faith and fair dealing, and unlawful retaliation as a result of a New Jersey lawsuit between plaintiffs and Ramada Worldwide Inc. (RWI).

The defendants sought to transfer the action to the U.S. District Court for the District of New Jersey pursuant to 28 U.S.C. § 1404(a), which permits a transfer “[f]or the convenience of the parties and witnesses, [and] in the interest of justice.” The defendants argued that New Jersey was a proper forum because two of the four franchise agreements at issue in the Minnesota action included a “nonexclusive” forum selection clause providing that New Jersey was an appropriate forum and because a significant portion of the events giving rise to the claims allegedly occurred in New Jersey. The plaintiffs argued that the forum selection clauses were nonexclusive and therefore not determinative. The court agreed with the plaintiffs and further noted that only two of the four agreements contained the forum selection provision.

The court then considered the § 1404(a) factors and concluded that transfer was not appropriate. First, the court found that the convenience of the parties’ factor did not weigh in favor of the defendants and “more likely weigh[ed] slightly against defendants.” Even though the plaintiffs were in litigation in New Jersey with RWI, the court was not persuaded that New Jersey was any more convenient than Minnesota because the plaintiffs were located in Minnesota. Therefore, the court concluded the defendants had
failed to establish that any inconvenience they may face in litigating in Minnesota “strongly outweigh[ed]” the plaintiffs’ inconvenience.

The court found that the second factor, the convenience of the witnesses, also did not weigh in favor of the defendants. Although many of the witnesses, including inspectors and hotel employees were based in New Jersey, the plaintiffs and individuals involved in the contract negotiations were located in Minnesota. Thus, the court found that this factor weighed in favor of the plaintiffs.

The court then turned to the interest of justice factor. The defendants argued that transfer would promote judicial economy because the Minnesota action was “inherently similar” to the New Jersey action and that both matters could be consolidated, thereby eliminating potential duplication and conflicting orders. The court found that while there may be some overlap between the parties and issues, the actions were different, involved different agreements, and were brought by different parties with different procedural postures. The court also noted that although there might be streamlined discovery and the like, such benefits were not enough to overcome the deference that the court was required to provide to the plaintiffs’ chosen forum. As a result, the court found that there would not be any substantial judicial economy resulting from transferring the matter. Accordingly, the court denied the defendants’ motion to transfer.

VICARIOUS LIABILITY


Plaintiff Paula Hamrick was the administratrix of the Estate of Nathaniel Hamrick, an employee of a Hardee’s franchise restaurant in West Virginia who ultimately died of first and second degree burns that he sustained while cleaning a fryer box. Hamrick filed suit in West Virginia state court against the franchisee of the Hardee’s restaurant where Hamrick worked, as well as Hardee’s Restaurants, LLC and Hardee’s Food Systems LLC (franchisor defendants) and the alleged manufacturer of the fryer box. The plaintiff asserted claims for deliberate intent workplace injury under West Virginia law, negligence, and a number of product liability claims. The defendants removed the matter to the U.S. District Court for the Southern District of West Virginia, and the franchisor defendants filed a Rule 12(b)(6) motion to dismiss. The plaintiff filed a motion to remand.

In her motion to remand, Hamrick asserted that the defendants had failed to present adequate proof of the defendants’ citizenship because (1) they had not alleged the precise names and addresses of the members of some of the LLC defendants, and (2) they had failed to properly allege the citizenship of one of the defendant LLCs that had dissolved. The court rejected both arguments, finding first that a removing party’s notice of removal is not held to a higher pleading standard than a plaintiff pleading diversity jurisdiction
in a complaint, and then finding that the plaintiff had failed to establish or suggest any reason why the citizenship of the dissolved LLC would have changed after its termination.

The court then turned to the motion to dismiss. With respect to the deliberate intent workplace injury claim, the plaintiff alleged that all defendants, including the franchisor defendants, were Hamrick’s employer and therefore liable. The franchisor defendants argued that the plaintiff had not pled any facts establishing that they were Hamrick’s employer. The court disagreed, noting the plaintiff had alleged that the franchisor defendants “were in the business of operating and managing Hardee’s restaurants[,] . . . including the Hardee’s restaurant where Hamrick worked when he was injured.” The franchisor defendants also argued that the plaintiff had not pled any facts establishing they had knowledge of the alleged unsafe working conditions. The court again disagreed, finding that the plaintiff’s allegation that the fryer box had been broken for some time and that there had been prior complaints about it were sufficient to infer that the franchisor defendants, as the claimed operators of the restaurant, should have had actual knowledge of the purportedly unsafe working conditions.

The court then addressed the plaintiff’s alternative claim for negligence, which alleged that if the franchisor defendants were not Hamrick’s employer, they were liable for negligence due to their involvement in the operation and management of the restaurant. The franchisor defendants argued that the plaintiff had not pled any facts supporting a legal duty and that they lacked the requisite control. The court, however, found that the plaintiff had adequately alleged that the franchisor defendants operated and managed the restaurant and provided training, supervision, and inspections. Based on these allegations, the court concluded that it was reasonable to infer that the franchisor defendants had control over the equipment and procedures that contributed to Hamrick’s injuries. Thus, the court also refused to dismiss the plaintiff’s negligence claim.

Finally, the court considered the plaintiff’s product liability claims alleging that “to the extent that the [defendants] were involved in the distribution, lease or sale” of the fryer box, they were liable under a variety of theories. The court found that this allegation was “conditional” and therefore insufficient to assert the product liability causes of action. Accordingly, the court dismissed the plaintiff’s product liability claims.