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From the Editor-In-Chief

Gary R. Batenhorst

When you receive this issue we will be in the early days of summer—when our reading choices tend toward the lighter side as we plan short escapes to the beach, the mountains, the lake, or wherever you like to go to get away. But sometimes lawyers do not successfully master the fine art of getting away. An image comes to mind of Richard Nixon once walking on a beach in a pinstriped suit and winged tip shoes—a feat I saw repeated at the Forum on Franchising in San Diego a few years ago!

So if you decide to sneak a little legal reading in your getaway bag or you want some good articles to read when you return, we have just the thing for you. We lead off our Spring issue with *Surviving the Tempest: Franchisees in the Brave New World of Joint Employers and $15 Now* by Caroline Bundy Fichter and Erin Conway. This is our first article from the franchisee perspective on the joint employer and minimum wage issues. Its authors are two active young members of the Forum whose perspective on these issues is well worth reading.

Next, we have a thought provoking proposal from Eric Karp and his colleague, Ari Stern. In *A Proposal for a Mandatory Summary Franchise Disclosure Document*, Eric and Ari propose that the FTC Rule be amended to permit the dissemination of a summary franchise disclosure document to prospective franchisees. Borrowing from our neighbors in the securities world, Eric and Ari believe this document would enable prospective franchisees to receive the information they need regarding a proposed franchise investment in a user-friendly and informative format. Their interesting and informative article includes the actual text of a proposed revision to the FTC Franchise Rule and should receive serious consideration when the FTC considers further revisions to the Rule.

We turn from the FTC Rule to the recent controversial revisions to California’s franchise relationship statute in *Strange Weather: California’s Amended*
Franchise Relations Act, AB 525. Elizabeth Weldon and Nicole Micklich present a thoughtful analysis of these revisions. After providing some background on the process that led to these revisions, Nicole and Elizabeth address some of the key issues from the franchisee and franchisor perspectives respectively in a point-counterpoint format that provides a helpful analysis of the issues raised by these amendments to the California Franchise Relations Act.

Staying in California, Peter Lagarias and Bruce Napell, two prominent members of the Bay Area franchise bar, are featured next in Lessons from Thucydides on Distinguishing Statutory from Common Law Fraud in Franchise Disclosure Actions. Even if Thucydides is not your idea of beach reading, this lively and provocative discussion of statutory and common law fraud in cases related to franchise disclosure is well worth your attention. Not only will reading this article significantly increase your substantive knowledge of this area, you will also learn what the Trojan Horse and franchise fraud have in common!

Next up, Cheryl Mullin and Sophilia Wu give us The Wheels on the Bus: Is There Protection for the Franchise Operating System? One of a franchisor’s most valuable assets is its franchise operating system. Cheryl and Sophilia explore the ways that statutory and common law intellectual property law as well as contract law provide the means to protect the confidentiality of the operating system, both during and after the term of a franchise agreement. They also explore the ways in which these legal theories sometimes come up short in providing this protection.

David Gurnick gives us a very creative way of resolving certain trademark infringement disputes in Technical Terms for Comparative Trademark Analysis. The hypothesis of David’s article is that courts should consider two under-utilized disciplines that provide vocabularies to compare and contrast the appearance and sounds of trademarks. These disciplines are the field of printing or typesetting, which can be used in judging the visual elements of letters, and linguistics and its subfield articulatory phonetics, which can be used in describing the sounds of letters and words. As you read David’s article, you will find yourself wondering why more courts are not using these principles in trademark cases.

If you enjoy David’s Gurnick’s article you can look forward to hearing much more from David at this year’s Forum on Franchising in Miami Beach on November 2–4, 2016. David and our very own Earsa Jackson, one of the FLJ’s Topic & Articles Editors, have taken on the important and daunting task of presenting the Current Developments program at the Forum. Our thanks go out to Earsa and David for doing this—we know they will be curling up with some good cases if they get away at all this summer! Speaking of the Forum, be sure to read the article by Chris Bussert and David Oppenheim, the co-chairs of this year’s Forum, at the beginning of this issue. You can finish with a very informative set of Currents. Our thanks to Jason Binford, Marlén Cortez Morris, and Jennifer Dolman for a fine job.

Enjoy your get away this summer and don’t forget to take the FLJ with you when you go!
Deadline for 2016 Edward Wood Dunham Rising Scholar Award Announced

The deadline for the 2016 Edward Wood Dunham Rising Scholar Award will be Monday, July 18, 2016. 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 Gary R. Batenhorst, the editor-in-chief of the Franchise Law Journal, no later than Monday, July 18, 2016, to be considered in this year’s competition. All inquiries should be directed to: gbatenhorst@clinewilliams.com.

We look forward to receiving the submissions!
Forum Nominating Committee Appointed

In accordance with the Forum’s By-Laws, the annual Governing Committee election process begins with the appointment of a Nominating Committee by the Forum Chair. The Nominating Committee, which is headed by the Immediate Past Chair, is responsible for recommending candidates to fill open positions on the Governing Committee.

Karen B. Satterlee, Chair of the Forum, is pleased to announce the appointment of the following members to the 2016 Nominating Committee:

Deborah S. Coldwell  
Haynes and Boone, LLP

Bret Lowell  
DLA Piper

Kathy Kotel  
TGI Friday’s, Inc.

Carol Ann Been  
Dentons US LLP

Robert M. Einhorn  
Zarco, Einhorn, Salkowski & Brito, PA

This year’s Nominating Committee will recommend candidates for the Chair of the Forum and four Member-at-Large positions on the Governing Committee, all beginning August 2017, when Chair Karen B. Satterlee and Governing Committee members Ronald T. Coleman, James A. Goniea, Allan P. Hillman, and Eric H. Karp complete their terms.

An election to fill these positions will take place at the Forum’s Annual Business Meeting, held in conjunction with the 39th Annual Forum on Franchising. This meeting will take place on Thursday or Friday, November 3rd or 4th, 2016, in Miami. Forum members wishing to recommend candidates to fill these positions should forward their comments to Deb Coldwell no later than June 10, 2016. Deb’s email address is Deborah.Coldwell@haynesboone.com.
Soak Up the Franchising in South Beach

Christopher P. Bussert and David W. Oppenheim

The ABA Forum on Franchising Annual Forum on Franchising is headed to the scenic Fontainebleau Hotel in Miami Beach where such iconic films as Goldfinger and Scarface were shot. This year’s Forum will take place November 2–4, 2016.

The Annual Forum will continue to provide many opportunities for socializing and networking, CLE credits, ethics credits, and the highest quality franchise programs.

The Forum will kick off with three intensive programs on Wednesday, November 2. As always, the Forum will offer the classic intensive Fundamentals of Franchising course. We have two other excellent intensive programs as well. For our members with an international practice, we are presenting Franchising in Latin America and the Caribbean, featuring experienced practitioners from countries in these areas. Attendees of this intensive will also be treated to dinner Tuesday night at Hakkasan, a magnificent Four Diamond Restaurant located on site at the Fontainebleau. We will also be offering another intensive entitled Structuring and Managing a Franchise Legal Compliance Program–Beyond Franchise Disclosure Issues. Speakers will include current and former in-house counsel. This program should be of interest to transactional and litigation lawyers who serve as outside counsel as well as in-house counsel who frequently are called on to organize and monitor compliance programs.

Our line-up of twenty-four high quality workshops will offer the best in franchise education and cover a variety of litigation, transactional and regulatory topics. Topics include an update on the joint employer conundrum, what every franchise lawyer needs to know about labor unions and union organizing activities, maximizing monetary recovery in franchise cases, structuring shared services and affiliation programs to avoid application of franchise laws, the risks and rewards of comparative advertising, the use of

Christopher P. Bussert (cbussert@kilpatricktownsend.com) is a partner in the Atlanta office of Kilpatrick Townsend & Stockton LLP. David W. Oppenheim (oppenheimd@gtlaw.com) is a shareholder in the Florham Park, New Jersey, office of Greenberg Traurig, LLP. They are co-chairs of the Annual Forum on Franchising.
experts in franchise litigation, changes to the federal rules on discovery, advanced drafting of financial performance representations, and many more.

We will also present two plenary programs. The first will feature our signature Annual Franchise and Distribution Law Developments, a lively and informative overview of the most important franchise and distribution cases in the past year, headlined by two of our colleagues, David Gurnick and Earsa Jackson. Our second plenary program will feature Sean Carter, Humorist at Law, a Harvard law grad, practicing attorney, and frequent commentator on legal ethics, who will present a fun filled ethics session like you have never experienced before.

In addition to the Forum’s traditional breakfast, lunch, and social events, we will also be debuting two new events. On Wednesday, we will have a social event specifically geared towards practitioners who represent franchisees. And on Saturday, there will be a golf outing for those who are interested.

The Forum offers the best in legal education and the South Florida setting couldn’t be more inviting. Our Thursday and Friday venues are South Beach favorites. Thursday night will feature a casual beach party at Nikki Beach, a quintessential South Beach landmark that will feature a wide variety of Florida-themed food items, live music, and night lit games. Friday’s event will take place at The Bath Club, a highly sought after venue frequented by celebrities and several presidents, and will feature a Cuban and casino night theme. There is nothing like it anywhere else.

Come to Miami Beach for the 39th Annual Forum on Franchising, November 2–4 and Soak Up the Franchising and the Florida sun!
As the economy slowly recovers from the Great Recession and accompanying unemployment, many American economists, activists, and policymakers are expressing concern about several features of the modern American workplace. While the economy has slowly recovered and unemployment numbers have fallen, post-recession jobs are not the same as those that were lost. In 2014, half of all wage earners made less than $28,852. As a result of high unemployment, many workers felt they could not advocate for important benefits such as insurance, predictable working hours, or better labor conditions. Although twenty years ago, wage earners could take concerns to their shop boss or other union leaders or, if they did not belong to a union, they could organize to form a union, today the rise of a decentralized workplaces means that it is not always clear which workers should organize or to whom they should take their concerns. Although both wage stagnation and the fissured workplace have concerned policymakers for decades, the Great Recession brought them to the attention of the general public. During the past few years, a growing concern over income inequality has led to wide support for a dramatic increase in the minimum wage, and the National Labor Relations Board (NLRB) has attempted to address concerns about the fissured workplace by proposing an expanded approach to joint employer liability. Both issues could have a substantial effect on the franchise industry.


Erin Conway (econway@yourfranchiselawyer.com) is an associate with Garner & Ginsburg, P.A. in Minneapolis. Caroline Fichter (fichter@bundylawfirm.com) is an associate with Bundy Law Firm in Kirkland, Washington.
This article takes its title from Miranda’s famous line in *The Tempest*. In the play, Miranda is enthralled by her first contact with the outside world and exclaims “O brave new world that has such people in it.” Aldous Huxley used the phrase “Brave New World” as the title for his dystopian novel; since then authors, scholars, and jurists have used the phrase as shorthand for a new concept or trend that poses a risk of disrupting the status quo. However, most people who use the phrase omit Prospero’s wise reply: “‘T’is new to thee.” This article adopts the proposition that neither an expanded joint employer standard nor a dramatic increase in the minimum wage is, in fact, a “brave new world” for franchising, but merely an economic and regulatory shift that the franchise industry can adapt to by returning to the principles that originally made franchising a successful industry.

This article explores the historical roots of collective bargaining and the original minimum wage; the current attempts to change the joint employer standard and raise the minimum wage; the legal challenges to those changes; and the ramifications of a post-joint employer, post-$15/hour world—primarily from a franchisee perspective. First, we review the existing standard for determining joint employer liability and how changes to that standard will affect the franchise relationship. Second, we examine the historical roots of the minimum wage, current minimum wage legislation, its focus on the franchise industry, and the legal challenges to that legislation. Third, we discuss how both a shift in the joint employer standard and a rise in the minimum wage present golden opportunities for franchisors and franchisees to adapt by taking a “back to basics” approach to franchising. Shakespeare wrote this article’s title, but a slightly more modern poet sang it best: “It’s the end of the world as we know it, and I feel fine.”

**I. Collective Bargaining**

“What’s a guy go to do around here to get a day off every now and then? Or a raise? Paternity leave?” For many employees of franchises, these questions are even more complicated than for employees of non-franchised businesses. The complicated nature of franchise employment relationships has come under greater scrutiny within the past year or so as a result of the NLRB’s proposal of a new test for determining who is an employer.

In general terms, two entities are joint employers when they both employ a person so both entities are responsible individually and jointly for compli-

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4. This article was written prior to California’s and New York State’s enactment of legislation that raises the state minimum wage to $15 an hour by 2022 and 2021, respectively. Therefore it will not specifically discuss that legislation.
ance with a statute.6 The definition of “employment” included in both the Fair Labor Standards Act and the Migrant and Seasonal Agricultural Worker Protection Act was written to have broad application; thus it is possible under both statutes for a worker to be jointly employed by two or more employers that are simultaneously responsible for compliance.7 In determining whether an entity is an employer under these statutes, decision-makers have adopted tests intended to examine the details of the relationship between employees and the entities for which they work to determine whether a joint employment classification is appropriate.

The old test utilized by the NLRB for determining if a joint employer relationship existed was based on whether the primary employer—the one whose operations are reliant on shared employees’ day-to-day work—actually exercised “direct and immediate” control, such as over the workers’ daily tasks, scheduling, and hiring and firing.8 In 2015, however, in a three-to-two decision involving Browning-Ferris Industries of California, the NLRB refined its standard for determining joint-employer status.9 The NLRB described the new standard as “designed to better effectuate the purposes of the Act in the current economic landscape.”10

In this decision, the NLRB updated its standard for determining joint employer status:

[T]wo or more entities are joint employers of a single workforce if (1) they are both employers within the meaning of the common law; and (2) they share or co-determine those matters governing the essential terms and conditions of employment. In evaluating whether an employer possesses sufficient control over employees to qualify as a joint employer, the Board will—among other factors—consider whether an employer has exercised control over terms and conditions of employment indirectly through an intermediary, or whether it has reserved the authority to do so.11

The NLRB’s revised standard provoked strong reactions in the franchising community. Under the new standard, for example, if a franchisor retains control over some terms and conditions of a franchisee’s employees, such as training, personnel policies, or compensation, the franchisor may now have a duty as a joint employer. If a franchisor is deemed to be a joint employer, it would likely be responsible for engaging in the collective bargaining process with employees of franchisees and could similarly be considered a joint

7. Id.
11. Id.; Browning-Ferris Indus. of Calif., 362 NLRB No. 186.
employer for purposes of state and federal employment laws, including, but not limited to, wage and hour and discrimination laws.

_Browning-Ferris_ and subsequent related cases bring to the foreground important questions that are by no means novel to the landscape of U.S. employment history: to whom can employees bring their workplace grievances regarding working conditions, hours, wages, and the like? And, more importantly: who actually has the power to effect change in response to such grievances? In this part, we examine the impact of a proposed change in the test for an employer-employee relationship on the collective bargaining rights of franchisees’ employees (for the purposes of this part, “franchise employees”).

A. Know Your Roots

Before considering the proper entity to which franchise employees should bring their grievances about working conditions, this part will review the law of collective bargaining, briefly examining its history and purpose in order to provide a backdrop for the larger discussion of collective bargaining in franchising. Collective bargaining is a process by which working people, through their unions, negotiate contracts with employers to determine their terms of employment, including pay, health care, pensions and other benefits, hours, leave, job health and safety policies, ways to balance work and family, and more.\(^\text{12}\) Unionization in the United States has roots dating back to the early 1900s and provides an opportunity for employees who otherwise might not have the ability to effectively negotiate with their employers greater bargaining power through strength in numbers. Historically, unions have largely failed in their attempts to organize franchise employees.\(^\text{13}\)

1. A (Very) Brief History of Unions and Collective Bargaining

In the United States, approximately three-quarters of private-sector workers and two-thirds of public employees have the right to collective bargaining, according to the American Federation of Labor and Congress of Industrial Organizations (AFL–CIO).\(^\text{14}\)

This right came to U.S. workers through a series of laws that gradually expanded to include different classifications of employees. In particular, the Railway Labor Act granted collective bargaining to railroad workers in 1926 and now covers a broader range of transportation workers.\(^\text{15}\) Less than a decade later, the National Labor Relations Act (NLRA) was enacted to “protect the rights of employees and employers, to encourage collective bargaining,” and to “curtail certain private sector labor and management

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15. 45 U.S.C. §§ 151–188.
practices, which can harm the general welfare of workers, businesses and the U.S. economy.” The right to collectively bargain is also recognized by numerous international human rights conventions.

Every year, according to the AFL-CIO, approximately 30,000 collective bargaining agreements are negotiated, and today about eight million private-sector workers and approximately eight and a half million public-sector workers are covered by collective bargaining agreements.

2. Purpose

As noted above, collective bargaining is the process by which employees negotiate contracts with employers to determine the terms of their employment through the vehicle of their unions. The topics that may be included in such negotiations include, but are not limited to, a fair and safe workplace; better wages; a secure retirement; and family-friendly policies, such as paid sick leave and scheduling hours. In collective bargaining arrangements, employees must jointly decide their priorities for negotiations to be presented by a chosen representative. Union employees decide on a speaker or speakers to represent the group in bargaining sessions with the employer, and the union body votes either to accept or reject whatever contract is eventually reached by the employer and employee-elected individuals or bargaining committees. A ratified contract legally binds both sides—management and workers—to the contract terms.

Unions, at their most basic level, are about a simple proposition: workers can gain strength in numbers by binding together so they can have a voice to their employer concerning the subjects about which they care. Workers, through their unions, can have a voice in how their jobs get done and in turn create a more stable, productive workforce providing better services and products. According to the American Civil Liberties Union, unions “adapt [ ] to the challenges of our nation’s evolving workforce” and “meet [ ] the needs of workers in today’s flexible and nontraditional work environments.”

21. Id.
22. Id.
The purpose, therefore, of collective bargaining statutes, is to take into account the economic reality that individual workers typically lack the bargaining power to stand up meaningfully for their individual rights, such that collective action is often necessary to sufficiently protect individual rights.24

B. Argument for Franchisor Joint-Employer Classification Through the Lens of Collective Bargaining

New to this landscape of worker collectivization and strength in numbers is the decision in Browning-Ferris and other recent related developments.25 Browning Ferris and the NLRB’s proposed change in the test for an employer could potentially have a large impact on collective bargaining in the United States. When boiled down to its most basic tenet, Browning Ferris advocates making a party a joint employer if its absence would be a key impediment to collective bargaining.26

The updated standard articulated by the NLRB would cause a shift in the current balance in the world of franchising, in that it would provide the basis for franchise employees to organize unions on two levels: locally at the franchisee level and nationally at the franchisor level. Franchise employees could thus bargain directly with either or both entities. As joint employers, both the franchisee and franchisor would have legal obligations to their shared employees to enter into collective bargaining agreements, resolve disputes, strikes and work stoppages, and renegotiate contracts.27

The reader might ask why franchise employees would even want the franchisor to be involved in collective bargaining negotiations, if their day-to-day interactions are primarily, if not exclusively, with the franchisee? For starters, the franchisor in nearly every franchise system has more resources from which to make concessions to unionized workers than do the individual franchisees. Furthermore, franchisees are, by the basic nature of their franchise relationship, bound by the terms of franchise agreements and operations manuals that are almost always written entirely by the franchisor. These documents can serve as ties to bind the hands of franchisees in collective bargaining negotiations because they can agree only to changes requested by franchise employees to the extent that these changes are within the scope of the franchisor’s system requirements. With the franchisor’s par-

24. Id.


participation in such negotiations, however, these limits on the scope of negotia-
tions lessen, even if they do not disappear entirely.

Although a change in the NLRB employer test is vehemently opposed by
the International Franchise Association (IFA)\textsuperscript{28} and bemoaned as the end of
franchising altogether by some,\textsuperscript{29} others see this move by the NLRB as a
much needed leveling of the playing field for franchisors.\textsuperscript{30}

This disparity of viewpoints on recent NLRB developments may be the
best reflection of what Dr. David Weil, current administrator of the Wage
and Hour Division of the Department of Labor, has called the “fissured work-
place” and its inherent imbalances.\textsuperscript{31} Weil argues, “The fundamental dilemma
of the fissured workplace [is in] . . . allowing [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.” He continues, “Any effort
to improve labor standards compliance in franchised industries must recognize
that organizational form’s role in creating fissured workplaces.”\textsuperscript{32}

This part explores the potential that the proposed new NLRB test presents a
midlife crisis for franchisors, rather than a death sentence. The modern work-
place is changing shape and, like other employers, franchisors are faced with a
decision on how to react to those changes. That decision provides franchisors
with two options: (1) continue business as is and face a franchisee-franchisor
joint employer future, or (2) adapt to a changing workplace and let go of
some of the restrictions currently placed on franchisees to the extent permitted
by the Lanham Act.

\textsuperscript{28} Letter from Robert C. Cresanti, President and Chief Executive Officer of the Inter-

\textsuperscript{29} See, e.g., Daniel Fisher, \textit{Controversial NLRB Ruling Could End Contract Employment As We
Know It}, FORBES, Aug. 27, 2015, \textit{available at} http://www.forbes.com/sites/danielfisher/2015/08/27/nlrb-declares-browning-ferris-a-joint-employer-whos-next/#7be95f3f14f; David J. Kauf-
ing CNBC’s Jim Cramer as stating, regarding \textit{Browning-Ferris}, “It could be the death knell
for franchising”).

\textsuperscript{30} Janet Sparks, \textit{Labor Law Experts React to NLRB Determining McDonald’s as a Joint Employer,
BLUE MAUMAU, July 30, 2014, http://www.bluemau mau.org/14045/labor_law_experts_react_nlrb_determining_mcdonald%E2%80%99s_%E2%80%99s_joint_employer%E2%80%999 (quoting Michael Fischl, professor of law at the University of Connecticut School of Law, as stating “[I]n order to circumvent the rights of its employees under the National Labor Relations
Act, [McDonald’s] proclaims that it is ‘shocked, shocked’ that anyone would think it actually ex-
erts such extensive control over its franchised stores”); Danielle Corley & David Madland, \textit{CTR.
org/issues/labor/news/2015/12/09/126868/unwarranted-outcry-nlrb-browning-ferris-decision-
re-establishes-employer-responsibility/}.

\textsuperscript{31} \textit{Weil, supra note 1}.

\textsuperscript{32} \textit{Id. at} 158.
Browning-Ferris held that two entities can be joint employers if there is a joint determination of important terms and conditions of employment, such as hiring, firing, scheduling, disciplining, dictating the number of employees, determining when the facility is open and the hours to be worked, and other similar terms and conditions. Further, the NLRB noted that merely retaining the right to determine these criteria is enough to result in joint employment status. Thus, what matters is not just whether control is exercised, but whether a company has the authority to exercise control. Or, framed another way, does the company have the power to say “no” to the potential demands of employees, or to bind an intermediary with respect to what employee demands they can say “yes” to?

As noted above, the restrictions placed on franchisees by franchisors through franchise agreements and operations manuals can restrict franchisees in just this way, leaving the franchisor on the “employer” side of the equation. Franchisors often argue that such restrictions are not their fault because, in fact, they are required under the Lanham Act to protect their brands through this type of quality control and system standards implementation. The NLRB, however, apparently disagrees. The amicus brief submitted by the NLRB Office of the General Counsel in Browning-Ferris stated that “the ‘traditional standard’ cases finding that franchisors were not joint employers preceded the advent of new technology that has enabled some franchisors to exercise indirect control over employee working conditions beyond what is arguably necessary to protect the product/brand.” Such technological advances can be seen, for example, in the real-time video monitoring of 7-Eleven stores by the franchisor.

So, what’s a franchise employee to do? On the one hand, technological advances, coupled with the increased level of control over franchisee operations exerted by many franchisors, make bargaining with the franchisee in many cases pointless. On the other hand, franchise employees are prevented from bargaining with the franchisor, which claims that it is not their employer and exerts control over the way they perform their jobs only because federal law says it must in order to protect its trademark.

34. Id.
37. Tiffany Hsu, Franchisees Allege Hardball Tactics, Store Seizures by 7-Eleven, L.A. TIMES, June 4, 2014, available at http://www.latimes.com/business/la-fi-7-eleven-lawsuits-20140605-story.html (“Many stores now have a 360-degree camera and a 180-degree analytics camera at the front door with the ability to measure traffic, the time consumers spend in stores, and other analytics.”).
1. Control over the Day-to-Day Operations of Business

As Weil has stated, “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.” Like-wise, Julius Getman, professor of law at the University of Texas at Austin School of Law, contends: “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.”

If franchise employees work at a physical location owned and managed by an individual franchisee, how is it possible for the franchisor to actually maintain control over the day-to-day operations of the business? As discussed below, this control comes not through the physical presence of a franchisor’s representative telling employees what to do. Rather, the control over franchise employees manifests itself in requirements imposed from a distance, such as directives over hours of operations, staffing levels, employee conduct, employee attire and appearance, and expenses of the franchised business.

The argument for these types of controls, although plausible (if paternalistic) in theory, can be problematic in practice. David Kaufmann and others stated in a recent article in this Journal:

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.

This information may certainly be helpful to provide to franchisees so that they may make informed decisions about staffing their business. However, as Kaufmann notes, there is a very important difference between providing information for franchisees to use in making business judgments and setting actual requirements for franchisees to follow.

It has been noted 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

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39. Sparks, supra note 30 (quoting Professor Getman) (emphasis added).
40. Id. (citing Catherine Ruckelshaus, general counsel, National Employment Law Project).
41. Kaufmann et al., supra note 35, at 456.
how long it takes for employees to fill every customer order.” 42 The argument to justify this level of oversight and control is that these are measures that “every large and reputable franchisor” implements in order to ensure adherence to its system standards. 43

To argue that McDonald’s systems merely assist franchisees by setting standards that franchisees must follow but does not control the day-to-day operations of its franchisees is nonsensical. The NLRB recognizes in its new standard that it does not make sense or benefit the worker in any way to make a technical delineation between “controlling the day-to-day operations” of a business and “setting standards” that franchisees must follow. If a franchisor sets out on paper all the requirements for how a franchisee must run its business and remotely tracks whether such standards are being met—at risk of default, in reality it does not matter to employees who the actual person is who informs them of such policies. Where policies are set by the franchisor, the franchisee becomes nothing more than an intermediary for voicing the franchisor’s desires and managing people in its outlet. 44

In the context of collective bargaining, this distinction, if it even exists, is immaterial. If an employee cannot effectively collectively bargain with its employer (where that employer is deemed to be the franchisee alone), either the ties by which the employer is bound must be loosened or the agent creating such ties must be brought to the bargaining table as an employer. Otherwise, the entire process will be futile.

2. Debunking the Lanham Act Argument

One of the main arguments against the new NLRB employer test is that franchisors are required, in order to comply with the mandates of the Lanham Act and to ensure brand uniformity, to control the business variables of franchisees discussed above. 45 Opponents of the new standard and Weil’s position have argued that his focus on the requirements on franchisees imposed by franchise agreements is misplaced because “the very standards and controls [that Weil uses to show heavy handed control by franchisors], . . . are required by the Lanham Act and form the very basis of the very legal definition of the term ‘franchise.’” 46

The argument that intense scrutiny and control by the franchisor create the entire foundation of the franchise system overstates the reach of the Lanham Act and suggests that anything that could potentially threaten the franchise relationship as it exists currently cannot possibly stand. This is sup-

43. Kaufmann et al., supra note 35.
44. Weil, supra note 1.
45. Kaufmann et al., supra note 35, at 447.
46. Id.
ported by the ongoing changes and progressively increasing controls that franchisors exert over their franchisees’ ability to control the day-to-day operations of their businesses as well as the technological advances that enable such control.

To protect trademarks, a franchisor must have “adequate control” over the quality of goods or services offered under the mark. The franchisor must also control certain aspects of the operations of its franchisees to ensure that the trademark is not used to deceive or mislead the public as to the quality of the goods or services bearing the name. Furthermore, it is not enough for a franchisor to simply reserve in its franchise agreements the right to exercise trademark control; it must actually exercise such control or risk abandonment of the trademark.

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. As such, a franchisor is required under Lanham Act to preserve its mark by regulating activities of franchisees, where the purpose of such controls is to achieve standardization, uniformity, and optimum public good will. However, for as long as courts have recognized this requirement of the franchisor, they have also recognized that the degree of control by franchisors has limits, beyond which the nature of the franchisor-franchisee relationship may change into, for example, a principal-agent relationship.

Herein lies the difficult, although not impossible, tightrope that franchisors must walk to protect their brands while avoiding becoming a joint employer under the new NLRB standard. They must stick their noses into franchisees’ business operations just the right amount to protect their trademarks.
while, simultaneously, leaving the franchisee enough leeway to operate its own business in a way that provides it with actual control over the day-to-day activities of its employees. Striking this perfect balance may seem an unfair task to assign to franchisors. However, given the advantages provided to franchisors by the very nature of franchising—the ability to expand rapidly and build a strong brand presence across the nation (or even the world) with limited liability or risk of outlet failure—perhaps it is a natural cost of doing business in this manner.

This balance will necessarily look different in different types of franchise systems. However, the 10,000-foot view of the dividing line is between product or service quality control and employee oversight. For example, a quick service restaurant can control the look of the store, the specifications for food source and quality, and the cooking method to be used in its preparation, while leaving entirely to the franchisees decisions regarding staffing levels, pay, benefits, flexible work schedules, etc. Or a service-based franchisor in the massage and salon industry may dictate the look of the salon and the types of services to be provided and train franchisees on proprietary products and services, but likewise leave other employment-related decisions entirely to the franchisees.

Some franchisors may argue that by setting minimum requirements, they already adequately toe this line. And, in some cases, this assessment may be accurate. However, franchisors must also take into consideration how the other controls imposed on franchisees’ businesses may, in fact, indirectly control important aspects of the franchise employees’ relationships with the franchisee, such as wages. Most franchisors recognize that they would be treading into dangerous waters by directly setting pay rates for their franchisees’ employees. Thus, franchisors claim that they have no influence over wages paid to workers of their franchisees.53 This, however, is not necessarily the case when a franchisor controls wages indirectly by controlling every other variable in the business.54

Franchisors must consider where control over franchisee spending is necessary for brand protection and where, instead, it is merely an exercise in achieving franchisee conformity in every aspect of its business, regardless of its necessity for brand protection. Although it may be in the best interests of a franchisee’s (and consequently the franchisor’s) bottom line for the franchisor to use its knowledge to control every variable of a franchisee’s business, keeping some distance can help keep franchisors on their preferred side of the franchisor/employer line.

54. Ruckelshaus et al., supra note 42, at 11.
C. The End of the World as We Know It . . .

1. Positive Implications of a New Employer Definition on Collective Bargaining

Working people form unions because they want to bargain with their employers over improvements in the workplace. If those employers, however, are able to avoid bargaining by inserting an intermediary between themselves and their employees, this undermines the employees’ ability to organize and bargain effectively. Likewise, if an employer is unable to effectively bargain with its employees due to constraints imposed upon it by a parent organization, the process of collective bargaining cannot operate as intended unless that parent organization is also brought to the bargaining table.

Currently the level of franchisor involvement in franchisees’ businesses creates a three-tiered relationship (employee-franchisee-franchisor), making a tiered approach to negotiations necessary. Franchise employees may come together to bargain collectively with the franchisee. Franchisees, in turn, may have the authority to negotiate on some issues with franchise employees. However, in many systems the franchisor’s overreach into day-to-day activities of the franchisee’s business can leave the franchisee in a position in which it is unable to negotiate other areas of the franchisee-employee relationship. Franchisees in the Brave New World of Joint Employers and $15 Now

For example, where a franchisor uses software to remotely track employees’ hours and instructs the franchisee on how to adjust those hours, the franchisee is either powerless to make its own decisions or may be in the position of risking its good standing with the franchisor if it refuses to adjust employee hours. Alternatively, where the franchisor controls every line item of a franchisee’s operations budget, other than employee pay, and profit margins are tight, the franchisor by default controls the franchisee’s ability to negotiate wages because the franchisee cannot cut costs elsewhere by, for example, switching suppliers for products used in the operation of the business. Thus, the franchisees would need to approach the franchisor in order to effect any change in these areas.

Franchisees do have options for presenting grievances to the franchisor, such as through franchise advisory councils (FACs) or franchisee associations. However, there are numerous limitations to this tiered approach to

55. Controls by franchisors that federal regulators have pointed to as potential instances of overreaching into the employer arena include (1) a franchisor’s ownership or control of the real estate where licensees operate, which allows the franchisor ultimately to control who has access rights (a relevant factor when it comes to access by union organizers); (2) use of recent technology that allows franchisors to monitor the performance of franchisee employees and guide franchisees to make adjustments to improve their employees’ results; and (3) requiring franchisees to add the franchisor as another insured on employer liability or workers compensation insurance policies.

solving workplace issues. For starters, FACs and franchisee associations are limited in their powers. Both types of organizations may present grievances to the franchisor, but they are nevertheless still bound by terms of individual franchise agreements, and so FACs and associations cannot unilaterally make any changes to the system. In addition, workplace issues are likely to be highly localized or regionally unique. One franchisee, or even all the franchisees in a particular city or state, might face a common issue with their employees as a result of regional culture, local legislation, or state law. That same issue, however, may not affect other franchisees in the FAC or association and thus may be inappropriate for the organization to present to the franchisor. Furthermore, a franchisor may require a certain percentage of “buy in” from the entire population of its franchisees to make system changes; this may not be possible where an employment-related issue is highly localized.57

Another issue with the tiered negotiating system is that franchisees and their employees generally have different interests. The different priorities between franchisees and employees can create a conflict of interest for franchisees in presenting workplace issues to their franchisors. The franchisee, without a direct stake in the issue at hand, or whose bottom line may actually be hurt by the proposals inherently has less motivation to advocate zealously for its employees’ position when it brings such an issue to the franchisor or the franchisee association for action.

Finally, in the tiered system, the franchisee is placed in the awkward position of “bargaining” with its employees when it cannot actually effect change. In the employee hours and wages scenarios mentioned above, for example, the franchisee could hear and be present for collective bargaining sessions with its employees. However, that franchisee’s ability to make any changes in its relationship with its employees, even if it would like to do so, is limited by its obligations under the franchise agreement and operations manuals of the franchisor, its desire to remain in good standing with its franchisor, and franchisor-imposed budgetary controls.

However, under the expanded employer definition of the NLRB, franchise employees would have the ability to band together to negotiate with both the franchisee and franchisor. The new employer definition set forth by the NLRB cuts out the tiered system of workplace negotiations in franchise systems and opens the door to true collective bargaining for franchise employees. There is a practical reason why few, if any, franchise systems have seen employee unionization—it is simply not effective or worth the cost to negotiate with an employer that does not have the power to effect workplace changes. The NLRB, through its new proposed employer definition, has provided franchisors with a choice: they may either continue to exert control over the day-to-day human resources decisions and affairs of franchisees’

57. Rochelle Spandorf & Rupert Barkoff, Close Encounters: Franchisee Associations and Councils (paper presented at ABA Forum on Franchising (2003)).
employees and accept a place at the collective bargaining table, or they may step back from trying to control every aspect of these day-to-day relationships and as a result not be required to be at the table.58

2. Negative Implications of a New Employer Definition on Collective Bargaining

Defining franchisors as employers could have negative implications for franchisors because it could make them liable for other employment-related responsibilities. For example, it could mean that franchisors could not only be forced to negotiate employee responsibilities, payment and hours, but potentially be liable for unfair labor practices and breaches of collective bargaining agreements.59 Franchisors may end up being vicariously liable for the negligent or intentional wrongdoing of a franchisee’s employee. For example, if a customer slips and falls when an employee fails to mop the floor as mandated by the franchisor, the franchisor may be responsible for the customer’s injuries in a way that it historically would not have been. Existing precedent generally says that the franchisor is not liable because it does not exercise day-to-day control.60 Franchisors may, in addition, find themselves responsible as joint employers for compliance with workers’ compensation and Affordable Care Act obligations, among others.61

Defining the franchisor as employer could be negative for franchisees because it provides the franchisor with direct access to franchisees’ employees and even greater control over a franchisee’s day-to-day operations of its business.62 There is also the risk that if franchisors determine that a high degree of control over all of the day-to-day aspects of franchise employees’ jobs is essential to their systems, they will seek to become employers instead and abandon their franchise systems in favor of direct ownership. This drastic step, however, could not be taken by most, if not all, franchisors without causing a breach of the existing franchise agreements with franchisees.

Regardless of the path franchisors decide to take in the face of a proposed new employer definition, the importance of collective bargaining as a basic right of franchise employees should not be overlooked or underestimated. Franchise employees have been left to date without any reasonable collective bargaining options. A push for a new employer definition may be, instead of an unwarranted attack on franchisors, simply an effort to realign employee

58. See, e.g., Spandorf, supra note 56 (providing advice and recommendations for licensors on how to avoid joint employer classification by providing leeway for licensees to make important employment decisions, among other strategies).
59. Kaufmann et al., supra note 35.
60. See, e.g., David A. Beyer, Vicarious Liability, DLA Piper US (2006) (“Because the success or failure of most vicarious liability claims turns on the degree or extent of controls imposed by the franchisor over the franchised business, there is increasing tension between a franchisor’s legitimate interest in insuring adherence to quality controls and standards, and minimizing those controls so that the risk of vicarious liability is diminished.”).
61. Kaufmann et al., supra note 35.
62. Id.
rights and expectations with the currently unbalanced world of franchise employment.

II. The Minimum Wage

The movement to increase the minimum wage began with a series of New York City fast food worker strikes in which employees demanded the right to unionize and a $15 an hour minimum wage. Over the next three years, the idea of a dramatic increase in the minimum wage gained widespread public support. In 2014, more than a dozen states increased the statewide minimum wage. In Seattle, San Francisco, and Los Angeles, elected officials acted to increase the city minimum wage to $15 an hour by the early 2020s. The Oregon legislature recently passed a minimum wage bill that would raise the minimum wage to $14.75 an hour in urban areas by 2022. On December 26, 2015, the New York Times editorial board endorsed raising the federal minimum wage to $15 an hour. The new laws will all apply to all businesses, but in Seattle and New York, the minimum wage legislation specifically addresses either the franchise industry (Seattle) or is directed at an industry with a high percentage of franchises (New York).

Regardless of where the franchisee is located, the growing support of a dramatic increase in the minimum wage means that most franchisors and franchisees will be forced to confront this issue in the near future. This part of the article explores the roots of the minimum wage, the legal challenges to the Seattle and the New York minimum wage laws, and then speculates as to how franchisees and their franchisors can adapt to this brave new world.

A. Past Is Prologue

If the idea of a $15 an hour minimum wage sounds outrageous to the modern reader, the idea of any minimum wage seemed even more outrageous to the early 20th century reader. During the early 20th century, courts rejected most labor regulations as unconstitutional infringements upon the freedom “to contract between the employer and the employees.” Courts repeatedly held that the “general right to make a contract in relation to

his business is part of the liberty of the individual protected under the 14th amendment of the Federal Constitution."68

However, although the Supreme Court remained convinced that “the right to contract about one’s affairs . . . is settled by the decision of this court and no longer open to question,”69 the social and political upheaval of the Great Depression shifted public opinion and within a decade there was growing public support of a minimum wage. In 1932, Franklin Roosevelt decisively won the presidential election by promising the country, and specifically the poor and industrial workers, a “New Deal” that included sweeping economic regulations and wage and labor standards. At the state level, New Deal Democrats passed minimum wage legislation in seventeen states.70

The Supreme Court remained unconvinced and continued to strike down virtually all federal attempts to regulate labor.71 In 1938, the Supreme Court rejected any attempts by the states to establish a minimum wage in Morehead v. People of the State of New York ex rel. Tipaldo.72 In sweeping language, the Court ruled that the states were “without power by any form of legislation to prohibit, change, or nullify contracts between employers and adult women workers as to the amount of wages to be paid.”73

The Tipaldo ruling overturned minimum wage laws in seventeen states, affected six million workers, and enraged supporters and opponents of the New Deal alike.74 Former President Herbert Hoover criticized the ruling as an infringement on states’ rights and called for a constitutional amendment to restore to the states “the power they thought they already had.”75 Hamilton Fish, a conservative congressman and vocal critic of Roosevelt, called the ruling “a new Dred Scott decision condemning millions of Americans to economic slavery.”76 President Roosevelt campaigned for re-election

68. In *Lochner*, the Supreme Court ridiculed the idea that the State of New York could have any legitimate interest in regulating the working conditions of bakers. The Court noted that “clean and wholesome bread does not depend upon whether the baker works but ten hours per day or only sixty hours per week” and that “to the common understanding the trade of baker has never been regarded as an unhealthy one.” The Court drew New York’s reasoning to an absurd conclusion, explaining that under the state’s interpretation of its police powers, legislatures would have the right in their “paternal wisdom” to conclude that it is against the public health to “condemn” employees “to labor day after day in building where the sun never shines” and could therefore take the patently ridiculous step of implementing a minimum wage for “doctors, lawyers and scientists.” *Id.* at 59.


72. 298 U.S. 587 (1936).

73. *Id.* at 611.

74. CHAMBERS, *supra* note 70, at 12.


76. CHAMBERS, *supra* note 70, at 13.
on the promise of minimum wage laws and was re-elected by 523 electoral votes to eight. At his inauguration dinner, he criticized the Tipaldo ruling and the Supreme Court. Shortly after taking office in February 1937, he announced his plan to reorganize the federal judiciary, including the appointment of a six new Supreme Court justices.

Days after Roosevelt’s announcing his “court-packing plan” the Supreme Court issued its ruling on another state minimum wage case, West Coast v. Parrish. Although the facts were virtually identical to prior minimum wage cases, this time the Court upheld the State of Washington’s authority to establish a minimum wage and disavowed the doctrine of “liberty to contract.” The Parrish ruling, and more specifically Justice Owen J. Roberts’ changed vote, became known as “the switch in time that saved nine.”

President Roosevelt abandoned his court packing plan and instead worked closely with Secretary of Labor Frances Perkins to draft the Fair Labor Standards Act, which banned “oppressive” child labor, created a forty-hour work week, and established national minimum wage. After almost a year of heated debate, Congress passed the bill and President Roosevelt signed the Act on June 25, 1938.

B. The Fight for New Minimum Wage

Roughly a century after the Supreme Court used the freedom to contract to strike down the first minimum wage legislation, the new minimum wage movement is forcing politicians, industry, and communities to reconsider the current minimum wage. Like the original minimum wage movement, the debate has its roots in an economic meltdown; has strong populist support; and, in a neat historical twist, the two cases that may decide its future come from New York and Washington State.

77. He noted that if the “three horse team [judicial, legislative, and executive] pulls as one the field will be ploughed” but not if one team “lays down in the traces or plunges off in another direction.” Franklin Delano Roosevelt, VI Public Addresses and Papers at 51–59 (1937).


79. “What is this freedom,” the Justices opined, “the Constitution does not speak of [it]. It speaks of liberty and prohibits the deprivation of liberty without due process of law. . . . Liberty . . . is thus necessarily subject to the restraints of due process, and regulation which is reasonable in relation to its subject and is adopted in the interests of the community is due process.” Id. at 391.

80. Critics of the Act used particularly colorful language: the National Association of Manufacturers exclaimed the Act “constitutes a step in the direction of communism, bolshevism, fascism and Nazism.” Representative Edward Cox of Georgia worried that the bill would “destroy small industry” and suggested that it was “the product of those who are bent upon the destruction of our whole constitutional and the setting up of a red-labor communist despotism upon the ruins of our Christian civilization.” In comparison, Representative Arthur Philip Lammenc’s statement that the bill “sets an all-time high in crackpot legislation,” his concern that the proposed bill was “utterly impractical and in operation would be more destructive than constructive to the very purposes to which it is designed to serve,” and his worry that the bill would “create chaos in business never yet known to us” seems almost sedate.
1. The Minimum Wage Ordinance in Seattle

On May 30, 2013, dozens of employees of Seattle franchised restaurants walked off their jobs and attended a rally organized by several community groups and labor unions.81 Throughout the day, several franchise locations were forced to close due to low staffing. Kshama Sawant, an economics professor and socialist candidate for city council made a minimum wage of $15 an hour the centerpiece of her campaign. In September 2013, mayoral candidate Edward Murray made a phased-in minimum wage a key platform in his campaign.82 Seattle voters elected both Sawant and Murray, making Sawant Seattle’s first socialist city council member in a century.83

Immediately after taking office, Mayor Murray convened an Income Inequality Advisory Committee (IIAC).84 The goal of the IIAC was to create a minimum wage ordinance that all parties could agree on.85 After several months of meetings and $30,000 in mediation bills, the committee proposed a phased-in minimum wage using a two-tiered system, in which Schedule One employers, defined as any employer with more than 500 employees, would be required to phase in a $15 an hour minimum wage within three years, and Schedule Two employers would be required to do so within seven years.86 The committee justified the distinction by explaining that the larger Schedule One employers had the economic resources to support a wage increase while smaller business would need more time to adjust.87

In May 2014, mayoral staff began circulating a draft that defined all franchisees associated with a franchisor, or network of franchises, that employ an aggregate of more than 500 employees nationally as Schedule One employers. Supporters of the franchise definition argued that franchises, unlike other small businesses, would be better able to adapt to the increase because they were associated with a known brand and have a larger support network.88 Predictably, Sawant framed the issue in class terms, arguing that “to be a franchisee, you have to be very, very wealthy. A small business person of color from Rainer Beach is not going to be able to afford to open a franchise outlet.”89
Some individuals seemed to be motivated by an anti-franchise bias. Seattle activist and entrepreneur Nick Hanauer, who had served on the IIAC committee, argued that:

The truth is that franchises like Subway and McDonald’s really are not very good for our local economy. . . . The net amount of food people in Seattle will consume will not change if we have fewer franchisees. What will change is what they consume and from whom. A city dominated by independent, locally owned, unique sandwich and hamburger restaurants will be more economically, civically and culturally rich than one dominated by extractive national chains.90

The franchise industry organized and called for removing the franchise definition.91 Michael Seid, an International Franchise Association board member, wrote a passionate letter to the mayor and the city council, in which he explained that the “the bill discriminates against a large class of small independent business owners merely because they have invested in their business under a brand name.”92

The mayoral staff wrestled with the implications of the franchise definition. In one email, a staffer wrote:

[I] would love some additional thinking to help think though how to answer concerns about the effect on the individual immigrant business owner who decided to open a Subway rather than a bahn mi shop. I will admit upfront that I probably know least about the franchise model so there might be big gaps that I don’t understand. That’s part of why I’m asking for help in thinking this through . . . if we lose franchises in Seattle, I won’t be sad . . . but are there ways for the cost to be born not on those franchise owners? Are they simply going to be a casualty of this transition? Are they less sympathetic or less at financial risk than I am imagining?93

The record is unclear whether that staffer ever received “additional thinking” but when the mayor sent the bill to the Seattle City Council, the franchise definition remained. On June 3, 2014, one year after the first fast food workers strike, the Seattle City Council voted unanimously for a phased in $15 an hour minimum wage.94

2. The Minimum Wage in New York State

While Seattle established its minimum wage ordinance through a contentious but ordinary municipal process, New York’s minimum wage legislation resulted from a more convoluted political one. After fast food worker strikes in 2012, the New York state legislature voted in March 2013 to increase the state minimum wage by $1.75 over three years.95 A year later, Governor Andrew Cuomo proposed raising it again to $11.50 per hour in New York City
and $10.50 per hour statewide. When the legislature rejected the proposal, Governor Cuomo acted under a Roosevelt-era law and directed the labor commissioner to impanel a wage board to investigate whether the current wages in the fast food industry were “sufficient to provide for the life and health” of fast food workers. The wage board recommended “that the minimum wage be raised to $15 for employees in fast food establishments.” Under the board’s proposal, the new minimum wage would apply only to those establishments that are “part of a chain; and . . . which is one of thirty or more establishments nationally including . . . an establishment operated pursuant to a Franchise where the franchisor and the franchisee(s) of such franchisors owns or operate thirty or more of such establishments in the aggregate nationally.” In September 2015, Labor Commissioner Musolino accepted the board’s recommendation and the new minimum wage went into effect, beginning with a wage increase on December 31, 2015.

C. The Franchise Minimum Wage Litigation

After legislation comes litigation. In both Seattle and New York, business organizations immediately filed suit to prevent the laws from taking effect. In Seattle, the International Franchise Association (IFA) and several individual franchisees filed a lawsuit and moved for a preliminary injunction. In New York, the National Restaurant Association filed a petition for review in the State of New York Board of Industrial Appeals. In both cases, the plaintiffs argue that the minimum wage legislation is unlawful because it violates the dormant Commerce Clause.

1. The Dormant Commerce Clause

Like the freedom to contract, the dormant Commerce Clause is not found in the Constitution. Rather, the term describes a legal doctrine that holds that when the drafters of the Constitution granted Congress the power to regulate commerce between the states, they included “a further negative command” that “bars states and local governments from enacting taxes, tariffs or regulations which favor local business at the expense of interstate commerce.” The central goal of the dormant Commerce Clause doctrine “is to prohibit state or municipal laws whose object is local economic protec-

96. Id. at 3.
97. Id. at 4.
98. Id. at 6.
99. Id. at 5.
100. Id. at 7.
104. Id.
tionism, laws that would excite those jealousies and retaliatory measures the Constitution was designed to prevent.”105 The “rules” courts use to determine if a law violates the dormant Commerce Clause “can be simply stated, if not simply applied.”106 Courts apply two different tests: the anti-discrimination test, which focuses on determining whether the law has a discriminatory purpose, motive, or effect; and the Pike test, which asks if the law’s benefits are outweighed by its harmful effects on interstate commerce. A law that “facially discriminates against interstate commerce” in its plain language, intent, or effect is “per se invalid”107 while a nondiscriminatory law that adversely affects interstate commerce is invalid only if “the burden imposed on [interstate] commerce is clearly excessive in relation to the putative local benefits.”108

In order to succeed on their claims, the plaintiffs would have to prove that the laws are discriminatory on their face, have a discriminatory intent, or would have a discriminatory effect against interstate commerce (the anti-discrimination test); or would impose a burden on interstate commerce that is clearly excessive in relation to the putative local benefits. In the Seattle case, both the district court and the Ninth Circuit have already rejected this argument.109

a. The Anti-Discrimination Test

The plaintiffs in both cases have argued that the respective ordinances fail the anti-discrimination test. In the Seattle case, the plaintiffs argued that that statements of committee members, city council members, and the mayor demonstrated a discriminatory intent110 while in the New York case, the IFA argued in an amicus brief that the wage order was discriminatory on its face because it “targets a business model almost entirely confined to interstate commerce,” namely fast food chains with more than thirty units nationwide.111 Both plaintiffs used the argument that because there is almost a hundred percent correlation between franchises and businesses that are associated with interstate commerce, any statute that distinguishes between franchises and other small businesses discriminates against interstate commerce by proxy.

In the Seattle case, both the U.S. District Court for the Western District of Washington and the Ninth Circuit rejected the argument that a law that distinguishes between businesses based on their size nationwide is facially

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108. Id.
109. See Int’l Franchise Ass’n v. City of Seattle, 97 F. Supp. 3d 1256 (W.D. Wash. 2015), aff’d but criticized, 803 F.3d 389 (9th Cir. 2015), petition for cert. filed, No. 15-958 (Jan. 29, 2016).
110. Plaintiffs’ Motion for a Limited Preliminary Injunction at 14–16, Int’l Franchise Ass’n, 97 F. Supp. 3d at 1256.
111. Id.
discriminatory because the law did not distinguish businesses on the basis of the “location of headquarters . . . [or] workers”\textsuperscript{112} but rather on the number of employees and the business model.\textsuperscript{113} The same reasoning applies to the New York wage order, which distinguishes on the basis of a business’s number of locations and its business model (in that the franchises are assessed based on the number of outlets system-wide).\textsuperscript{114} At least two other courts in a franchise context have rejected the proxy argument as a way to prove discrimination although the laws were ultimately overturned on the basis of their discriminatory effect.\textsuperscript{115}

Nor are the plaintiffs likely to prevail on their claims that the laws have a discriminatory purpose. Under this prong of the anti-discrimination test, the lawmakers are entitled to a presumption “that the objectives articulated by the legislature are actual purposes unless an examination of the circumstances forces us to conclude they could not have been the goals of the legislation.”\textsuperscript{116} In order to prevail on this prong of the test, the plaintiffs must prove that the lawmakers’ stated objective was to impose either a higher minimum wage (New York) or a faster minimum wage rollout (Seattle) only on those businesses that are “better equipped to absorb a wage increase due to [the franchise’s] greater operational and financial resources, and brand recognition was pretextual.”\textsuperscript{117} Although the New York plaintiffs have not yet articulated the basis for their claim of discriminatory intent, the plaintiffs in the Seattle case attempted to overcome the presumption of legitimacy with “five emails and five public statements.” They were not successful.\textsuperscript{118} Both the trial and appellate courts discounted the Hanuaer emails because Hanuaer was acting as an advocate, not a lawmaker.\textsuperscript{119} The courts were only slightly less dismissive of allegedly discriminatory comments of city council members, the mayor, and mayoral staffers. The Ninth Circuit noted that the lawmakers’ comments “reflected a debate about the character-

\textsuperscript{112} \textit{Int'l Franchise Ass'n}, 803 F.3d at 400.

\textsuperscript{113} Id.


\textsuperscript{115} See Island Silver & Spice, Inc. v. Islamorada, 542 F.3d 844 (11th Cir. 2008), Cachia v. Islamorada, 542 F.3d 839 (11th Cir. 2008).

\textsuperscript{116} Rocky Mt. Farmers Union v. Corey, 730 F.3d 1070, 1097 (9th Cir. 2013).


\textsuperscript{118} Attempts to prove discriminatory intent based on legislative history are typically unsuccessful. As Justice Scalia explained, it is “the equivalent of a entering a cocktail party and looking over the heads of guests for one’s friends.” Conroy v. Aniskoff, 507 U.S. 511, 519 (Scalia, J., concurring).

\textsuperscript{119} \textit{Int'l Franchise Ass’n}, 803 F.3d at 403.
istics and the resources of the franchises,” and the staffer’s comments were not “a cipher that decodes the City Council and the Mayor’s motives.”

However, the New York plaintiffs may be able to prevail. Courts are more likely to find that a facially neutral statute has a discriminatory purpose if there are “significant departures from normal procedures” in drafting the law, such as the affected community being excluded from the lawmaking process or the “ordinance [being] debate[d] in secret.” The New York plaintiffs could argue that employing a little used, eighty-year-old law to establish a wage board is a “significant departure from normal procedures” and that there were no fast food chain representatives on the three-person wage board. However, it will be hard to argue that the committee, which held four public meetings, heard testimony from 225 people, and received over 2,000 written comments, deliberated in secret.

If the plaintiffs cannot show discriminatory language or intent, they must show that the laws impose a “substantial burden on interstate commerce.” To support their claim, the plaintiffs must make a “substantial showing” of “probative evidence of an adverse impact.” The plaintiffs may not rely on “potential” or “probative harm” and invite courts to “speculate or infer” a discriminatory effect. In order to prevail, the plaintiffs must “prove it or lose it.”

In the Seattle case, the plaintiffs could not meet that burden. The courts explained that “not every exercise of local power is invalid simply because it affects in some way the flow of commerce between the states.” Merely increasing the costs of a particular kind of business model (even a model closely linked with interstate commerce) was not sufficient to demonstrate a discriminatory effect without “a further showing of impact on the flow of goods.” Although neither the trial nor the appellate court explicitly delineated where the line between incidental effect on interstate commerce and

120. For an example of the kinds of statements that courts will find discriminatory, see Waste Management Holdings, Inc. v. Gilmore, 252 F.3d 316 (4th Cir. 2001). In Gilmore, the governor who sponsored a bill limiting the importation solid waste into Virginia issued a series of press releases in which he stated that the challenged law was “the only effective way of limiting the amount of waste that is being imported to Virginia” and that “the home state of Washington, Jefferson and Madison has no intention of becoming New York’s dumping ground.” Id. at 339.
122. Id. at 1256.
123. Int’l Franchise Ass’n v. City of Seattle, 803 F.3d 389, 402 n.3 (9th Cir. 2015).
125. Nat’l Ass’n of Optometrists & Opticians v. Harris, 682 F.3d 1144, 1148 (9th Cir. 2012).
126. Nat’l Paint & Coatings Ass’n v. City of Chicago, 45 F.3d 1124, 1132 (7th Cir. 1995).
127. Cherry Hill Vineyard, LLC v. Baldacci, 505 F.3d 28, 36 (1st Cir. 2007).
128. Int’l Franchise Ass’n, 97 F. Supp. 3d at 1273 (quoting Black Star Farms LLC v. Oliver, 600 F.3d 1225, 1232 (9th Cir. 2009)).
129. Id. (quoting Black Star Farms, 600 F.3d at 1233).
130. Id. (quoting Black Star Farms, 600 F.3d at 1232).
132. Id. at 1273.
substantial discriminatory effect fell, the trial court noted in the two cases where a court found that laws regarding formula stores and restaurants did violate the dormant Commerce Clause, the law either “created a barrier to entry”\textsuperscript{133} into the local market or “effectively eliminated”\textsuperscript{134} the business model from the market. For either the Seattle or New York plaintiffs to prevail, they must show a substantial effect on interstate commerce. Evidence that the new law may cause a single franchisee to close her business or the law was “likely” to cause franchisees to limit their future expansion plans will not be sufficient. Perhaps as the cases progress, the plaintiffs will be able to gather additional evidence to demonstrate a discriminatory effect, namely that the laws have either forced the franchisors to incur substantial costs\textsuperscript{135} in complying with the law or franchisees have closed their businesses as “a direct result of the statute.”\textsuperscript{136}

b. Pike Balancing Test

A law that survives that anti-discrimination test may still violate the dormant Commerce Clause if it fails the \textit{Pike} balancing test. Under the \textit{Pike} test, a law that “regulates even-handedly to effect a legitimate public interest” and imposes only an “incidental” effect on interstate commerce will be upheld unless plaintiffs can show that the “the burden imposed on commerce is clearly excessive in relation to the putative local benefits.”\textsuperscript{137} Unfortunately, it is challenging to predict the outcome under the \textit{Pike} test. Legal scholars have noted that “a number of the . . . cases are, in fact, impossible to reconcile,”\textsuperscript{138} and courts have referred to the jurisprudence surrounding the \textit{Pike} test as “hopelessly confused,”\textsuperscript{139} a “tangled underbrush,”\textsuperscript{140} and a “quagmire.”\textsuperscript{141} The Seattle and New York plaintiffs will have their work cut out for them.

When applying the \textit{Pike} test, courts are deferential to the “the empirical judgments of lawmakers concerning the utility of legislation,”\textsuperscript{142} particularly when the state is exercising its police powers to ensure the public health and safety. Laws exercising these powers “carry a strong presumption of validity . . . if there are alternative ways of solving the problem, we do not sit to determine which of them is best suited to achieve a valid state objective . . .

\textsuperscript{133} Island Silver & Spice, Inc. v. Islamorada, 542 F.3d 844 (11th Cir. 2008).
\textsuperscript{134} Cachia v. Islamorada, 542 F.3d 839 (11th Cir. 2008).
\textsuperscript{135} See \textit{Hunt v. Washington State Apple Advertising Commission}, 432 U.S. 333, 347 (1977), where the plaintiffs demonstrated that “individual growers and dealers lost accounts as a direct result of the statute” and that the statute increased the growers’ costs by 5 to 15 cents a carton.
\textsuperscript{136} \textit{Id}.
\textsuperscript{140} \textit{Id}.
\textsuperscript{141} \textit{Id}.
\textsuperscript{142} S.D. Myers, Inc. v. City of San Francisco, 253 F.3d 461, 471 (9th Cir. 2001).
policy decisions are for the state legislature.”143 Thus, the minimum wage laws will be upheld unless the plaintiffs can show that the “legislative facts on which the classifications are based could not reasonably be conceived to be true by the governmental decision maker.”144

Both Seattle’s IIAC commission and the New York wage board thoroughly documented the goals of the proposed legislation, which were to “assist low wage workers” and “eliminate . . . the employment of persons in occupations . . . at wages insufficient to provide adequate maintenance for themselves or their families,”145 and the rationale for the distinction, which was that businesses that either have thirty outlets or 500 employees nationwide, or are associated with systems that do, was based on the rationale that those larger entities were better equipped to adapt to a higher wage. They also explained their reasoning for distinguishing franchises from other small businesses; specifically, the franchise model offers franchises benefits that other small businesses do not have. In order to prevail under the Pike test, the plaintiffs will need to show that the purpose of the law was illegitimate; the rationale for the distinction was inconceivable; or the burden on interstate commerce, and not merely a type of business format that operates in interstate commerce, is outweighed by the benefits of increasing the minimum wage.

III. A Brave New World? Not Really

For franchisees and franchisors, a different economic and regulatory environment with a higher minimum wage or an expanded joint employer standard is not a brave new world; it is a golden opportunity to return the fundamental principles of franchising.

A. Reintroduce the Model

Even if the plaintiffs in the Seattle and New York cases prevail, franchisees and franchisors will face higher minimum wages in several jurisdictions. Support for a dramatic increase in the minimum wage continues to grow across the nation.146 At the same time, news coverage of low paid workers struggling to balance two or three low-paying jobs to make ends meet are heartbreaking; the stories of those same workers who had their franchisee

144. Int’l Franchise Ass’n v. City of Seattle, 97 F. Supp. 3d 1256, 1277 (W.D. Wash. 2015).
146. In a January 2014 Pew Research poll, 73 percent of Americans said they supported raising the minimum wage to $10.10 an hour. In 2014, thirteen states raised the state minimum wage. Both Democratic presidential candidates have endorsed a higher minimum wage of at least $12 an hour.
employer wrongfully withhold their wages, fail to pay their overtime, or prevent them from organizing are infuriating.147

As a whole, the franchise industry’s response has been underwhelming. Whether the topic is an increased minimum wage or an expansion of the joint employer doctrine, the response has focused on describing how the purposed change would decimate the franchise industry148 or how the alleged problems are not the franchisors’ responsibility.149 For the lawmakers, political figures, and influential economists who have identified the franchise business model as “a problem,” the argument that new laws and regulations would destroy that business model is not compelling. In other words, the destruction of the franchise model is not a bug; it is a feature.

As part of telling a better story, franchisees should avoid depicting minimum wage supporters or organized labor as villains.150 Dismissing the minimum wage movement or an expanded joint employer definition as a union ploy is problematic for two reasons: first, it presumes that the voters and other decision makers dislike unions as much as the IFA does;151 and second,

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147. Because of their decentralized structure, independent and sometimes inexperienced franchisees, and frequently thin profit margins, franchises may have a higher risk of wage and hour complaints or violations than other industries. McDonald’s franchisees are facing wage and hour claims in seven different states. In November 2015, a Papa John’s franchisee was sentenced to sixty days in jail and ordered to pay roughly $500,000 in damages for violating wage and hour laws. Grace Schneider, *Papa John’s Franchisees Ordered to Pay Back Wages*, USA TODAY, Oct. 20, 2015, available at http://www.usatoday.com/story/money/nation-now/2015/10/20/papa-johns-labor-violations/74299592/.

148. The plaintiffs in the Seattle minimum wage case argued that if the ordinance went into effect, franchisees would be “placed at a severe competitive disadvantage which will result in the loss of customers and goodwill and may even force some of them to cease operations altogether.” Opponents to the new standard have also argued that if franchisors are deemed to be joint employers of their franchisees’ employees, “the investments of franchisees and their ability to reap the profits of their independent businesses could either be vastly diminished or disappear altogether.” See Kaufmann et al., supra note 35.

149. For a well reasoned defense of the current joint employer standard, see John Bender, *Barking up the Wrong Tree: The NLRB’s Joint Employer Standard and the Case for Preserving the Formalities of Business Format Franchising*, 35:2 FRANCHISE L.J. 209 (2015).

150. In response to Seattle’s minimum wage ordinance, the IFA launched an “ad campaign highlighting [the] agenda behind Seattle minimum wage law.” Press Release, Int’l Franchise Ass’n, International Franchise Association Launches Ad Campaign Highlighting Agenda Behind Seattle Minimum Wage Law (Aug. 20 2014), available at http://www.franchise.org/international-franchise-association-launches-ad-campaign-highlighting-agenda-behind-seattle-minimum). In the advertisement, the IFA quoted David Rolf, the SEIU president admitting “that part of the SEIU’s motivation for the higher minimum wage in Seattle was to break the business model for franchisees and in turn, expand the union’s membership.” *Id*.

151. The “blame the unions” tactic is likely to fail in the same sections of the country where the $15 Now movement has the strongest support, specifically large urban areas on both coasts, including New York City, San Francisco, and Los Angeles. The argument was particularly tone-deaf in Seattle, a city that was built on union wages, had just elected a socialist city council member, and claims a statue of Lenin as a beloved local landmark. Even outside cities, union support
it minimizes the substantive concerns many Americans have regarding the minimum wage and income inequality. In 2014 alone, more than a dozen states moved to increase the minimum wage. The four states that raised their minimum wages through ballot measures, Alaska, Arkansas, Nebraska and South Dakota, are all right-to-work states. Although almost half of Americans approve of unions, a much larger percentage of Americans support a substantial increase in the minimum wage. According to the Pew Research Center, nearly half of Americans have a favorable opinion of unions but a staggering 78 percent of Americans support a substantial increase in the minimum wage.

In fact, by minimizing the problem and denying responsibility for it, the franchise industry may be doing more harm than help. As Paul Steinberg explained, “with every franchisor who turns a blind eye to wage theft . . . and [the] taxpayer subsidy of wages,” the position of supporters of a higher minimum wage and an expanded joint employer standard are “going to get a more sympathetic ear.”

The franchise community must explain why the franchise business model should survive. Educating decision makers about the total number of franchise outlets and amount of gross sales is incomplete if it does not explain why franchising is a good thing for their communities. Franchisees sponsor Little League teams, host school field trips, and donate student prizes to local schools. The franchise business model allows new immigrants, downsized employees, and returning veterans the opportunity to be their own boss and build a family business. By personalizing the industry, franchisees and franchisors can shift the narrative from downtrodden employees versus wealthy corporate interests to one that reflects the more complicated reality of the franchise system.

B. Re-examine the Model

Either a higher minimum wage or an expanded joint employer doctrine will force franchisees to ask for more information and perhaps, different things from their franchisors. The traditional mantra has been that a franchise combines “the right to use a trademark” with “the right to become part of a system whose business methods virtually guarantee [their] success.” But if becoming a franchisee comes with an increased cost, prospect...
Franchisees must ask if the system and the mark are really worth what they are paying for it.

The story of two successive pizza shops in the same retail space in Seattle’s Capitol Hill neighborhood illustrates the perils of purchasing a franchise without considering whether the benefits of the system justify the expense. When Ritu Shah-Burnham opened her Z pizza franchise she was the only Z Pizza franchise in the Pacific Northwest. Although she received access to a supply chain and support with menus and advertising, she paid for those services through her franchise and royalty fees and ultimately saw them as a cost, not an advantage. She paid $7,000 a month for retail space in an incredibly competitive area and estimated that 33 percent of her budget went to labor costs. She only had ten employees but because her California franchisor had 90 locations, her business was a Schedule One employer. On July 4, 2015, she closed her business.

After Z Pizza closed, a new pizza franchise opened in the same space. Like Z Pizza, Ian’s Pizza offers gourmet pizzas by the pie and the slice with several beers on tap. Like Z Pizza, Ian’s Pizza is an unknown brand opening in a new market. However, Ian’s Pizza has only a handful of other locations and is classified as Schedule Two employer and will not have to reach a $15 an hour minimum wage until 2021.

Despite its status as a smaller franchise system with no stores in the Pacific Northwest, Z Pizza charged a $30,000 franchise fee and a 6 percent royalty. Assuming Ms. Shah-Burnham paid the full franchise fee and royalty, was the value of an unknown brand and system untried in her region worth the hefty investment cost including the classification as a Schedule One employer?

Franchisees and individuals considering becoming franchises must incorporate the likelihood of an increased minimum wage into their pre-purchase due diligence. Any franchisee evaluating a Franchise Disclosure Document (FDD) should ask if the document provides enough information to determine if the model is profitable, not only at the existing minimum wage, but at one that is 20 percent to 50 percent higher. A prospective franchisee should ask if there is enough independence in the system for a franchisee to adjust to changing market conditions. A system that controls hours, staffing, inventory and pricing, either directly or through “supported” prices and of-

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157. Id.
158. Id.
159. Id.
160. Id.
161. Id.
162. Id.
fers, does not give a franchisee sufficient room to adapt. Franchisees must ask is this system sustainable?

The franchise industry frequently touts the benefits of franchising by claiming that it “increases your chance of success because [franchisees] are associating with proven products and methods.”164 If this assertion is true, a franchisor should be able to provide extensive financial performance representations in Item 19 of the FDD. Those representations should not only include sales, but also such costs as food and labor and, most importantly, profits. If a franchisor cannot provide this information, an individual should not become a franchisee of that system.

C. Refine the Model

Both the possibility of an increase in the minimum wage and an expanded joint employer definition present an opportunity for the franchise community to get back to basics by providing franchisees an opportunity to purchase the “right to use a trademark,”165 along with “business methods . . . [that] virtually guarantee success,”166 and creating a system in which the franchisors and the franchisees succeed.

In the last several decades, the franchise industry may have strayed from that model. In its brief, the IFA acknowledged that owning a franchise business is “no safer on average than independent business ownership and in some cases more risky”167 and that in terms of franchisor support “franchisees get only what they pay for.” Three trends in franchising are most likely to hinder a franchisee’s ability to adapt: (1) the dramatic increase in royalty fees, (2) the rise in “unbundled” franchisor services, and (3) the drift towards broader franchisor control.

The franchisees most likely to survive a dramatic increase in the minimum wage are those with the greatest ability to adapt. Togo Sandwich CEO Tony Gioia said that he is still looking to expand into the Seattle market despite the higher minimum wage, explaining that his company “had a way to adjust the pricing and labor models to help us be competitive and still make a profit.”168 He speculated that the Seattle franchises might have slightly different pricing, such as no $5 daily sandwich specials, than other markets.

Of course, all the price adjustment in the world cannot help a franchisee if the system imposes unrealistically high royalties or overcharges for franchise services. In the last decade, franchisors have unbundled franchisee support services such as site selection, build out services, and operational support,

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165. Bender, supra note 149, at 229.
166. Id.
which used to be included in the franchise package. Additionally, franchisors are charging dramatically higher royalty rates than they have in the past. In 1980, the mean royalty rate was 4.5 percent of sales. Over the next twenty years, the royalty rate increased gradually to 5.2 percent of sales by 2001.169 But between 2001 and 2006, the average royalty rate skyrocketed to 6.7 percent of sales.170

The drift toward more franchisor control also poses a threat to adaptation. By limiting their involvement in the franchisee’s day-to-day operations and aiming for the smallest amount of oversight possible without compromising brand standards, franchisors can both increase the likelihood that their franchisees will survive minimum wage increases and limit the possibility of joint employer liability. To ensure their future, the franchise industry must return to the principles of its past.

Rather than providing franchisors with a mandate that will take down the entire system of franchising, as the IFA and other commenters appear to indicate, the NLRB has provided franchisors with a choice. Franchises are often sold to prospective franchisees with a pitch that franchisees will be able to own their own businesses and have control over them with higher-level guidance from the franchisor only on brand and system standards. As the IFA’s president stated in his letter to Congress, franchisors purport to provide to franchisees “entrepreneurship opportunities.” Franchisors may choose, in light of recent NLRB guidance, to step up to their own advertising pitches and allow franchisees greater control over the day-to-day operations of their businesses, particularly in terms of management and control of employees, while still complying with the requirements of the Lanham Act. If a franchisor instead determines that it is vital to the success of the entire system to exert this higher level of control over its franchisees’ employees, it is the franchisor, rather than the NLRB, that is aiming to redefine the “franchise business model” that has proven to be such a “successful engine for economic development in the United States.”

IV. Conclusion

As franchisees and franchisors face the prospect of a changed regulatory landscape with a dramatically higher minimum wage and expanded interpretation of joint employer liability, what if, rather than trembling at the brave new world, they channeled their inner Prospero and viewed these challenges as a “golden opportunity” to return to the basics of what made the franchise model so successful? In the commentary surrounding both the minimum wage debate and the joint employer standard, the franchise industry’s refrain has been: if X happens, franchising will not survive. A more accurate state-

ment would be: if X happens, franchising as it is currently practiced will not survive. Franchisees may be able to adapt to higher minimum wages if they have significant flexibility to adjust prices, special offers, operating hours, and staffing ratios even if they are paying for unbundled franchise services and a 6.7 percent royalty. But if franchisees have no ability to adjust their operations and are paying a royalty of 12.7 percent, they likely will not survive. Franchise systems that provide independence and a strong system at a reasonable rate will survive. Franchise systems that micromanage their franchises, overinflate the value of their systems, and overcharge their franchisees will not. As those systems struggle, prospective franchisees will be drawn to the systems that have demonstrated their ability to adapt to a changing environment. The franchise systems that embrace this opportunity and adapt will not only survive but also flourish.
A Proposal for a Mandatory Summary Franchise Disclosure Document

Eric H. Karp and Ari N. Stern

In the arena of disclosure and registration, franchising has lost its way.

The prevention of fraud and abuse was the primary driver behind the creation of the franchise disclosure regime at both the state and federal levels. The U.S. Federal Trade Commission (FTC) issued the original franchising rule, “Disclosure Requirements and Prohibitions Concerning Franchising and Business Opportunity Ventures” (the Franchise Rule), on December 21, 1978. It did so on the basis of its findings of widespread deceitful practices in the franchising industry, which had resulted in serious economic harm to consumers. Such deception was particularly noted to exist with respect to misrepresentations concerning: (1) the opportunity, costs, and contractual terms to which a potential franchisee would be subject; (2) the success or lack thereof of the franchise seller; (3) prior purchasers of the franchise opportunity; and (4) the franchise seller’s financial viability. A number of the states that enacted franchise disclosure and/or registration laws, most notably California, Maryland, Illinois, and New York, did so on the basis of similar findings.

3. For example, the legislative findings that supported enactment of the first state franchise disclosure law (i.e., California in 1971) concluded that “California franchisees have suffered substantial losses where the franchisor or his or her representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between the franchisor and the franchisee, and the prior business experience of the franchisor.” See California Franchise Investment Law, CAL. CORP. CODE § 31001.
A parallel purpose of franchise disclosure generally has been to provide the prospective franchise investor with the information needed to make a knowing, intelligent, and informed decision about whether to accept the offer of a franchise opportunity. Indeed, the California Franchise Investment Law states that one of its goals is to provide “each prospective franchisee with the information necessary to make an intelligent decision regarding the franchise being offered.”4 The Maryland Franchise Registration and Disclosure Law, in a similar vein, states that one of its purposes is to “[g]ive each prospective franchisee necessary information about any franchise offer.”5 And the Rhode Island Franchise Investment Act seeks to “. . . assure that each offeree receives the information necessary to make an informed decision about the offered franchise.”6

Two developments have undermined these objectives.

First, these laudable goals of franchise disclosure have been eroded in favor of franchise disclosure documents whose primary purpose is to protect the franchise seller from liability arising from pre-sale statements and representations. This shift in priorities was in many ways signaled by the Third Circuit’s 1997 decision in *Queen City Pizza, Inc. v. Domino’s Pizza, Inc.*7 Although many properly interpreted this case as perhaps the death knell of antitrust tying and monopolization claims in the franchise context, another important message was embedded in the court’s determination in favor of the franchisor.

In *Queen City Pizza*, the franchisees alleged that they suffered harm on account of the franchisor’s requirement that they purchase ingredients, supplies, and materials from the franchisor or its approved vendors only. More specifically, the franchisees alleged that the these restrictions yielded annual revenue to the franchisor of $450 million, and because these ingredients and supplies were sold at a markup, in some cases as high as 40 percent, each of the 3,500 franchisees in the system paid between $3,000 and $10,000 per year more for ingredients and supplies than they would have in an open and competitive market. The franchisees thus argued that the franchisor was subject to liability under the Sherman Act for engaging in illegal tying and monopolization.8

The Third Circuit ruled against the franchisees, noting, in part, that the limitations on their purchasing choices were imposed by their contract and not the overall marketplace. What this meant was that the franchisees were bound by their contract and the presale disclosure, which enabled them, in the court’s eyes, to “assess the potential costs and economic risks at the time they signed the franchise agreement.”9 To put it another way,
the court was saying that the franchisor could impose commercially unreasonable prices on its captive franchisees, presumably without limit, and reap an enormous benefit, as long as it disclosed the right to control the supply chain up front.

Other cases before and after Queen City Pizza also demonstrate that the drafting of franchise disclosure documents, including franchise agreements, has evolved to the point of placing a greater emphasis on protecting franchisors than on protecting prospective investors. For example, the 1991 decision in Scheck v. Burger King Corp. involved a franchise agreement that did not grant or impute exclusive territorial rights to the franchisee. When the franchisor opened a competing location two miles away from the franchisee’s location, a claim based on the implied covenant of good faith and fair dealing ensued. The court, in denying Burger King’s motion for summary judgment held that, although the plaintiff did not have an exclusive territory, he was entitled to an expectation that the franchisor would not “actively destroy the right of the franchisee to enjoy the fruits of the contract.” This decision created a rush among franchisors to revise their franchise agreements, as well as Item 12 in their franchise disclosure documents, to fill the void created by the apparent ambiguity in the Burger King franchise agreement.

In short, the franchise disclosure document has, in recent times, grown greatly in length and complexity for the benefit of franchisors. The document now primarily serves to expand the control of a franchisor over its system, as well as to protect the franchisor from liabilities and claims.

A second and related development has been the material and marked increase in the sheer amount of information contained in a typical franchise disclosure document. Such an increase in information makes the document impenetrable and intimidating to most potential franchisees. It is now not unusual for the entire franchise disclosure document, including all related attachments, to exceed 300 pages. In fact, it is not unheard of for a franchise disclosure document to exceed 500 pages, or 7.5 pounds, of material. See a typical FDD on the next page.

11. See id. at 548.
For these reasons, the authors now question whether “more is less,” frustrating the goal of allowing a prospective franchisee to engage in meaningful due diligence and comparative shopping of franchise opportunities.

As the next review of the FTC Franchise Rule approaches, it is time to pause and thoroughly examine the purposes and intent behind franchise disclosure. To help restore franchise disclosure to its original mission, the authors propose the creation of a summary franchise disclosure document in order to enable prospective franchisees to receive the information they need in a format that is user-friendly and informative. Our proposal also suggests that “less can be more.”

In making this proposal, the authors have looked to the securities industry—and for good reason. In 2009, the Securities and Exchange Commission (SEC) issued a regulation that authorized the use of a separate summary prospectus for mutual funds. Further, many of the state franchise disclosure and registration statutes are modeled after securities laws.13

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13. The Illinois statute is a typical example of state laws designed to get at the core of preventing fraudulent practices. It makes it unlawful for any individual to “directly or indirectly (a) employ any device, scheme, or artifice to defraud; (b) make any untrue statement of material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or (c) engage in any act, practice or course of business which operates or would operate as a fraud or deceit upon any person.” See 815 ILL. COMP. STAT. ANN. § 705/6.
These statutes have explicitly incorporated into their laws the provisions of SEC Rule 10(b)(5), which is based upon the Securities Exchange Act of 1934, § 10(b), 15 U.S.C. § 78(b). 14

In addition, in part reflecting the genesis of franchise disclosure law and its relationship to securities laws and regulations, state franchise regulators in Connecticut, Hawaii, Indiana, Maryland, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin all work in an office, bureau, or division within the securities agencies of their respective states. 15 State officials, accordingly, recognize a strong parallel between regulating securities and regulating franchising.

More importantly, the SEC, prior to enactment of its summary prospectus rule, conducted substantial research, including the use of focus groups, to assure that the use of a summary prospectus would add to, and not subtract from, the utility of the information provided to the typical investor. The authors believe that this research can be used as part of an administrative record that would justify the creation of a new section in the FTC Franchise Rule on the same subject. 16

Finally, the authors acknowledge that there is nothing in the current FTC Franchise Rule that would prohibit a franchisor from creating a summary of its franchise disclosure document, or publicizing some, but not all, of the information contained within its disclosure document, as long as there is no inconsistency between that information and the information contained in the disclosure document. 17 Such summaries or excerpts can already be found on websites of many franchisors. 18 Our proposal would not only make a summary franchise disclosure document a mandatory and integral part of the disclosure process, but would also carefully and specifically prescribe and limit what would be contained in such a summary document.

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16. During the process that led to the issuance of the amended FTC Franchise Rule on January 23, 2007, many franchise advocates urged the agency to address post-sale relationship issues. In declining to do so, the FTC opined that the record of the administrative proceedings did not yield adequate evidence to support a finding of prevalent actual practices that would meet the statutory prerequisites for unfairness as articulated in the FTC Act. See Statement of Basis and Purpose, Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. 436 at 15447.
17. Under 16 C.F.R. § 436.6(d), a franchisor may not include any materials or information in the franchise disclosure document other than those that are specifically permitted by the FTC Franchise Rule or by a state law not preempted by the FTC Rule. On the other hand, a franchisor may provide information outside the franchise disclosure document as long as it does not contradict any of the information required to be disclosed in the disclosure document. See 16 C.F.R. § 436.9 (a).
18. For example, the pizza franchisor, Papa John’s, has a section on its website providing information concerning the cost to build a shop, the standard franchise fee, the standard royalty fee, the marketing and advertising fees, minimum financial requirements, and training provided. See http://www.papajohns.com/franchise/frequently-asked-questions-about-franchising.html (last visited on Feb. 15, 2016). See also the website of KFC, which has a similar set of disclosures, http://www.kfcfranchise.com/faqs-qsr-restaurant.php (last visited on Feb. 15, 2016).
In order to allow for a better appreciation of the relevance of the authors’ proposal, the relevant background information is summarized as follows.

II. Franchising in the United States: An Overview

The first business format franchise appears to have started in the United States during the 1930s. Howard Johnson, the owner of a highly profitable ice cream parlor, entered into a licensing deal under which an entrepreneur received the right to open an ice cream store that utilized Johnson’s lucrative business model. Since this initial “franchising deal,” the concept of franchising has mushroomed. According to the International Franchise Association, franchising now permeates 300 different business format categories.

To what extent, though, does franchising impact the U.S. economy and its overall vitality? Here is a snapshot of some of the statistics highlighted in Chapter 2 of The Franchise Guide on the website www.franchising.com:

- An estimated 6,000 franchise companies operate in the United States.
- Seventy-five industries use franchising to distribute goods and services to consumers.
- Nearly 50 percent of all retail sales come through franchising.
- One in twelve businesses is a franchise.
- Over 300 franchises are sold every week. . . . [E]very 8 minutes of a typical week, a new franchised business is started.
- 750,000 franchised businesses in the United States generate almost $1 trillion in sales each year.

The Franchise Guide goes on to explain that “franchises employ more than 18 million people in the U.S. directly, and over 25 million indirectly.” Thus, to say that franchising has a substantial impact on the U.S. economy, without more, would be a material understatement. Franchising is a fundamental component of the U.S. economy. And by all indications, franchising will grow well into the future.

A recent study of the U.S. franchise industry, focusing on data from 1,695 businesses that ran franchise systems from 2010 to 2014, found that the fran-

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20. See id.
23. See id.
franchising sector grew by 3.8 percent. This finding, as well as the above statistics, is bolstered by data in a 2015 report for the International Franchise Association Educational Foundation, *Franchise Business Economic Outlook for 2015*. The report predicted, in pertinent part, that in 2015, the number of franchise establishments would increase by 1.6 percent. This is the identical pace of growth found in 2014. The report also makes the following conclusion: “The gross domestic product (GDP) of the franchise sector will increase by 5.1% to $521 billion in 2015. This will exceed the growth of U.S. GDP in nominal dollars, which is projected at 4.9%. The franchise sector will contribute approximately 3% of U.S. GDP in nominal dollars.” In short, more and more Americans and U.S. residents, especially those who seek to operate as franchisees, will be impacted by the franchising industry for years to come.

Although one of the most important goals of effective disclosure is to reduce risk, there is no lack of risk in any franchise investment. Indeed, in 2013, the Office of Inspector General of the Small Business Administration (SBA) conducted an analysis of three franchise systems with a high number of SBA guaranteed loans. The agency reported that those three franchise systems, Planet Beach, Petland, and Cold Stone Creamery, had received in the aggregate more than 1,000 franchise loans during the period 2002–09 totaling $199 million, 501 of which were defaulted, costing the agency $84 million. Although the purpose of the report was to highlight the risk to the SBA of guaranteed loans to franchisees, the risk to the borrowers cannot be overlooked.

A broader view of the risks associated with SBA guaranteed loans was provided by a 2013 report of the U.S. Government Accountability Office. From 2003 to 2012, the SBA guaranteed 32,323 franchise loans totaling approximately $10.6 billion. Due to defaults, the SBA was required to make payments on 28 percent of those loans at a cost to the taxpayers of approximately $1.5 billion.

26. See id. at 1.
27. See id.
28. See id.
30. See id. at 3.
32. See id. at 1.
A report issued by FranchiseGrade.com on 1,695 franchise systems states that between 2010 and 2013, franchisees invested an estimated $59.4 billion in franchised outlets. During that same period, 135,289 new franchised locations opened, but 118,645 turned over, meaning that they were terminated, reacquired by the franchisor, not renewed, ceased operations, or sold to other franchisees.33

Of course, complete failure of the business is not the only risk associated with investing in a franchise opportunity. These risks include a relationship with the franchisor as well as financial results, which are less than those expected. In its 2015 survey of franchisees, Franchise Grade.com reported that 42 percent of respondents were dissatisfied or very dissatisfied as a franchisee and that 64 percent would not recommend that friends or family invest in the franchise system in which they were operating.34

The question must therefore be asked: do potential franchisees, more than 30,000 of whom open new franchised locations each year, really understand what they are getting into before investing in a franchise system?

III. Potential Franchisees Have Difficulty Making Well-Informed Decisions

As previously noted, federal law requires a franchisor to provide potential franchisees with a franchise disclosure document (FDD).35 Each FDD is to contain information on twenty-three topics, known as “Items,” with respect to the franchise opportunity.36 Further, the FDD must be in plain English.37

Notwithstanding these requirements, FDDs are typically quite cumbersome and can be hundreds of pages filled with legalese making the presentation of information convoluted. Because of this, many believe that potential franchisees do not fully understand the contents of a FDD. For example, the 2014 Franchise Grade Franchise Expert Survey found that an astounding 84 percent of survey takers believed that potential franchisees “sometimes, 33. See Industry Statistics, FranchiseGrade.com, http://www.franchisegrade.com/index.php/resource-tools/industry-statistics/ (last visited Feb. 25, 2016).
34. See National Survey of Franchisees 2015: An Analysis of National Survey Results, FranchiseGrade.com 8 (2015), http://franchisegrade.com/ctw/Nat-Survey-Franchisees-2015.pdf. The risks associated with a franchise investment are not just directly financial, but also relate to the unique culture in each franchise system. The survey reported that 46 percent of respondents answered in the affirmative to at least one of the following questions: “(a) My franchisor has indicated that there could be negative consequences to participating in a franchise association, (b) My franchisor has indicated that there could be negative consequences to speaking out about problems within the franchise system, or (c) My franchisor has increased the frequency of inspections or evaluations of my business after I raised questions or spoke about problems in the system.” See id. at 22.
35. See generally 16 C.F.R. 436 and 437.
36. See id.
37. See id.
rarely, or never” understood the FDD that they were given.38 That belief is buttressed by logical reasoning, empirical evidence, and common sense.

For starters, new franchisees generally have no experience in owning a business, whether a franchise or another entity.39 Franchising generally draws people who want to own a business and believe that the way to minimize the risk of failure is to work with a franchisor that will provide a reputable system, strategic counsel, detailed operations plans, continuous advice, and training for success.40 Yet, a 2013 Albany Law Review article highlighted a study by Kimberly Morrison finding that 80 percent of the sample of franchisees, which hailed from forty-six states, had never owned a business before joining the franchise system.41 Another study by Alden Peterson and Rajiv Dant, which was also highlighted in the Morrison article, found that only 6.7 percent of a particular sample had owned an independent business before becoming franchisees.42 These statistics strongly underscore the lack of knowledge and business insight possessed by potential franchisees.

Secondly, potential franchisees, by virtue of that lack of knowledge, experience, and business insight, tend to avoid the “difficult work” of digesting an FDD and engaging in other investigative activities.43 As the authors of the Albany Law Review article noted, potential franchisees “face significant cognitive obstacles when attempting to consider all of the relevant information before acquiring ownership of a franchise unit. More specifically, the novice franchisee will face three cognitive obstacles: the unawareness problem, screening difficulty, and comprehension limitations.”44 The authors proceed to cite various studies in support of their conclusions.45 For example, the Morrison study found that “most franchisees ignored the franchise disclosure documents before investing in [a] franchise.”46 The study also found that “most franchisees did not consult with a lawyer before the signing of the franchise contract.”47

Recognizing these realities, it is imperative that more be done to enable and empower potential franchisees to make an educated decision before investing in a franchise system.

40. See id. at 203–05.
41. See id. at 206–07. In its 2015 survey of franchisees, Franchise Grade.com reported that 63 percent of respondents stated that they had never before owned any type of business before investing in their franchised business.
42. See id. at 207–08.
43. See id. at 209.
44. See id. at 210.
45. See generally id. at 213–15.
46. See id. at 213.
47. See id.
IV. The Motivation for a Summary Disclosure Document

For almost fifty years, practitioners and academics have recognized a “connection” between securities and franchising. 48 It is this “connection” that underlies and motivates our proposal. There is no reason that good public policy in the securities realm cannot be applied to the world of franchising, and vice versa. The authors submit that the SEC’s summary prospectus rule is one such directive that merits serious consideration.

The summary prospectus rule is succinctly summarized in the following passages of an informative note 49 drafted by then law student and now attorney Sarah Zimmer:

The newly adopted rule grants mutual funds the option to satisfy prospectus delivery obligations under section 5(b)(2) of the Securities Act of 1933 (“Securities Act”) by providing investors with a summary of key information . . . while posting additional information—including the statutory prospectus—on the Internet. The summary prospectus is a streamlined disclosure document that contains key investment information in plain English and in a standardized order. All mutual fund companies [are] required to replace the current Risk/Return Summary located at the beginning of the statutory prospectus with the newly adopted summary prospectus. If funds choose to disseminate the summary prospectus as a stand-alone, preliminary disclosure document, the statutory prospectus must be made available on funds’ websites and sent to investors upon their request . . . 50

The SEC’s new rule creates a distinct layered approach to disclosure whereby investors are given key information up front and later provided with more detailed information upon request. The foundation of the initiative is the user-friendly, streamlined summary prospectus. Every prospectus will be required to incorporate a summary section at the beginning of the document. It is important to note that at this time, mutual funds will not be required to create a separate summary prospectus; however, they must include the summary section in the beginning of the statutory prospectus. The summary section will contain information identified by the SEC as central to making an investment decision. If a fund chooses to rely on a summary prospectus to meet its Securities Act prospectus delivery obligations, the amendments provide that the fund’s current statutory prospectus . . . [and certain other materials] be made available, free of charge, at a web address specified in the summary prospectus. Moreover, mutual funds may satisfy delivery obligations under the Securities Act by sending “key information” to investors via a summary prospectus. In theory, the summary prospectus is to be supported by the statutory prospectus, which must be available online and sent to investors upon their request. 51

Importantly, this pragmatic rule was not created out of thin air. It was developed after much “trial and error” by the SEC, and as noted above, after the federal government conducted many focus groups to carefully and methodically study the matter.

50. See id. at 1432 (internal citations deleted).
51. See id. at 1442 (internal citations deleted).
More specifically, with regard to its “trials and errors,” the SEC spent over twenty years on different initiatives to make the disclosure of information more consumer friendly. 52 This includes, for example, the 1983 initiative to streamline the final prospectus and the 1998 adoption of Securities Act Rule 498 that applied a type of summary prospectus to the mutual fund industry. With each of these initiatives, the SEC got closer and closer to a model that would provide consumers with legible information that they needed (and deserved). The SEC’s “trials and errors,” accordingly, would be included in an administrative record that supports the proposed summary disclosure document rule.

Such an administrative record would also include qualitative data from the focus groups that the SEC ran in connection with the summary prospectus rule. Indeed, the federal government’s effort to solicit consumer feedback culminated in the drafting of a twenty-eight page paper on the matter. 53 The qualitative data contained in this report, in many respects, can be applied to the world of franchising. For example, the report noted that participants liked the shorter prospectus. It states the following: “Essentially, participants thought it could be used as a screening tool to identify mutual funds in which they might be sufficiently interested to do some additional review. The language seemed easier to understand and the font was larger than in the long-form prospectus.” 54 The report also indicates that focus group participants regarded the short form prospectus as “a tool in determining whether or not to pursue additional research about a given fund.” 55

Potential franchisees, no different from mutual fund investors, need certain legible information in a uniform summary format in order to make informed choices. Thus, certain qualitative data points, especially with regard to the presentation and types of information, are applicable here.

V. Proposed Summary Franchise Disclosure Document

Appendix A contains the text of a proposed addition to the FTC Franchise Rule that would mandate the furnishing of a summary franchise disclosure document.

Appendix B contains a sample summary franchise disclosure document based on the proposed rule.

Here are the highlights of the proposal:

A. Format: The main franchise disclosure document must be provided at the same time as the summary franchise disclosure document. This is a material departure from the SEC mutual fund rule, which permits the

54. See id. at 5.
55. See id. at 6.
issuer of a summary prospectus to direct the investor to a website in order to obtain the main prospectus. The authors believe this will provide greater protection to the prospective investor. The proposed rule requires the documents to be furnished as a package, with each section heading in the summary disclosure document acting as a hyperlink to the corresponding section in the main disclosure document. In addition, the summary disclosure document would not be bundled with any document other than the disclosure document, and nothing other than the disclosure document would be incorporated by reference into the summary disclosure document. The goal is to allow a prospective franchisee to electronically move back and forth between the two documents with ease.

B. Manner of Delivery: If furnished by email by sending a link to the summary disclosure document and the disclosure document on the Internet, the link would send the recipient directly to the summary disclosure document; the email would be required to disclose how long the link will be usable and must encourage the recipient to access and save the document in order to retain it. If furnished through a website, the Web address must send the prospective franchisee directly to the summary disclosure document and to the disclosure document and not to the home page or other section of the franchisor’s website.

C. Format: Both the summary disclosure document and the franchise disclosure document must be in human readable format, capable of being printed on paper. The recipient must be able to permanently retain, without charge, electronic versions of both disclosure documents in formats that are convenient for both reading online and printing on paper.

D. Length: The summary disclosure document would be limited to five pages in length and 1,500 words using 12-point type throughout. The sample summary disclosure document at Appendix B contains 1,284 words. Disclaimers, footnotes, or other similar information typically contained in the disclosure document would not be permitted in the summary disclosure document. These restrictions are intended to make the summary disclosure document user-friendly.

E. Newly Required Disclosures: The summary franchise disclosure document would include a significant amount of information not currently required to be disclosed under the FTC Franchise Rule. The goal of this article is primarily to elucidate the benefits of a summary franchise disclosure document, but the authors do not assume that such a summary franchise disclosure document would be based on the current FTC Franchise Rule. These new disclosures include:
1. The identity of the principal owner of the franchisor;

2. Identification of the principal competitors of the products and services offered by franchise system;

3. Median initial investment over the first twelve months of operation;

4. The length of time that the typical franchised business takes to achieve breakeven status;

5. Median gross revenue of all franchised outlets during the first twelve months of operation;\(^{56}\)

6. The percentage increase or decrease in same-store sales on a year-over-year basis;\(^{57}\)

7. Working capital required over the first twelve months of operation;

8. A prohibition on the use of the word “renewal” unless the franchisee is permitted to continue the franchise relationship on the same terms and conditions;

9. Specific risk-based disclosures concerning the supply chain, territory, minimum royalties or minimum gross sales, pricing restrictions, the presence or absence of limits on additional investment required by franchisees,\(^{58}\) and any requirements for personal guarantees by spouses or other persons;

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\(^{56}\) In its report, the U.S. Government Accountability Office (GAO) highlighted the fact that those franchisors that do include a financial performance representation in Item 19 of their disclosure document typically provide data only for units open one full year as of the end of its most recent fiscal year. The GAO found that revenues reflected in the FDDs of the particular franchise organization that was the subject of the report were on average 143 percent of the average revenue of the franchisees in that system over a ten-year period. See U.S. GOV’T ACCOUNTABILITY OFFICE, supra at 31. Franchisees seeking SBA guaranteed loans are required to include first-year revenue estimates in their loan applications. Yet, that information is not available in the typical FDD. See id. at 21.

\(^{57}\) The Form 10-K filed by McDonald’s Corporation on February 25, 2016, provides same store sales and same store guest counts for the previous three years. According to that report, same-store sales increased (or declined) by 0.5 percent, (2.1 percent), and (0.2 percent) respectively. Same-store guest counts declined by 3.1 percent, 4.1 percent, and 1.6 percent during the same years. This is certainly important information for a franchise investor. See http://www.sec.gov/Archives/edgar/data/63908/000006390816000103/mcd-12312015x10k.htm. As of March 1, 2016, 100 shares of McDonald's Corporation stock cost approximately $11,900. See Yahoo! Finance, http://finance.yahoo.com/q?s=MCD&ql=0 (last visited Mar. 1, 2016). The investment required to open a new U.S. McDonald’s franchised location ranged from a low of $944,352 to a high of $2,172,045. See http://www.aboutmcDonalds.com/mcd/franchising/us_franchising/acquiring_a_franchise/new_restaurants.html (last visited on Mar. 5, 2016).

\(^{58}\) FranchiseGrade.com reported in its 2015 survey that 58 percent of respondents were required to make major investments into equipment, facility renovations, or other capital investments in their franchised business. Of those respondents, 31 percent reported that those capital
10. Mandatory financial performance representations of franchised businesses in the system as to gross revenue and net profit for the immediately preceding five years,\(^\text{59}\) including definitions of “gross revenue” and “net profit”;

11. Disclosures concerning franchised and company-owned outlets over a five-year period, including a definition of “company-owned outlets”; and

12. The turnover rate of both franchised and company-owned outlets over the preceding five years, including a definition of “turnover rate.”

The authors believe that each of these additional disclosures:
(1) are necessary in order to achieve the purposes and goals of franchise disclosure, (2) would be based on information readily available to most franchisors, (3) form a standard part of due diligence in any commercial transaction outside of franchising, and (4) are routinely disclosed in securities filings of publicly held franchisors.\(^\text{60}\)

F. Averages: The summary disclosure document calls for the use of a median. The authors believe that the use of a median is a more meaningful and accurate measurement than the “mean” of a data set. After all, one or more outlying data points could, in certain circumstances, unfairly impact the mean and mislead a potential franchisee.\(^\text{61}\) “Median” is defined as the midpoint of the range of the values indicated.

G. Reasonable Basis: The summary disclosure document proposal expands the concept of reasonable basis, currently only found in the FTC Franchise Rule with respect to the financial performance disclosures required in Item 19.\(^\text{62}\) The proposal requires the franchisor to have a reasonable basis and written substantiation available for each and every disclosure made in the summary disclosure document and in

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\(^{59}\) The McDonald’s Corporation Form 10-K provides selected financial data for the previous six years.

\(^{60}\) A more specific and detailed explanation of and justification for each of these additional disclosures is beyond the scope of this article.


\(^{62}\) See 16 C.F.R. § 436.5(s)(3).
the disclosure document. In our view, there is no reason not to apply this core reliability standard to every element of the disclosure document. If a franchisor does not have a reasonable basis or written substantiation, the disclosure should not be made.

H. Use of Charts: The use of charts is extensive throughout the summary disclosure document in order to present information in a readable and organized context. All of the charts in the summary disclosure document must be derived from information required to be disclosed in the disclosure document. The use of charts also conserves space and advances the goal of having a document which does not exceed five pages in length.

I. Contents: The content of the Summary Disclosure Document is limited to nine sections, all of which must be presented in the order and in the form described in the proposed Rule. These twelve sections are as follows:

   I. The Franchisor and the Franchise Business
   II. Litigation Matters
   III. Fees and Charges
   IV. Your Total Estimated Investment–12 Months
   V. Principal Trademarks
   VI. Term, Successor Franchise, and Transfers
   VII. Provisions Affecting Profitability and Value of the Franchised Business
   VIII. Franchisee Median Financial Performance
   IX. Franchised Outlets
   X. Company-Owned Outlets
   XI. Franchisor Balance Sheet-Selected Items
   XII. Franchisee Associations

V. Conclusion

The time has come for franchise disclosure to restore its original mission by pursing two distinct but related goals. First, to present user-friendly disclosure documents that focus on investor education and information, facilitating due diligence and marked by the use of technology of the kind that
prospective investors expect in the twenty-first century. Second, to return to the roots of franchise disclosure so that the disclosure document serves the interests of the investor more than that of the issuer. It is our hope that this proposal will spark a spirited debate and lead to the adoption of a summary disclosure document as part of the next generation of the FTC Franchise Rule.
Summary Franchise Disclosure Document

Worldwide Pizza Franchising, Inc.
1000 Main Street
Boston, Massachusetts
www.worldwidepizzafranchising.com
April 30, 2016

Our Franchise Disclosure Document (FDD) dated March 15, 2016 is incorporated by reference into (legally made a part of) this Summary Franchise Disclosure Document. Before you invest in this franchise, we strongly recommend that you review this complete Summary Franchise Disclosure Document and also review the complete FDD, which contains more detailed and important information about the franchise and its risks. Each of the section headings in this Summary Franchise Disclosure Document is a hyperlink that will take you directly to the relevant Item of the FDD.

I. The Franchisor and the Franchise Business

The franchised business will sell at retail pizzas, calzones, subs, salads, and other similar menu items in a distinctive décor.

We are a Delaware limited liability company formed on January 1, 2005. We first offered franchises on March 31, 2006.

Our principal owner is ABC Investments, Inc., a private equity firm located at 100 Central Avenue, Chicago, Illinois 60609. ABC Investments, Inc. has investments in the following franchise brands: Worldwide Sub Franchising, Inc. and International Chicken Franchising, Inc.

The following brands are the principal competitors of the franchise system: Pizza Hut, Domino’s Pizza, Papa John’s International, Little Caesar’s Pizza and Papa Murphy’s International.

The median total investment over the first 12 months of the operation of the franchised business is $400,000. Newly developed franchised businesses take on average 14 months to break even before owner compensation. Median gross revenue for the first 12 months of operation of franchised businesses opened in 2014 averaged $295,000. In 2015, our same outlet gross revenue by franchisees decreased year over year (YOY) by 1.2%.

This Summary Franchise Disclosure Document and the accompanying FDD contain information, including information about risks, that you should know before investing in this franchise offering. Please read both documents before you invest and keep them for future reference. This franchise offering has not been approved or disapproved by any federal or state agency. Any representation to the contrary is a criminal offense. This franchise investment is not insured and may lose value.
II. Litigation Matters

<table>
<thead>
<tr>
<th>Year</th>
<th>Pending</th>
<th>Resolved</th>
<th>Filed Against Franchisees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>4</td>
<td>5</td>
<td>3</td>
</tr>
<tr>
<td>2014</td>
<td>4</td>
<td>5</td>
<td>6</td>
</tr>
<tr>
<td>2013</td>
<td>3</td>
<td>2</td>
<td>5</td>
</tr>
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</table>

III. Fees and Charges

<table>
<thead>
<tr>
<th>To Whom Payment Is To Be Made</th>
<th>Type of Fee</th>
<th>Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Payable to Franchisor</td>
<td>Royalty</td>
<td>4% of Gross Revenue</td>
</tr>
<tr>
<td></td>
<td>Advertising Fund</td>
<td>3% of Gross Revenue</td>
</tr>
<tr>
<td></td>
<td>Co-op</td>
<td>2% of Gross Revenue</td>
</tr>
<tr>
<td></td>
<td>Transfer</td>
<td>$5,000</td>
</tr>
<tr>
<td></td>
<td>Technology</td>
<td>$200/month</td>
</tr>
<tr>
<td></td>
<td>Successor Franchise</td>
<td>$15,000</td>
</tr>
<tr>
<td>Payable to Third Parties</td>
<td>Local Spend</td>
<td>1% of Gross Revenue</td>
</tr>
<tr>
<td></td>
<td>Accounting</td>
<td>Actual Cost</td>
</tr>
<tr>
<td></td>
<td>Mystery Shopper</td>
<td>Actual Cost</td>
</tr>
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</table>

IV. Your Total Estimated Investment–First 12 Months

<table>
<thead>
<tr>
<th>Fee or Expense</th>
<th>Median Amount</th>
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</thead>
<tbody>
<tr>
<td>Initial Franchise Fee</td>
<td>$35,000</td>
</tr>
<tr>
<td>Other Amounts Payable to Franchisor</td>
<td>$25,000</td>
</tr>
<tr>
<td>Amounts Payable to Third Parties</td>
<td>$275,000</td>
</tr>
<tr>
<td>Working Capital–First 12 Months</td>
<td>$65,000</td>
</tr>
<tr>
<td>Total Investment–First 12 Months</td>
<td>$400,000</td>
</tr>
</tbody>
</table>

V. Principal Trademarks

<table>
<thead>
<tr>
<th>Mark</th>
<th>Date Registered</th>
<th>Owner</th>
<th>Contests/Claims</th>
</tr>
</thead>
<tbody>
<tr>
<td></td>
<td>January 15, 2009</td>
<td>Franchisor</td>
<td>None</td>
</tr>
<tr>
<td>Worldwide Pizza</td>
<td>March 25, 2010</td>
<td>Franchisor</td>
<td>None</td>
</tr>
<tr>
<td>PizzaWorld</td>
<td>March 25, 2010</td>
<td>Affiliate</td>
<td>None</td>
</tr>
</tbody>
</table>
VI. Term, Successor Franchise and Transfer

<table>
<thead>
<tr>
<th>Initial Term</th>
<th>10 Years</th>
</tr>
</thead>
<tbody>
<tr>
<td>Successor Franchise Term(s)</td>
<td>Two 5 Year Terms</td>
</tr>
<tr>
<td>Conditions to Obtaining a Successor Franchise</td>
<td>You must sign the then current franchise agreement, which may contain increased or new fees and charges and materially different terms, conditions and obligations; pay the successor franchise fee; refurbish the franchised business; and execute a release of claims in favor of the Franchisor.</td>
</tr>
<tr>
<td>Conditions to Obtaining Approval of a Transfer</td>
<td>Your buyer must sign the then current franchise agreement, which may contain increased or new fees and charges and materially different terms, conditions and obligations; pay the transfer fee; refurbish the franchised business; and execute a release of claims in favor of the Franchisor.</td>
</tr>
</tbody>
</table>

VII. Provisions Affecting Profitability and Value of the Franchised Business

a. Supply Chain. You must purchase all or nearly all of the inventory, equipment, and supplies that you need to operate your business from us, our affiliates, or suppliers designated by us and at prices we or the supplier set. These prices may be higher than prices you could obtain elsewhere for the same or similar goods or services.

b. Territory. You will not receive an exclusive territory. You will be subject to competition from us and our affiliates, possibly from other franchised or company owned outlets in close proximity to your franchised business.

c. Minimums. You must make minimum royalty or advertising payments regardless of your sales levels. You must maintain minimum sales performance levels. You must make inventory and supply purchases at specified minimums and/or maintain minimum inventory on hand, even if you do not need inventory at that level. Your inability to meet these minimums may result in termination of your franchise and loss of your investment.

d. Pricing. You must comply with minimum and/or maximum prices set by us for the goods and services that you sell. You must also participate in any promotional pricing established by us. These requirements may reduce your anticipated revenue and profit.
e. **No Limit on Additional Investment.** There are no limits on our ability to require you to make additional capital investments in your franchised business.

f. **Guarantees.** You will and your spouse will be required to sign a document that makes both of you liable for your financial obligations under the franchise agreement, even if your spouse has no ownership interest in the business. This guarantee will place both your and your spouse’s marital and personal assets, including your house, at risk if your franchise fails.

### VIII. Franchisee Median Financial Performance

<table>
<thead>
<tr>
<th>Year</th>
<th>Gross Revenue</th>
<th>YOY +/- %</th>
<th>Net Profit</th>
<th>% of Gross Revenue</th>
<th>YOY +/- %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>$445,300</td>
<td>(1.2%)</td>
<td>$37,850</td>
<td>8.5%</td>
<td>(8.1%)</td>
</tr>
<tr>
<td>2014</td>
<td>$450,500</td>
<td>5.9%</td>
<td>$41,200</td>
<td>9.1%</td>
<td>18.2%</td>
</tr>
<tr>
<td>2013</td>
<td>$425,125</td>
<td>3.0%</td>
<td>$34,850</td>
<td>8.2%</td>
<td>5.9%</td>
</tr>
<tr>
<td>2012</td>
<td>$412,600</td>
<td>1.9%</td>
<td>$32,900</td>
<td>7.9%</td>
<td>13.1%</td>
</tr>
<tr>
<td>2011</td>
<td>$404,700</td>
<td>2.6%</td>
<td>$29,100</td>
<td>7.2%</td>
<td>6.5%</td>
</tr>
</tbody>
</table>

### IX. Franchised Outlets

<table>
<thead>
<tr>
<th>Year</th>
<th>Outlets</th>
<th>YOY +/-</th>
<th>YOY +/- %</th>
<th>Turnover %</th>
<th>Transfers</th>
<th>Sold Not Open</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>225</td>
<td>25</td>
<td>12.5%</td>
<td>11%</td>
<td>8</td>
<td>40</td>
</tr>
<tr>
<td>2014</td>
<td>200</td>
<td>50</td>
<td>33.3%</td>
<td>8%</td>
<td>11</td>
<td>30</td>
</tr>
<tr>
<td>2013</td>
<td>150</td>
<td>45</td>
<td>39.1%</td>
<td>1%</td>
<td>5</td>
<td>17</td>
</tr>
<tr>
<td>2012</td>
<td>115</td>
<td>35</td>
<td>35.0%</td>
<td>3%</td>
<td>7</td>
<td>9</td>
</tr>
<tr>
<td>2011</td>
<td>100</td>
<td>15</td>
<td>26.3%</td>
<td>4%</td>
<td>3</td>
<td>6</td>
</tr>
</tbody>
</table>

### X. Company Owned Outlets

<table>
<thead>
<tr>
<th>Year</th>
<th>Outlets</th>
<th>YOY +/-</th>
<th>YOY %</th>
<th>Turnover %</th>
<th>From (To) Franchisees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td>85</td>
<td>10</td>
<td>13.3%</td>
<td>1%</td>
<td>1</td>
</tr>
<tr>
<td>2014</td>
<td>75</td>
<td>25</td>
<td>50%</td>
<td>0%</td>
<td>(2)</td>
</tr>
<tr>
<td>2013</td>
<td>50</td>
<td>5</td>
<td>9.1%</td>
<td>0%</td>
<td>(4)</td>
</tr>
<tr>
<td>2012</td>
<td>55</td>
<td>(5)</td>
<td>(11.1%)</td>
<td>7%</td>
<td>3</td>
</tr>
<tr>
<td>2011</td>
<td>45</td>
<td>5</td>
<td>5.9%</td>
<td>11%</td>
<td>4</td>
</tr>
</tbody>
</table>
### XI. Franchisor Profit and Loss Statement-Selected Items ($000)

<table>
<thead>
<tr>
<th>Year</th>
<th>2015</th>
<th>2014</th>
<th>2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalties</td>
<td>$3,790</td>
<td>$3,060</td>
<td>$2,250</td>
</tr>
<tr>
<td>Initial Franchise Fees</td>
<td>875</td>
<td>1,750</td>
<td>1,575</td>
</tr>
<tr>
<td>Franchisee Purchases</td>
<td>1,500</td>
<td>1,350</td>
<td>956</td>
</tr>
<tr>
<td>Total Revenue</td>
<td>$43,500</td>
<td>$39,900</td>
<td>$26,030</td>
</tr>
<tr>
<td>Expenses-Franchisee Purchases</td>
<td>100</td>
<td>90</td>
<td>75</td>
</tr>
<tr>
<td>Total Expenses</td>
<td>$41,065</td>
<td>$37,950</td>
<td>$24,705</td>
</tr>
<tr>
<td>Net Income</td>
<td>$2,435</td>
<td>$1,950</td>
<td>$1,325</td>
</tr>
<tr>
<td>YOY % Increase (Decrease)</td>
<td>24.8%</td>
<td>47.1%</td>
<td>26.8%</td>
</tr>
</tbody>
</table>
IX. Franchisee Associations

The following franchisee association is endorsed by us and acts as the designated representative of our franchisees:

Independent Association of Worldwide Pizza Franchisees, Inc., John Smith, President, 501 Maple Avenue, Kansas City, Missouri, 1-800-555-6666, john.smith@IAWPF.com, www.IAWPF.com
Title 16 Commercial Practices

PART 436—Disclosure Requirements and Prohibitions Concerning Franchising

Subpart C—Contents of a Disclosure Document

§ 436.3A Summary Disclosure Document

a) General Instructions

1. Use 12-point type throughout the summary disclosure document.

2. The summary disclosure document may not exceed five (5) pages in length and 1,500 words.

3. Make each section heading a hyperlink to the applicable Item of the disclosure document. The prospective franchisee must be able to move directly back and forth between the summary disclosure document and the disclosure document.

4. Furnish the summary disclosure document at the same time as the disclosure document, both in an electronic format, which allows the use of hyperlinks between the summary disclosure document and the disclosure document.

5. The summary disclosure document and the disclosure document (a) must be presented in a format that is human-readable and capable of being printed on paper in human-readable format; (b) may not bound together with any materials other than the disclosure document; and (c) may not incorporate by reference any materials or any information other than the disclosure document.

6. This recipient of the summary disclosure document must be able to permanently retain, free of charge, an electronic version of the summary disclosure document in a format, or formats, that are convenient for both reading online and printing on paper.

7. If the summary disclosure document is furnished by email by sending a direct link to the document on the Internet, the document must be directly accessible through the link from the time that the email is sent through the date that is six months after the date that the email is sent and the email must explain how long the link will be remain usable and that, if the recipient desires to retain a copy of the document, he or she should access and save the document.

8. If the summary disclosure document is furnished through a Web site, the Internet Web site address must be specific enough to lead the prospective franchisee directly to the summary disclosure
document and to the disclosure document, rather than to the home page or other section of the Web site of the Franchisor on which the materials are posted.

9. Do not use disclaimers, footnotes, or other similar information contained or required to be contained in the disclosure document.

10. The summary disclosure document calls for the use of a median. The use of a median is a more meaningful and accurate measurement than the “mean” of a data set because, for example, one or more outlying data points could, in certain circumstances, unfairly impact the mean and mislead a potential franchisee. For the purposes of the summary disclosure document, “median” is defined as the midpoint of the range of values indicated.

11. The franchisor must have a reasonable basis and written substantiation for each and every disclosure made in the summary disclosure document and in the disclosure document.

12. No disclosure made in the summary disclosure document shall contradict or vary from the same or similar disclosure in the disclosure document.

b) Cover Page. Begin the summary disclosure document with a cover page, in the order and in the form as follows:

1. The title “Summary Franchise Disclosure Document” in initial capital letters and bold type.

2. The franchisor’s name, principal business address, primary Internet home page address and the date of the summary disclosure document.

3. A sample of the primary business trademark that the franchisee will use in the business.

4. The following statement in bold type: Our Franchise Disclosure Document (FDD) dated _______ is incorporated by reference into (legally made a part of) this Summary Franchise Disclosure Document. Before you invest in this franchise, we strongly recommend that you review this complete Summary Franchise Disclosure document and also review the complete FDD, which contains more detailed and important information about the franchise and its risks. Each of the section headings in this Summary Franchise Disclosure Document is a hyperlink that will take you directly to the relevant Item of the FDD.

5. Information required by subsection (c)-Section I, infra.
6. The following statement at the bottom of the cover page in bold type: This Summary Franchise Disclosure Document and the accompanying FDD contain information, including information about risks, that you should know before investing in this franchise offering. Please read both documents before you invest and keep them for future reference. This franchise offering has not been approved or disapproved by any federal or state agency. Any representation to the contrary is a criminal offense. This franchise investment is not insured and may lose value.

c) Section I. The Franchisor and the Franchise Business. Disclose:

1. The business the franchisee will conduct.

2. The type of business organization used by the franchisor, the date on which it was organized, and the state in which it was organized.

3. The date on which the franchisor first offered franchises providing the type of business the franchisee will operate.

4. The name and address of the ultimate principal owner or owners of the franchisor.

5. A description of other brands or lines of business owned, operated, or franchised by such principal owner or its affiliates.

6. The names of the top five competitors of the business the franchisee will operate. For the purposes of this disclosure, use information derived from publicly available sources.

7. The median estimated total investment over the first twelve (12) months of operation of the business the franchisee will operate.

8. The average length of time franchises of the type that will be operated by the franchisee take to reach break even.

9. The median gross revenue of all franchises over the first twelve (12) months of operation.

10. The increase or decrease, expressed as a percentage, in year-over-year (YOY) same outlet gross revenue of franchised outlets in the most recent fiscal year of the franchisor from the previous fiscal year, in each case with respect to outlets open during the entire fiscal year.

d) Section II. Litigation Matters. Disclose in the following tabular form a summary of litigation matters required to be disclosed in Item 3 of the disclosure document. State the title “Litigation Matters” in initial capital letters using bold type.
Table II
Litigation Matters

<table>
<thead>
<tr>
<th>Column 1 Year</th>
<th>Column 2 Pending</th>
<th>Column 3 Resolved</th>
<th>Column 4 Filed Against Franchisees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. In column 1, state the last three fiscal years.

2. In column 2, state the number of litigation matters pending at the end of each fiscal year.

3. In column 3, state the number of resolved litigation matters at the end of each fiscal year.

4. In column 4, state the number of franchisor-initiated litigation matters commenced in each fiscal year.

e) Section III. Fees and Charges. Disclose in the following tabular form a summary of other fees and charges required to be disclosed in Item 6 of the disclosure document. State the title “Fees and Charges” in initial capital letters using bold type.

Table III
Fees and Charges

<table>
<thead>
<tr>
<th>Column 1 To Whom Payment Is To Be Made</th>
<th>Column 2 Type of Fee</th>
<th>Column 3 Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Row 1 Payable to Franchisor</td>
<td></td>
<td></td>
</tr>
<tr>
<td>Row 2 Payable to Third Parties</td>
<td></td>
<td></td>
</tr>
</tbody>
</table>
1. In column 1, state to whom the payment is to be made.

2. In column 2, row 1, list each type of fee or charge required to be disclosed in Item 3 and which is payable to the franchisor or its affiliates, to a supplier in which an officer of the franchisor owns an interest, or that the franchisor imposes or collects in whole or in part for a third party.

3. In column 2, row 2, list each type of fee or charge required to be disclosed in Item 3 and which is payable to a third party.

4. In column 3, state the amount of the fee.

f) Section IV. Your Total Estimated Investment—First 12 Months. Disclose in the following tabular form a summary of the franchisee’s estimated investment over the first 12 months of operation based on the information required to be disclosed in Item 7 of the disclosure document. State the title “Your Total Estimated Investment—First 12 Months” in initial capital letters using bold type.

<table>
<thead>
<tr>
<th>Table IV</th>
</tr>
</thead>
<tbody>
<tr>
<td>Your Total Estimated Investment–First 12 Months</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Column 1 Fee or Expense</th>
<th>Column 2 Median Amount</th>
</tr>
</thead>
<tbody>
<tr>
<td>Initial Franchise Fee</td>
<td></td>
</tr>
<tr>
<td>Other Amounts Payable to Franchisor</td>
<td></td>
</tr>
<tr>
<td>Amounts Payable to Third Parties</td>
<td></td>
</tr>
<tr>
<td>Working Capital–First 12 Months</td>
<td></td>
</tr>
<tr>
<td>Total Investment–First 12 Months</td>
<td></td>
</tr>
</tbody>
</table>

1. In column 1, list the following categories of expenses from those disclosed in Item 7 of the disclosure document: (i) initial franchise fee; (ii) other amounts payable to the franchisor; (iii) amounts payable to third parties; (iv) working capital—first 12 months of operation; and (v) total investment—first 12 months of operation.

2. In column 2, state the amount of expense in each listed category. Where the franchisor uses a high-low range based on its current experience in Item 7, state the median of that range.

3. If the franchisor uses multiple tables in Item 7 of the disclosure document, disclose the aggregate information from all such tables.
g) Section V. Principal Trademarks. Disclose in the following tabular form each principal trademark to be licensed to the franchisee and required to be disclosed in Item 13 of the disclosure document. State the title “Principal Trademarks” in initial capital letters using bold type.

Table V
Principal Trademarks

<table>
<thead>
<tr>
<th>Column 1</th>
<th>Column 2</th>
<th>Column 3</th>
<th>Column 4</th>
</tr>
</thead>
<tbody>
<tr>
<td>Mark</td>
<td>Date Registered</td>
<td>Owner</td>
<td>Contests/Claims</td>
</tr>
</tbody>
</table>

1. In column 1, disclose each principal trademark to be licensed to the franchisee and which is registered on the Principal or Supplemental Register of the United States Patent and Trademark Office.

2. In column 2, disclose the date of each trademark registration.

3. In column 3, disclose the name of the owner of each trademark.

4. In column 4, briefly describe any contest, claim, or infringement required to be disclosed in Item 13 of the disclosure document.

h) Section VI. Term, Successor Franchise and Transfer. Disclose in the following tabular form the following portions of the information required to be disclosed in Item 17 of the disclosure document. State the title “Term, Successor Franchise, and Transfer” in initial capital letters using bold type.

Table VI
Term, Successor Franchise, and Transfer

<table>
<thead>
<tr>
<th>Row</th>
<th>Column 1</th>
<th>Column 2</th>
</tr>
</thead>
<tbody>
<tr>
<td>Row 1</td>
<td>Initial Term</td>
<td></td>
</tr>
<tr>
<td>Row 2</td>
<td>Successor Franchise Term(s)</td>
<td></td>
</tr>
<tr>
<td>Row 3</td>
<td>Conditions to Obtaining a Successor Franchise</td>
<td></td>
</tr>
<tr>
<td>Row 4</td>
<td>Conditions to Obtaining Approval of a Transfer</td>
<td></td>
</tr>
</tbody>
</table>

1. In column 1, list the following categories of information disclosed in Item 17 of the disclosure document.
2. In column 2, row 1, state the duration of the initial term of the franchise agreement.

3. In column 2, row 2, state the number and the duration of any renewal, extension, or successor terms. For the purposes of this disclosure, do not refer to the successor franchise term as a renewal unless the franchisee is permitted to continue the franchise relationship on the same terms and conditions.

4. In column 2, row 3, briefly summarize the conditions imposed on the franchisee in order to obtain a renewal, extension, or successor franchise.

5. In column 2, row 4, briefly summarize the conditions imposed on the franchisee in order to obtain the franchisor’s approval for a transfer.

i) **Section VII. Provisions Affecting Profitability and Value of the Franchise Business.** Disclose the following risks to the extent contained in the applicable provision of the franchise agreement:

1. **Supply Chain.** You must purchase all or nearly all of the inventory, equipment, or supplies that you need to operate your business from us, our affiliates, or suppliers designated by us and at prices we or the supplier set. These prices may be higher than prices you could obtain elsewhere for the same or similar goods or services.

2. **Territory.** You will not receive an exclusive territory. You will be subject to competition from us and our affiliates, possibly from other franchised or company owned outlets in close proximity to your franchised business.

3. **Minimums.** You must make minimum royalty or advertising payments regardless of your sales levels. You must maintain minimum sales performance levels. You must make inventory and supply purchases at specified minimums and/or maintain minimum inventory on hand, even if you do not need inventory at that level. Your inability to meet these minimums may result in termination of your franchise and loss of your investment.

4. **Pricing.** You must comply with minimum and/or maximum prices set by us for the goods and services you sell. You must also participate in any promotional pricing established by us. These requirements may reduce your anticipated revenue and profit.

5. **No Limit on Additional Investment.** There are no limits on our ability to require you to make additional capital investments in your franchise business.
6. **Guarantees.** You and your spouse will be required to sign a document that makes both of you liable for your financial obligations under the franchise agreement, even if your spouse has no ownership interest in the business. This guarantee will place both your and your spouse’s marital and personal assets, including your house, at risk if your franchise fails.

j) **Section VII. Franchisee Median Financial Performance.** Disclose in the following tabular form a summary of the financial performance information required to be disclosed in Item 19 of the disclosure document. State the title “Franchisee Median Financial Performance” in initial capital letters using bold type.

| Table VII |
| Franchisee Median Financial Performance |

<table>
<thead>
<tr>
<th>Column 1 Year</th>
<th>Column 2 Gross Revenue</th>
<th>Column 3 YOY +/- %</th>
<th>Column 4 Net Profit</th>
<th>Column 5 % of Gross Revenue</th>
<th>Column 6 YOY +/- %</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. In column 1, state the last five fiscal years.

2. In column 2, state the median gross revenue of all franchises of the franchisor during each fiscal year. For the purposes of this disclosure, “gross revenue” is defined as the total amount of revenue derived from the sale of goods or services less sales tax, discounts, allowances, and returns.

3. In column 3, state the increase or decrease, expressed as a percentage, in the median gross revenue of all franchises of the franchisor from the previous fiscal year.

4. In column 4, state the median net profit of all franchises of the franchisor during each fiscal year. For the purposes of this disclosure, “net profit” is defined as gross revenue less all ordinary and recurring operating expenses, including depreciation, but excluding income taxes, interest, and amortization.

5. In column 5, state the median net profit of all franchises of the franchisor as a percentage of the median gross revenue of all franchises of the franchisor during such fiscal year.
6. In column 6, state the increase or decrease, expressed as a percentage, in the median net profit of all franchises of the franchisor from the previous fiscal year.

k) Section IX. Franchised Outlets. Disclose in the following tabular form a summary of the information required to be disclosed in Item 20 of the disclosure document. State the title “Franchised Outlets” in initial capital letters using bold type.

<table>
<thead>
<tr>
<th>Table IX Franchised Outlets</th>
</tr>
</thead>
<tbody>
<tr>
<td><strong>Column 1 Year</strong></td>
</tr>
<tr>
<td>-------------------</td>
</tr>
<tr>
<td>2015</td>
</tr>
<tr>
<td>2014</td>
</tr>
<tr>
<td>2013</td>
</tr>
<tr>
<td>2012</td>
</tr>
<tr>
<td>2011</td>
</tr>
</tbody>
</table>

1. In column 1, state the last five fiscal years.

2. In column 2, state the total number of franchised outlets in all states at the end of each fiscal year.

3. In column 3, state for each fiscal year the increase or decrease in the total number of franchised outlets in all states from the end previous fiscal year.

4. In column 4 state for each fiscal year the increase or decrease, expressed as a percentage, in the total number of franchised outlets in all states from the previous fiscal year.

5. In column 5, state, expressed as a percentage, the turnover rate of franchised outlets during each fiscal year. For the purposes of this disclosure, the “turnover rate” is computed as the total number of franchised outlets terminated, non-renewed, or ceased operations for other reasons, during the fiscal year, divided by the number of franchised outlets at the start of each such fiscal year.

6. In column 6, state the number of franchised outlets transferred from franchisees to new owners other than the franchisor or its affiliates in all states during each fiscal year.
7. In column 7, state the total number of franchise agreements that have been signed for new outlets to be located in all states at the end of the fiscal year, where the outlet had not yet opened.

1) **Section X. Company Outlets.** Disclose in the following tabular form a summary of the information required to be disclosed in Item 20 of the disclosure document. State the title “Company Outlets” in initial capital letters using bold type.

<table>
<thead>
<tr>
<th>Column 1 Year</th>
<th>Column 2 Outlets</th>
<th>Column 3 YOY +/-</th>
<th>Column 4 YOY %</th>
<th>Column 5 Turnover %</th>
<th>Column 6 From (To) Zees</th>
</tr>
</thead>
<tbody>
<tr>
<td>2015</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2014</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2013</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2012</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>2011</td>
<td></td>
<td></td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. In column 1, state the last five fiscal years.

2. In column 2, state the total number of company-owned outlets in all states at the end of each fiscal year. For the purposes of this disclosure, a “company-owned outlet” is defined as an outlet owned or managed by the franchisor or its affiliate, operating a substantially similar business under the same brand as the business the franchisor offers to franchisees.

3. In column 3, state for each fiscal year the increase or decrease in the total number of company-owned outlets in all states from the end of the previous fiscal year.

4. In column 4, state for each fiscal year the increase or decrease, expressed as a percentage, in the total number of company-owned outlets in all states from the previous fiscal year.

5. In column 5, state, expressed as a percentage, the turnover rate of company-owned outlets during each fiscal year. For the purposes of this disclosure, the “turnover rate” is defined as the total number of outlets closed plus the number of outlets sold to franchisees during the fiscal year, divided by the number of company-owned outlets at the start of each such fiscal year.
6. In column 6, state the number of company-owned outlets sold to franchisees minus the number of outlets reacquired from franchisees during each fiscal year.

m) Section XI. Franchisor Profit and Loss Statements—Selected Items. Disclose in the following tabular form a summary of the information required to be disclosed in Item 21 of the disclosure document. State the title “Franchisor Profit and Loss Statements—Selected Items” in initial capital letters using bold type.

Table XI
Franchisor Profit and Loss Statements—Selected Items ($000)

<table>
<thead>
<tr>
<th>Column 1 Year</th>
<th>Column 2 2015</th>
<th>Column 3 2014</th>
<th>Column 4 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Royalties</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Initial Franchise Fees</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Franchisee Purchases</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Revenue</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Expenses-Franchisee Purchases</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Expenses</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Net Income</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>YOY % Increase (Decrease)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. In columns 2, 3, and 4 state the following from the information contained in the financial statements of the franchisor for the last three fiscal years: (a) revenue from royalties; (b) revenue from initial franchise fees; (c) revenue derived from required purchases or leases by franchisees; (d) total revenue from all sources; (e) expenses incurred by the franchisor on account of required purchases or leases by franchisees; (f) total expenses, including, without limitation, interest, taxes, and depreciation; (g) net income after all expenses; and (h) the increase or decrease, expressed as a percentage, in the net income of the franchisor from the previous fiscal year.

n) Section XII. Franchisor Balance Sheet—Selected Items. Disclose in the following tabular form a summary of the information required to be disclosed in Item 21 of the disclosure document. State the title “Franchisor Balance Sheet—Selected Items” in initial capital letters using bold type.
Table XI
Franchisor Balance Sheet-Selected Items ($000)

<table>
<thead>
<tr>
<th>Column 1 Year</th>
<th>Column 2 2015</th>
<th>Column 3 2014</th>
<th>Column 4 2013</th>
</tr>
</thead>
<tbody>
<tr>
<td>Current Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Current Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Working Capital</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Intangible Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Assets</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Long-Term Debt</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Total Liabilities</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>Shareholder Equity</td>
<td></td>
<td></td>
<td></td>
</tr>
<tr>
<td>YOY Increase (Decrease)</td>
<td></td>
<td></td>
<td></td>
</tr>
</tbody>
</table>

1. In columns 2, 3, and 4 state the following information contained in the financial statements of the franchisor for the last three fiscal years: (a) all current assets, but not including intangible assets; (b) all current liabilities; (c) working capital, defined as current assets minus current liabilities; (d) intangible assets, including without limitation, goodwill, trademark rights, and franchise rights; (e) total assets; (f) long-term debt; (g) total liabilities; (h) owners’ equity, defined as total assets minus total liabilities; and (i) the increase or decrease in owners’ equity of the franchisor from the previous fiscal year.

o) Section XII. Dispute Resolution. Disclose in the following tabular form the following portions of the information required to be disclosed in Item 17 of the disclosure document. State the title “Dispute Resolution” in initial capital letters using bold type.

Table XII
Dispute Resolution

<table>
<thead>
<tr>
<th>Provision</th>
<th>Summary</th>
</tr>
</thead>
<tbody>
<tr>
<td>Governing Law</td>
<td></td>
</tr>
<tr>
<td>Venue</td>
<td></td>
</tr>
<tr>
<td>Arbitration/Litigation</td>
<td></td>
</tr>
<tr>
<td>Damages</td>
<td></td>
</tr>
<tr>
<td>Legal Fees and Costs</td>
<td></td>
</tr>
<tr>
<td>Class Action/Consolidation</td>
<td></td>
</tr>
<tr>
<td>Shortened Limitation of Claims</td>
<td></td>
</tr>
<tr>
<td>Royalties after Termination</td>
<td></td>
</tr>
<tr>
<td>Noncompetition Provisions</td>
<td></td>
</tr>
</tbody>
</table>
1. Briefly summarize:
   
   a. The choice of law provisions of the franchise agreement.
   b. The choice of forum provisions of the franchise agreement.
   c. The types of disputes that are subject to arbitration and/or litigation.
   d. The provisions in the franchise agreement that serve to limit the damages that may be recovered by the franchisee or the franchisor.
   e. Any legal fee shifting provisions in the franchise agreement.
   f. Any provisions that would serve to limit or prohibit the franchisee from participating in a consolidated or class action proceeding.
   g. Any provisions in the franchise agreement that limit the period of time during which claims must be asserted by the franchisee or the franchisor.
   h. The extent to which the franchisee is liable for royalties or other fees and charges after termination of the franchise agreement.
   i. Any covenants against competition which apply to the franchisee following termination or expiration of the franchise agreement.

p) Section XIII. Franchisee Associations.

1. Disclose the name, address, telephone number, email address, and web address of each trademark specific franchisee organization associated with the franchise system being offered and which is required to be disclosed in Item 20 of the disclosure document.

2. Disclose whether such trademark specific franchisee organization has been created, sponsored, or endorsed by the franchisor and, if so, state the relationship between the organization and the franchisor.
Strange Weather: California’s Amended Franchise Relations Act, AB 525

Elizabeth M. Weldon and Nicole Liguori Micklich

I. Introduction

In 2015, California’s Assembly Majority Leader Chris Holden introduced California Assembly Bill (AB) 525 to offer greater protection to franchise owners from franchisors that may seek to unjustly terminate a franchised business without fairly compensating the franchisee. Naturally, there are differing opinions between those representing franchisees and those representing franchisors about the need for this amendment to California’s laws and the stated reasoning behind it. This article presents an initial analysis of AB 525 through a review of the background and intent behind AB 525, reference to similar laws in other states, and opinion about the changes from two attorneys from their respective standpoints of representing the franchisor and the franchisee viewpoints. In this point/counter-point format, the authors analyze four of the main elements of the new law:

1) revisions to California Business & Professions Code Section 20020, which limits termination for good cause after an opportunity to cure to a franchisee’s failure to “substantially comply with lawful requirements of the franchise agreement”

2) the addition of Section 20028, which makes it unlawful to prevent a franchisee from selling or transferring a franchise (or substantially all of its assets) if the transferee is qualified under the franchisor’s standards for new/renewing franchisees;

1. All citations to the former and revised sections affected by AB 525 are from the California Business & Professions Code.

Elizabeth M. Weldon (eweldon@swlaw.com) is a partner in the Costa Mesa, California, office of Snell & Wilmer. Nicole Liguori Micklich (nmicklich@garciamilas.com) is a principal of Garcia & Milas, P.C. in New Haven, Connecticut. The authors would like to express their deepest thanks to California attorney Kelly C. Smith, who provided invaluable contributions to this paper. This paper is all the better because the authors had to keep up with her!
3) the addition of Section 20022, which requires the franchisor on lawful termination or non-renewal to purchase the franchisee’s inventory, supplies, equipment, and fixtures purchased under the franchise agreement for the value of price paid, minus depreciation, and

4) revisions to Section 20035, which entitles the franchisee, upon unlawful termination or non-renewal, to the fair market value of the franchised business and its assets as well as other damages.

While the bill is broader than these four points, these are essential elements and are a good starting point for understanding what the law is (and is not). This law was not without controversy, evidenced by the seven different versions of the bill proposed before the eighth and final version was approved, as well as by strong sentiments from the proponents of the bill. “Franchise corporations should not be able to use their dominance to rob franchisees of their livelihood,” Majority Leader Chris Holden of the California Assembly said. “They should not be able to destroy someone’s future by hiding behind an unjust contract and weak state laws.” The authors anticipate and agree that the new law will eventually be litigated, analyzed, interpreted by California courts, and likely amended further.

II. Section 20020 and the Good Cause for Termination Standard

Prior to AB 525, Section 20020 already prohibited a franchisor from prematurely terminating a franchisee unless: (1) the franchisor had good cause or (2) another statute in California’s Franchise Relations Act otherwise permitted termination. This previous version of Section 20020 defined good cause as including, but not limited to, “the failure of the franchisee to comply with any lawful requirement of the franchise agreement after being given notice thereof and a reasonable opportunity, which in no event need be more than 30 days, to cure the failure.”

Like the old Section 20020, the new Section 20020 prohibits a franchisor from prematurely terminating a franchisee unless: (1) the franchisor has good cause or (2) another statute in California’s Franchise Relations Act otherwise permits termination. However, the newly enacted version of Section 20020 defines good cause as follows:

Except as otherwise provided by this chapter, no franchisor may terminate a franchise prior to the expiration of its term, except for good cause. Except as provided in Section 20021, good cause shall be limited to the failure of the franchisee to substantially comply with the lawful requirements imposed upon the franchisee by the fran-
chise agreement after being given notice at least 60 days in advance of the termination and a reasonable opportunity, which in no event shall be less than 60 days from the date of the notice of noncompliance, to cure the failure. The period to exercise the right to cure shall not exceed 75 days unless there is a separate agreement between the franchisor and franchisee to extend the time.6

By amending Section 20020, AB 525 changed both the wording of the definition of good cause for termination and the required notice and cure period.7

A. Good Cause Is Now Limited to Substantial Non-Compliance

Under the former version of § 20020, good cause included, but was not limited to, a franchisee’s “failure to comply” with any lawful requirement of the franchise agreement after notice and opportunity to cure.8 AB 525 amended Section 20020 so that good cause is limited to a franchisee’s “failure to substantially comply with” lawful requirements of the franchise agreement.

B. Increased Notice and Cure Periods

Under the former Section 20020, a franchisor seeking to terminate a franchisee for good cause had to give the franchisee notice of its failure and a “reasonable opportunity” to cure the deficiency of no more than thirty days.9 AB 525 amended Section 20020’s notice and cure requirements by doubling the required notice and cure period to at least sixty days.10

C. Stated Reasoning Behind Section 20020

Proponents of the bill pointed to portions of California’s contract law to support this amendment: “California courts have been interpreting substantial performance of contracts dating back to at least the early 1900s.”11 Proponents argued that the proposed amendments would better align California’s franchise law with established contract law principles.

7. The differences between the prior law and the revised § 20020 can also be seen in blackline:

Except as otherwise provided by this chapter, no franchisor may terminate a franchise prior to the expiration of its term, except for good cause. Good cause shall include, but not be limited to, except as provided in Section 20021, good cause shall be limited to the failure of the franchisee to substantially comply with any lawful requirement of the franchise agreement after being given notice thereof at least 60 days in advance of the termination and a reasonable opportunity, which in no event need shall be more than 30 days, less than 60 days from the date of the notice of noncompliance, to cure the failure. The period to exercise the right to cure shall not exceed 75 days unless there is a separate agreement between the franchisor and franchisee to extend the time.

CAL. BUS. & PROF. CODE § 20020 (West 2008), compared to CAL. BUS. & PROF. CODE § 20020 (West 2016).

8. CAL. BUS. & PROF. CODE § 20020 (West 2008). It is notable that the revisions in AB 525 are not retroactive, they apply only to “franchise agreements entered into or renewed on or after January 1, 2016, or to franchises of an infinite duration that may be terminated by the franchisee or franchisor without cause.” CAL. BUS. & PROF. CODE § 20041(b) (West 2016).


10. CAL. BUS. & PROF. CODE § 20020 (West 2016).

11. See, e.g., Thomas Haverty Co. v. Jones, 197 P. 105 (Cal. 1921) (holding that substantial performance was achieved when the non-breaching party still “is enjoying the fruits of the . . . work in performance of the contract”).
ments also noted that current California jury instructions provide for a simple two-part test to determine the existence of substantial performance. First, the breaching party must show it “made a good faith effort to comply with the contract,” and second, “[the non-breaching party] received essentially what the contract called for because . . . failures, if any, were so trivial that they could have been easily fixed or paid for.”

D. Similar Statutes in Other States

The phrasing “failure to substantially comply” has been used as a definition of “good cause” for termination of franchise agreements in states other than California. The authors reviewed some of these laws for guidance about how the phrase “failure to substantially comply” has been further detailed in practice.

1. New Jersey

New Jersey § 56:10-5 prohibits a franchisor from terminating, canceling, or failing to renew a franchise absent good cause. “For the purposes of this act, good cause for terminating, canceling, or failing to renew a franchise shall be limited to failure by the franchisee to substantially comply with those requirements imposed upon him by the franchise.” New Jersey courts have held that “‘substantial compliance’ is surely something less than absolute adherence to every nuanced term of an agreement, but substantial compliance—at a minimum—requires that the franchisee refrain from acting in direct defiance of a term of the Agreement.” For example, courts have held that a franchisee was not in substantial compliance with the terms of the franchise agreement when it operated a franchise of another automobile manufacturer without the prior consent of the franchisor, violated federal gas pricing regulations by overcharging its customers, under-reported sales to the franchisor in order to avoid paying fees and taxes, and failed to build a showroom as the franchise agreement required.

14. Id.
16. Id.
2. Minnesota

Minnesota’s Franchise Act allows a franchisor to terminate a franchisee for good cause. Good cause is defined as “failure by the franchisee to substantially comply with the material and reasonable franchise requirements imposed by the franchisor.” Minnesota statute Section 80C.14(3)(b) provides five examples of situations in which a franchisor would have good cause to terminate, much like the situations provided for in California Business and Professions Code Section 20021 that allow for termination without an opportunity to cure. One Minnesota appellate court, examining Section 80C.14(3)(b), held that the trial court did not err in determining that good cause to terminate existed under the Minnesota Franchise Act after the distributor failed to make payment without explanation multiple times, despite the manufacturer’s demand for payment.

E. Franchisor’s Point of View About Section 20020

One of the most eye-catching changes to California’s Franchise Relationship Act was altering the wording of the definition of “good cause” as “be[ing] limited to the failure of the franchise to substantially comply with the lawful requirements imposed upon the franchisee by the franchise agreement.”

1. More Limited Good Cause

At the outset, franchisors should note that good cause for termination after the opportunity to cure under the new Section 20020 is limited to the failure to substantially comply with the franchise agreement. The limitation of good cause to only breaches of the franchise agreement in Section 20020 is notable because it may provide limitations on the termination for business reasons. While this is a significant change, the “substantial

20. Minn. Stat. § 80C.14, subd. 3(b)(2013).
21. Id.
22. Minn. Stat. § 80C.14, subd. 3(b)(1-5)(2013). Minnesota’s Franchise Act allows termination for good cause, which includes, but is not limited to,
   (1) the bankruptcy or insolvency of the franchisee; (2) assignment for the benefit of creditors or similar disposition of the assets of the franchise business; (3) voluntary abandonment of the franchise business; (4) conviction or a plea of guilty or no contest to a charge of violating any law relating to the franchise business; or (5) any act by or conduct of the franchisee which materially impairs the good will associated with the franchisor’s trademark, trade name, service mark, logotype or other commercial symbol.
23. OT Indus., Inc. v. OT-tehdas Oy Santasalo-Sohlberg Ab, 346 N.W.2d 162, 165 167 (Minn. Ct. App. 1984). While this case provides helpful background for the use of a “substantial compliance” standard, it is worth noting that, in California, one could avoid the good cause/substantial compliance analysis under similar circumstances. The franchisor would not need to resort to § 20020 because it could terminate the non-paying franchisee under § 20021(j) for failure to pay “any amounts due to the franchisor or its affiliate within five days after receiving written notice that such fees are overdue.”
noncompliance language may not be as big of a change and may even end up being a distinction without a difference.

2. Meaning of Substantial Compliance

Section 20020 does not define what it means to fail to substantially comply with the franchise agreement. Some of the items the proponents cited in the legislative history do not clearly lead to a definition and should be viewed with a critical eye. From a franchisor perspective, it is reasonable to assert that “the failure of franchisee to substantially comply” can include the legal principle of “material breach,” even if it may not be limited to that standard.

As mentioned above, in the legislative history for Section 20020, the proponents pointed to CACI 312 (a California form of jury instruction), among other things, as showing that “substantial compliance” has been part of California’s body of contract law of substantial performance. Although CACI 312 indeed exists, it relates to defense—it is not an instruction for a direct claim for relief or an instruction for breach of contract. CACI 312 applies often in a construction contract situation, where the defendant on a breach of contract claim asserts that the plaintiff did not perform its obligations, and the plaintiff must show a good faith effort to comply with the contract and that the defendant “received essentially what the contract called for because [plaintiff’s] failures, if any, were so trivial or unimportant that they could have been easily fixed or paid for.”

The proponents of the law also cited *Thomas Haverty Co. v. Jones* as an example of “substantial performance” to justify the “substantial compliance” standard. But this case also provided guidance that appears to be specific to construction cases. The defendant owner alleged that the plaintiff building contractor’s performance was defective and that he should not have to pay. The California Supreme Court affirmed the judgment for the plaintiff.


28. CACI 312 Substantial Performance

29. 197 P. 105 (Cal. 1921).


contractor, utilizing the following construction law principle of substantial performance:

It has now been greatly relaxed and it is settled, especially in the case of building contracts where the owner has taken possession of the building and is enjoying the fruits of the contractor’s work in the performance of the contract, that if there has been a substantial performance thereof by the contractor in good faith, where the failure to make full performance can be compensated in damages to be deducted from the price or allowed as a counterclaim, and the omissions and deviations were not willful or fraudulent and do not substantially affect the usefulness of the building for the purposes for which it was intended, the contractor may, in an action upon the contract, recover the amount unpaid of his contract price, less the amount allowed as damages for the failure in strict performance.\footnote{32}

This is not particularly illuminating in the context of a franchise termination where the franchisee generally will not pay for the failures or a cure would have already occurred.

The bill’s sponsor stated, “At no time has Assembly Bill 525’s ‘substantial compliance’ standard been intended to require a provision-by-provision analysis of a franchisee’s compliance with the contract. ‘Substantial compliance’ has always been intended to require an analysis of the franchisee’s compliance with the franchise agreement as a whole.”\footnote{33}

This sounds somewhat like a finding of material breach—which is the standard in California when terminating a contract because of a breach: “The important question, however, is whether a particular breach will also give the injured party the right to refuse further performance on his or her own party, i.e., to \textit{terminate the contract}. The test is whether the breach is material \ldots .”\footnote{34}

Whether a breach of contract is total or partial depends upon its materiality. (Rest., Contracts, s 317, p. 471) In determining the materiality of a failure to fully perform a promise the following factors are to be considered: (1) the extent to which the injured party will obtain the substantial benefit which he could have reasonably anticipated; (2) the extent to which the injured party may be adequately compensated in damages for lack of complete performance; (3) the extent to which the party failing to perform has already partly performed or made preparations for performance; (4) the greater or less hardship on the party failing to perform in terminating the contract; (5) the willful, negligent, or innocent behavior of the party failing to perform; and (6) the greater or less uncertainty that the party failing to perform will perform the remainder of the contract. (Rest., Contracts, s 275, pp. 402–03).\footnote{35}

A franchisor looking for clarity on the meaning of “failure to substantially comply” may also look to New Jersey and Connecticut for examples. In \textit{General Motors Corp. v. New A.C. Chevrolet, Inc.}, the court noted that the parties agreed that “substantial compliance” is simply the absence of a material

\footnote{32. \textit{Id.} (emphasis added).}
\footnote{33. Holden Letter, \textit{supra} note 15.}
\footnote{34. Witkin, \textit{Summary of California Law}, \textit{CONTRACTS} § 852 (10th ed. 2005).}
breach of contract.\textsuperscript{36} In an earlier portion of the same case, the court held that "‘substantial compliance’ is surely something less than absolute adherence to every nuanced term of an agreement, but substantial compliance—at a minimum—requires that the franchisee refrain from acting in direct defiance of a term of the Agreement. This is especially true when, as here, the franchisee has received specific notice from the franchisor that its behavior is a violation of the agreement."\textsuperscript{37} Indeed, the proponents of AB 525 cited this very opinion and quote to state that the “substantial compliance language as applied in California is intended to follow the New Jersey court’s interpretation of ‘substantial compliance. . . .’”\textsuperscript{38}

Connecticut’s courts have addressed the meaning of “failure to comply substantially with any material and reasonable obligation of the franchise agreement” and have found it to “leave[] no doubt that good cause exists when the franchisee materially breaches the agreement.”\textsuperscript{39}

Under this revised section, it is likely that franchisors will continue to be able to terminate franchise agreements at least when franchisees directly defy provisions of the franchise agreements or are in material breach of the contracts. And, as noted in the franchisee section below, the California legislature has provided that franchise agreements may be terminated for other specific items listed in Section 20021 without an opportunity to cure.

F. Franchisee’s Point of View About Section 20020

Franchisees should appreciate the hard work of proponents of AB 525, whose stated purpose was to protect franchisees and to expand the rights of franchisees in relation to termination and nonrenewal by the franchisor. The prior version of Section 20020 allowed franchisors to prematurely terminate a franchise for “good cause.” Previously Section 20025 allowed franchisors to refuse to renew a franchise simply by providing 180 days’ written notice.\textsuperscript{40} Franchisees were faced with acting quickly and spending significant funds, to the extent they could do so, to prosecute injunction actions to save their businesses and preserve their goodwill. Those provisions, contrary to their intent, permitted some unscrupulous franchisors to take advantage of franchisees and use immaterial or typically waived provisions of the franchise agreement to steal franchisees’ businesses. A franchisor could terminate a

\textsuperscript{36} 263 F.3d 296, 317 n.8 (3d Cir. 2001).
\textsuperscript{38} Holden Letter, supra note 15.
\textsuperscript{39} Petereit v. S.B. Thomas, Inc., 63 F.3d 1169, 1184–85 (2d Cir. 1995) (holding that “good cause” for termination is not limited to a franchisee’s non-performance, but included the franchisor’s business goal of increasing sales). See CONN. GEN. STAT. § 42-133f(a) (“No franchisor shall, directly, or through any officer, agent or employee, terminate, cancel or fail to renew a franchise, except for good cause which shall include, but not be limited, to the franchisee’s refusal or failure to comply substantially with any material and reasonable obligation of the franchise agreement or for the reasons stated in subsection (e) of this section.”) (emphasis added).
\textsuperscript{40} CAL. BUS. & PROF. CODE § 20025 (West 2008).
franchisee, take over the franchised business itself or sell a franchise to a new franchisee, and place the new franchisee in the terminated franchisee’s location, allowing the new franchisee to benefit from the local goodwill developed by the terminated franchisee, receive royalties on the former franchisee’s business, and then go to court and seek lost profit damages from the terminated franchisee.\footnote{Postal Instant Press, Inc. v. Sealy, 43 Cal. App. 4th 1704, at n.9 (1996). In Postal Instant Press, the plaintiff franchisor declared overdue payments for past royalties a material breach and sent the defendant franchisee a termination letter in 1992. The franchisor then brought action for breach of franchise agreement and the Superior Court of Los Angeles County entered judgment, including damages for lost future profits, for the franchisor. The franchisee appealed and the California Court of Appeal held that the franchisee’s failure to make past royalty payments was not the proximate cause of the franchisor’s failure to receive future royalty payments and even if it were, an award of future lost profits as damages for the franchisee’s breach would be unreasonable, unconscionable, and oppressive. The Court of Appeal reversed the judgment insofar as it awarded estimated future lost profits and remanded. Rehearing and review were denied in 1996.}

AB 525 makes it more difficult for franchisors to terminate franchisees without a just cause and provides greatly improved remedies for violations of the law, which should deter franchisors from taking unfair advantage of franchisees. The revised act also allows more time to cure (sixty days) than some franchise agreements presently permit and allows termination only for failure to substantially comply with the franchise agreement and failure to cure the breach. This should prohibit franchisors from terminating any franchisee that is in substantial compliance with the franchise agreement. That standard should be much narrower than one based broadly on a franchisee’s failure to comply with any requirement of the franchise agreement. Many large franchisors have a working definition of substantial compliance in their system already and those franchisors and their franchisees should already have a common understanding of the franchisor’s expectations and the conditions under which termination is proper under the statute.

However, the new Sections 20020 and 20021 may have the unintended effect of encouraging franchisors to utilize Section 20021 and any possible argument thereunder to immediately terminate a franchisee without providing an opportunity to cure. That will leave franchisees in the same position as they were prior to the revisions to the California Franchise Relations Act (CFRA); they will have to scramble to scrape together a retainer and hire counsel to seek injunctive relief. Section 20021 was left largely unchanged by AB 525. On its face, Section 20021 expands the definition of good cause and provides a litany of specific situations in which a franchisor can immediately terminate a franchisee with no notice or opportunity to cure. Although Section 20020 limits good cause as a franchisee’s substantial failure to comply with the franchise agreement, Section 20020 also incorporates Section 20021 as providing circumstances that constitute good cause for immediate termination. Section 20021 provides twelve circumstances that qual-
ify as good cause and allows the franchisor to terminate a franchisee immediately upon notice and without an opportunity to cure.42

Good cause, the prior standard, was loosely defined in Section 20020 of the CFRA, which provided that “good cause shall include, but not be limited to, the failure of the franchisee to comply with any lawful requirement of the franchise agreement” after notice and the applicable cure period. In addition, prior Section 20021 specified various grounds under which immediate notice of termination without an opportunity to cure was per se reasonable. It still does.

Although Section 20021 was on the books prior to AB 525 and routinely relied upon by franchise counsel, Section 20020 did not expressly incorporate the section. Despite the eight versions of AB 525 prior to its adoption, and the fact that the revised and adopted Section 20020 specifically mentions the provisions of Section 20021, the two sections still do not incorporate the same standards. Now, except as provided by Section 20021, good cause is limited to a franchisee’s failure to substantially comply with lawful requirements imposed on the franchisee by the franchise agreement after being given the statutory notice and opportunity to cure. The new reference in Section 20020 to Section 20021 may cause confusion because Section 20020 requires that a franchisee’s failure be substantial to constitute good cause, but Section 20021 does not require a substantial failure, or indicate that the delineated failures are “substantial,” but allows immediate termination.

The new law also added a right for the franchisor to terminate without notice or an opportunity to cure if there is a lawful termination or non-renewal of a separate motor fuel franchise that is operated by the franchisee or an affiliate of the franchisee located at the same business premises if both franchises are granted by the same franchisor or an affiliate of the franchisor.43 This new provision, and specifically the use of the word “separate,” may be the California legislature’s answer to the successful argument of the franchisee in Aurigemma v. Arco Petroleum Products Co.44 In that case, a federal district court held that, under the Connecticut Franchise Act, a franchisor’s unilateral decision to withdraw from marketing of petroleum in

42. The circumstances include a franchisee: (i) filing for bankruptcy or admitting inability to pay debts; (ii) failing to operate the franchise for five days; (iii) agreeing in writing to terminate the franchise; (iv) making material misrepresentations to acquire the franchise; (v) failing to comply with federal, state, or local laws and regulations after ten days of notice; (vi) engaging in the same noncompliant behavior after previously curing that behavior; (vii) repeatedly failing to comply with one or more franchise requirements; (viii) being convicted of a felony or criminal misconduct relevant to the franchise; and (ix) failing to pay overdue franchise fees or other amounts within five days of receiving notice. Additional grounds include: (x) if the franchise or its premises are seized by the government or foreclosed by a creditor, (xi) the franchisor makes a reasonable determination that continuing to operate the franchise will result in imminent danger to public health or safety, and (xii) if the franchise is a motor fuel franchise and permits termination under the Petroleum Marketing Practices Act. CAL. BUS. & PROF. CODE § 20021 (West 2016).
43. CAL. BUS. & PROF. CODE § 20021(l) (West 2016).
44. 698 F. Supp. 1035, 1042 (D. Conn. 1988).
Connecticut did not constitute “good cause” for terminating franchises for the operation of convenience stores associated with gasoline stations.

Worse than that limitation on franchisee rights, Section 20021(f) arguably makes “substantial compliance” with “lawful requirements” irrelevant. Section 20021 expressly states that immediate notice without the opportunity to cure is reasonable if the franchisee repeatedly fails to comply with one or more requirements of the franchise, whether or not corrected after notice. The “requirements” of Section 20021(f), on their face, need not be “lawful” and the failure to comply need not be “substantial,” merely repeated after notice. It seems likely that franchisors will rely, at least in the alternative, on Section 20021 when terminating a franchisee. If that occurs, California courts may avoid interpreting or analyzing Section 20020, at least in some cases.

Section 20021(j) also permits termination without the newly enacted sixty-day cure period if the franchisee fails to pay any franchise fees or other amounts due to the franchisor or its affiliate within five days after receiving written notice that such fees are overdue. The amount of the fees or sums due need not be substantial for a franchisor to rely on Section 20021(j). Thus, Section 20021(j) may be another alternative avenue for termination without consideration of the new Section 20020. Undoubtedly, creative franchisors and franchisor counsel will find additional ways to rely on Section 20021. This could lead to increased litigation as franchisees faced with immediate termination without an opportunity to cure will be left with few avenues to pursue other than to seek injunctive relief.

Proponents of AB 525 sought to protect franchisees’ investments in their franchises from being taken without compensation. The authors of the bill believed that the previous Business and Professions Code Section 20020 allowed “some franchisors to unfairly take advantage of franchisees by using the contract to punish franchisees by taking their business away and to avoid their legal obligations to give franchisees another chance.” Accordingly,” they wrote a bill to “allow termination of franchise agreement for good cause only upon the failure of the franchisee to substantially comply with any lawful requirement of the franchise agreement, and give the franchisee advance notice and an opportunity of at least 60 days to cure the breach.” In addition, they wrote the bill to prohibit a franchisor from failing to renew a franchise unless the franchisee failed to substantially comply with the franchise agreement. According to the bill’s authors, this provision, new Section 20020, ensures fairness to franchisees. But, without corresponding changes to Section 20021, it is unclear whether the authors’ intentions will be met.

III. Section 20028 and the Ability to Transfer Franchises

Prior to the enactment of AB 525, California law protected franchisees’ ability to transfer their franchises to family members upon death. AB 525 expanded living franchisees’ ability to sell and transfer their franchises to anyone through the enactment of new Section 20028, which states:

(a) It is unlawful for a franchisor to prevent a franchisee from selling or transferring a franchise, all or substantially all of the assets of the franchise business, or a controlling or noncontrolling interest in the franchise business, to another person provided that the person is qualified under the franchisor’s then-existing standards for the approval of new or renewing franchisees, these standards to be made available to the franchisee, as provided in Section 20029, and to be consistently applied to similarly situated franchisees operating within the franchise brand, and the franchisee and the buyer, transforee, or assignee comply with the transfer conditions specified in the franchise agreement.

To ensure franchisors are given notice, Section 20028(b) states that franchisees do not have the right to sell, transfer, or assign their franchises, franchise assets, or their franchise interest without written consent of the franchisor, which the franchisor cannot withhold unless the potential new owner does not meet standards referenced in Section 20028(a) or does not comply with transfer conditions put forth in the franchise agreement. Section 20028(c) clarifies that this section does not bar a franchisor’s contractual right of first refusal to buy the franchise or part of it.

It is notable that the original proposed version of Section 20028 prohibited a franchisor from unreasonably withholding consent to a proposed transfer. The revised statute, as adopted, does not include a reasonableness limitation and provides only that consent must not be withheld unless the transferee does not meet the standards for new or renewing franchisees or the franchisee and the transferee do not comply with transfer conditions specified in the franchise agreement.

A. Intent Behind Section 20028

The intent behind the new Section 20028, and its related Section 20029 regarding the timeline and process for sale, was to help small business owners pass their business on to family members and sell their franchises as a

46. CAL. BUS. & PROF. CODE § 20027 (West 2016). Under Section 20027 of California’s Business and Professions Code, a franchisor cannot not deny a surviving spouse, heir, or estate of a deceased franchisee or majority holder in a franchise from participating in the franchise for a “reasonable” amount of time after the franchisee’s or majority franchise holder’s death. If the estate fails to meet the current qualifications for a purchaser of the franchise, the estate can “sell, transfer, or assign the franchise to a person who satisfies the franchisor’s then current standards for new franchisees.” Id.

47. CAL. BUS. & PROF. CODE § 20029 (West 2016).

48. CAL. BUS. & PROF. CODE § 20028(b) (West 2016).

49. CAL. BUS. & PROF. CODE § 20028(c) (West 2016).

source of retirement income.\(^{51}\) The bill’s sponsor stated “[t]he ‘similarly situated franchise’ standard requires franchisors to treat a franchisee’s proposed transfer similarly to those proposed by other franchisees with comparable business volume, size and locations.”\(^{52}\)

**B. Similar Statutes in Other States**

Other states have limited a franchisor’s ability to refuse a transfer of a franchise to situations where the transferee fails to meet the franchisor’s standards. For example, the Michigan Franchise Investment Law voids any provision in a franchise document that “permits a franchisor to refuse to permit a transfer of ownership of a franchise, except for good cause.”\(^{53}\) Good cause includes, among other things, a proposed transferee’s failure to meet the franchisor’s then existing, reasonable standards.\(^{54}\) But this law was limited in its effect for franchisees when a Michigan court found that liability for a violation of this section was limited to persons seeking to purchase franchises—the sellers did not have a private right of action under this act.\(^{55}\)

**C. Franchisor’s Point of View About Section 20028**

Franchisors will note that the newly added Section 20028 limits their ability to refuse any transfer of a franchise, the assets of a franchise, or any interest (controlling or non-controlling) if the transferee “is qualified under the franchisor’s then existing standards for the approval of new or renewing franchisees . . . .”\(^{56}\) It is notable that Section 20028 applies to essentially any interest in a franchised business—not just a controlling interest. This breadth could actually allow for more franchisor control over the transfer process since it could be interpreted as approving a franchisor’s refusal of a transfer of even a very small interest in a franchisee when that transferee does not meet the standards for approval of a new or renewing franchisee.

Because the existence of standards appears to be the main reason a franchisor could refuse a transfer of any portion of the franchise (unless it utilizes a right of first refusal, see Section 20028(c)), it is likely that this section will

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51. The bill’s author asserted that “the new standards and processes for transfers will reduce litigation by providing a clear, step-by-step procedure for the approval or denials of a transfer. . . . AB 525 requires the franchisor to clearly state the grounds for denying transfer, which so long as they are equally applied to other similarly situated franchisees, precludes the franchisee from objecting to the denial.” The bill was supposed to “establish a streamlined process and timeline for the sale or transfer of a franchise without decreasing the advance notice period of 180 days that franchisees must provide to the franchisor. The bill requires the franchisor to approve the sale or transfer request without unreasonably withholding consent.” *Senate Judiciary Comm. Hearing*, supra note 27.

54. *Mich. Comp. Laws Ann.* § 445.1527(g)(i); see also *Minn. Stat. Ann.* § 80C.14(5) (“[i]t is unfair and inequitable for a person to unreasonably withhold consent to an assignment, transfer, or sale of the franchise whenever the franchisee to be substituted meets the present qualifications and standards required of the franchisees of the particular franchisor.”).  
cause franchisors to issue more and detailed standards for what is required to be a franchisee in the system or any part of a franchisee in the system. One can envision comprehensive requirements, such as minimum net worth, minimum cash on hand, credit history, education, and business experience. This greater degree of certainty will hopefully help reduce litigation.

Section 20028 also calls for the standards “to be consistently applied to similarly situated franchisees operating within the franchise brand.” This requirement could cut both ways in terms of being a benefit or a negative for franchisors and franchisees. Although it calls for uniform treatment, it could be argued that this requirement limits the franchisor’s ability to make reasonable exceptions or leeway in standards for unique circumstances. A rejoinder to this is that special circumstances are just that—special and outside the standards because the transferee may not be “similarly situated”—and thus are not impacted by the consistently applicable standard. Moreover, because the sponsor intended for the consistency to relate to the business volume, size, and location, the franchisor may have more leeway in dealing with unique situations. In any case, this standard is another of the items that could lead to litigation.

D. Franchisee’s Point of View About Section 20028

This section recognizes that franchisees build valuable relationships and equity in their franchise businesses and develop personal and local goodwill, apart from the corporate goodwill that may be associated with the franchisor’s trademarks and system. These new provisions may also make succession planning easier for franchisees and their families because franchisees now may be more confident that their heirs can take over their franchise business.

On the other hand, the sections contain ambiguities and do not reduce the likelihood that a franchisee will have to litigate a franchisor’s unreasonable decision not to permit a transfer. The new law also does not change the reality that it may be difficult to keep up with, and to understand, the franchisor’s then current standards. And, unfortunately for franchisees, there is no remedy prescribed for the event when the franchisor wrongfully refuses to permit a transfer. So the legislation does not deter franchisors from being unreasonable or compel them to be even-handed.

Despite the issues that may arise related to the enacted Sections 20028 and 20029, one intended benefit of the law will likely triumph. Sections 20028 and 20029 should make reasonable succession planning and inheritance by spouses and children of franchisees easier. The new transfer provision of the CFRA contains a self-explanatory procedure to make it easier for franchisees to pass their businesses on to family members. The procedure provides some certainty for franchisees and franchisors. Prior California law did prohibit a franchisor from denying the surviving spouse, heirs, or estate of a deceased franchisee or the majority shareholder of the franchisee the

opportunity to own the franchise for a reasonable time after the death of the franchisee or the majority shareholder of the franchisee. The surviving person had to satisfy the franchisor’s then current standards for new franchisees and maintain all standards and obligations of the franchise. This did not prohibit the franchisor from exercising its right of first refusal to purchase a franchise after receiving a bona fide offer to purchase the franchise by a proposed purchaser of the franchise.

Of course, just as they did prior to AB 525, franchisors and franchisees will have different opinions about whether franchisors' decisions not to renew are “reasonable.” Franchise transfer law in California was fairly well developed through the judicial system. There is uncertainty as to the effect of those decisions now. For example, since 2008 franchisors have known that a requirement that prospective transferees pass an English Language Proficiency Assessment was enforceable. Franchisees may attempt another bite at that apple under the new sections.

IV. Section 20022 and Repurchase Rights Upon Lawful Termination and Non-Renewal

Section 20022 requires franchisors to purchase from franchisees numerous supplies and equipment upon lawfully terminating or declining to renew the franchise contract. Specifically, Section 20022(a) states:

Except as provided in this section, upon a lawful termination or nonrenewal of a franchise, the franchisor shall purchase from the franchisee, at the value of price paid, minus depreciation, all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary or collateral agreement by the franchisee to the franchisor or its approved suppliers and sources, that are, at the time of the notice of termination or nonrenewal, in the possession of the franchisee or used by the franchisee in the franchise business. The franchisor shall have the right to receive clear title to and possession of all items purchased from the franchisee under this section.

Section 20022 then puts forth six exceptions detailing certain items a franchisor need not purchase or certain situations in which a franchisor need not purchase any items from the franchisee upon termination or non-renewal. These include: (1) a franchisor need not purchase “any personalized items, inventory, supplies, equipment, fixtures, or furnishings not reasonably required to conduct the operation of the franchise business in accordance with the franchise agreement or any ancillary or collateral agreement,” or items to which the franchisee cannot grant the franchisor clear title; (2) the franchisor need not purchase any items from the franchisee if the reference text is not clearly visible or not provided.
franchisee declines a “bona fide offer of renewal;”64 (3) the franchisor need not purchase any items if the franchisor “does not prevent the franchisee from retaining control of the principal place of the franchise business;”65 (4) the section does not apply if a franchisor decides to completely withdraw from franchise activity in the “relevant geographic market area” where the franchise is located, and the decision to withdraw is non-discriminatory and publicly announced;66 (5) the section is inapplicable if the franchisor and franchisee agree in writing to terminate or not renew the franchise;67 and (6) the section does not apply to any items the franchisee sells before stopping the operation of the franchise.68 Additionally, the section’s final subsection allows a franchisor to offset amounts owed to the franchisor against amounts owed to a franchisee under Section 20022.69

While Section 20022 begs certain questions like what constitutes a bona fide offer of renewal or what items are not reasonably required to conduct the franchise business, the final, enacted version of Section 20022 is infinitely clearer than its initial proposed version. AB 525’s initial version of Section 20022 gave franchisees “the opportunity to monetize any equity the franchisee may have developed in the franchised business prior to the termination of the franchise agreement.”70 From first to final version, many noteworthy changes were made to Section 20022, which served to clarify its ambiguities, but also to increase franchisors’ obligations and franchisees’ benefits.

A. Intent Behind Section 20022

Through their addition of Section 20022, AB 525’s proponents again sought to protect franchisees and their investments in their franchises. Proponents believed that under the existing law, monetary remedies available to franchisees upon dissolution of their franchises were inadequate.71 While franchisees could recover the cost of existing resalable inventory upon terminations that violated the relationship law before AB 525,72 proponents believed that franchisors were unjustly enriched because they could “essentially take all equity, personal capital, and goodwill a franchisee has developed upon franchise dissolution,” leaving franchisees with little.73

Proponents specified that Section 20022’s “narrow compensation requirements” apply only when a franchisor retains the franchise premises.74 Proponents believed Section 20022 would help both franchisees and franchisors by

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64. CAL. BUS. & PROF. CODE § 20022(c).
65. CAL. BUS. & PROF. CODE § 20022(d).
66. CAL. BUS. & PROF. CODE § 20022(e).
67. CAL. BUS. & PROF. CODE § 20022(f).
68. CAL. BUS. & PROF. CODE § 20022(g).
69. CAL. BUS. & PROF. CODE § 20022(h).
72. CAL. BUS. & PROF. CODE § 20035 (West 2012).
74. Senate Judiciary Comm. Hearing, supra note 27.
“simply provid[ing] the franchisee compensation for goods they purchased that can now be used by the franchisor, or future franchisee, in running the business for a profit.”

B. Similar Statutes in Other States

Section 20022 was based on Connecticut and Washington franchise laws. Under Section 19.100.180(2)(i) and (j) of Washington’s Revised Code, respectively, a franchisor may not fail to renew or terminate a franchisee unless the franchisor compensates the franchisee for the fair market value of things like inventory and supplies, with some exceptions. It is significant that a Washington court found that the reimbursement right was not equivalent to an automatic right to renewal and that franchises are terminable in accordance with their terms as long as the franchisor complies with reimbursement requirements.

C. Franchisor’s Point of View About Section 20022

There are many exceptions to Section 20022—so many that the new rule essentially applies when the franchise is “lawfully” terminated for the franchisees’ breach of the franchise agreement (now called “substantial noncompliance”). The rule to pay the franchisee at the end of a franchise does not apply, for example, when “when the franchisee declines a bona fide offer of renewal from the franchisor” or when “the franchisor does not prevent the franchisee from retaining control of the principal place of the franchise business.” These various factual situations listed in the statute raise questions as to how it will actually be enforced and may lead to litigation.

1. No Buyback If the Franchisee Keeps the Location

Section 20022(d), which does not require buyback if the franchisee can retain control of the principal place of business, is equitable to the franchisee because there is no reason the franchisee needs to be compensated for items it purchased for the business if it can operate a business at the premises. But

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75. Id.
76. “Section 20022 is based, in large part, on franchise law from Washington and Connecticut, which require the franchisor to reimburse the franchisee, upon termination under the terms of the franchise (WASH. REV. CODE § 19.100.180(i)–(j), CONN. GEN. STAT. § 42-133(f)(c)).” Holden Letter, supra note 15. Connecticut’s General Statutes § 42-133(f) differs from Section 20022 in that the former only applies to termination and sets compensation price at a “fair and reasonable” amount, whereas the latter applies to termination and non-renewal and sets compensation price at price paid minus depreciation. While one Connecticut federal court described § 42-133(f)(c) as a remedy “protect[ing] a franchise from being stuck with useless inventory at termination,” the authors found no cases meaningfully interpreting Section 42-133(f)(c). Chem-tek, Inc. v. Gen. Motors Corp., 816 F. Supp. 123, 128, 131 (D. Conn. 1993) (denying defendant-motor company’s motion to dismiss and holding, in relevant part, that the court could not determine on the pleadings whether the plaintiff-company was a franchisee protected under the Connecticut Franchise Act).
77. WASH. REV. CODE ANN. § 19.100.180(2)(i) & (j).
79. CAL. BUS. & PROF. CODE § 20022 (c) & (d) (West 2016).
it is not entirely clear how the phrase “does not prevent the franchisee from retaining control” could play out in all circumstances.

2. No Buyback If the Franchisor Is Withdrawing from the Area

Section 20022(e), which does not require buyback if the franchisor is withdrawing from franchise activity in the area of the franchise, is another section left open as to its effect. It requires that the franchisor “publicly announce” its withdrawal from the region, but there is no statement as to what the announcement must be like or where it must be announced. Additionally, this requirement seems punitive and unnecessary to the application of the section. Hopefully, franchisors in this situation can fashion a public announcement that makes the withdrawal of the relevant area clear, but does not impact their business more widely than the geographic area at hand.

Even the statement that the franchisor must “completely withdraw” may require some focus. For example, imagine if the franchisor decides to wind down the system in a certain area by not renewing contracts as they legally expire. Although the franchisor would not be participating in franchise sales activity in that situation, the franchisor may be in some form of franchise activity in that it has other franchisees still existing in the area. Franchisor counsel may argue such a franchisor is not subject to the repurchase provision because it does not make sense to require a franchisor that is winding down a system in an area to buy materials back.

3. Items and Pricing of Buyback May Be Disputed

The language of Section 20022(a) is stated in broad terms that are not necessarily framed in the reality of how franchised businesses operate. It calls for the repurchase of “all inventory, supplies, equipment, fixtures, and furnishings purchased or paid for under the terms of the franchise agreement or any ancillary agreement or collateral agreement by the franchisee to the franchisor or its approved suppliers and sources. . . .” The statute does not detail what it means to purchase or pay for something under the terms of an agreement. If the agreement actually said, “franchisee must buy X,” that is one thing, but many agreements are not structured to that level of detail and, with good reason, because operations may differ by location, and the franchisee may be in charge of deciding what items to buy for the business the franchisee operates.

The pricing structure of the repurchase—“value of price paid, minus depreciation”—may result in litigation. This section seems to assume the franchisee has proof or receipts, which is not necessarily reality. There is no provision for valuation where one does not know the value of the price paid. Accordingly, some valuation of the item (from the time of purchase) would likely need to be made by a qualified party, probably an accountant. This sounds much like a litigation exercise in damage analysis. Yet, there is no guidance in the statute as to who has the burden to prove the value or the depreciation—certainly each party will be pointing at the other.
The expansion of this section to not only items purchased under the franchise agreement, but also to items purchased under ancillary and collateral agreements with approved suppliers and sources could take this section to unreasonable places. One potential effect is that the franchisor may pare down amenities and suppliers, as well as equipment required for production, in order to better control its ultimate risk. This is not necessarily a win for franchisees because having approved suppliers and items can streamline the choices facing franchisee business owners. Nor is this a win for franchisors, or the ultimate customer, as it could cause less consistency in the brand and quality.

D. Franchisee’s Point of View About Section 20022

Section 20022 is now the toughest franchisee protection law in the nation and probably the world. Previously, Section 20020 provided a meager remedy for wrongfully terminated franchisees. The pendulum has swung. Section 20022 is likely to be the most frequently litigated section of the revised Act. So, while it favors franchisees in the sense that it protects from franchisor abuses, recognizes franchisees’ equity in their businesses, and encourages continued investment in the franchised business, including upgrades even near the end-of-term, the cost of litigation will be high because the stakes are high and it is not clear how to value the cost of inventory, supplies, etc.

Franchisees should delight in the extraordinary remedy provided by Section 20022 and both franchisors and franchisees should recognize that the fairness in Section 20022 is in the legislature’s nod to site control. If the former franchisee keeps the site and the entrenched local goodwill, the franchisor does not have a repurchase obligation. By enacting Section 20022, California has said that it will not allow the franchisor or its designee, often the fair-haired franchisee neighboring the terminated franchisee, to step in and commandeer the terminated franchisee’s goodwill and continue running the store. Of course, franchisors can also set off amounts owed by the former franchisee, which seems fair in principle, but which may provide unscrupulous franchisors with a mechanism for abuse. The reality of Section 20022 is that it should compel franchisors and franchisees to negotiate, but with as much at stake as the statute puts on the line, the provision will likely be frequently litigated.

V. Section 20035 and Remedies for Unlawful Termination and Non-Renewal

In its former version, Section 20035 governed franchisees’ rights after lawful termination or non-renewal, which was amended and moved to Section 20022. Section 20035 was amended so that it now speaks to franchisees’

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80. CAL. BUS. & PROF. CODE § 20035 (West 2008).
81. CAL. BUS. & PROF. CODE § 20035 (West 2008).
rights upon termination or non-renewal in violation of the Act.\textsuperscript{82} According to the new Section 20035:

(a) In the event a franchisor terminates or fails to renew a franchisee, in violation of this chapter, the franchisee shall be entitled to receive from the franchisor the fair market value of the franchised business and franchise assets and any other damages caused by the violation of this chapter.

(b) A court may grant preliminary and permanent injunctions for a violation or threatened violation of this chapter.\textsuperscript{83}

In its final form, Section 20035 varies from AB 525’s initial, proposed version of Section 20035 in two important ways.

Whereas new Section 20035 provides compensation to a franchisee that is unlawfully terminated or not renewed, AB 525’s initial, proposed version of Section 20035 also provided franchisees the option for reinstatement under the same terms as the existing franchise agreement plus resulting damages.\textsuperscript{84} Under the enacted Section 20035, reinstatement is not an available, stated remedy. However, proponents of AB 525 believe that Section 20035 still provides specific relief for franchisees that wish to continue operating their franchises by allowing “unlawfully terminated franchisee[s] to seek an injunction to preserve the status quo in addition to seeking monetary relief.”\textsuperscript{85}

While the legislative history from the proponent of the bill suggests injunctions can be obtained to preserve the status quo, franchisors can argue (1) affirmative injunctions are disfavored in California; and (2) injunctions that force franchisors to do business with and entrust their brand to a person/franchisee that the franchisor may no longer trust are not the proper use of injunctive relief, especially when the statute itself says damages are available.

A. \textit{Intent Behind Section 20035}

Upon unlawful termination or non-renewal, proponents sought to protect franchisees by providing them monetary compensation or their ability to continue operating their franchise businesses in the event of actual or threatened unlawful termination/non-renewal through specific relief.\textsuperscript{86}

B. \textit{Similar Statutes in Other States}

Similar to California Business and Professions Code Section 20035, Arkansas and Hawai‘i have adopted statutes requiring franchisors to pay fair market value for some number of franchise assets upon termination or non-renewal. Arguably the most similar to Section 20035, Arkansas Code Section 4-72-209 requires a franchisor that terminates a franchisee without

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\textsuperscript{82} CAL. BUS. & PROF. CODE § 20035 (West 2016).

\textsuperscript{83} Id.

\textsuperscript{84} A.B. 525, 2015–16 Leg., Reg. Sess. (as amended in the Assembly, Apr. 6, 2015).

\textsuperscript{85} Holden Letter, supra note 15.

\textsuperscript{86} Id.
good cause to repurchase, “at the franchisee’s option,” “the franchisee’s in-
ventory, supplies, equipment, and furnishings purchased by the franchisee
from the franchisor or its approved sources” at a value of the franchisee’s
net cost minus reasonable depreciation.87

Hawaii Revised Statutes Section 437-58(g) requires an automobile fran-
chisor that terminates or fails to renew a franchise without good cause to
compensate the franchisee at fair market value for the franchisee’s “capital
investment, which shall include the going business value of the business,
goodwill, property, and improvement owned or leased by the dealer for
the purpose of the franchise.”88

C. Franchisor’s Point of View About Section 20035

Although it is clear that Section 20035 was implemented in order to give
franchisees additional remedies for a wrongful termination of a franchise, it
is not so clear how it is going to work in practice, except that it seems des-
tined to lead to litigation.

First, the section calls for the franchisee “to receive from the franchisor
the fair market value of the franchised business. . . .” Often “fair market
value” of a business is determined via a battle of the experts in the course
of litigation, and there is litigation over how this valuation should occur.
This remedy may become a matter of expert opinion because there is no pro-
cess put in place by Section 20035 to create a path to a valuation outside of
litigation, unless the parties create a path of their own—perhaps in the fran-
chise agreement.

And there are differing methods of valuation, such as:

1) the cost or book value approach, which values the balance sheet assets
or calculates the replacement cost of the balance sheet assets minus li-
abilities (though this balance sheet may not show intangible assets);

2) the income or capitalization of earnings approach, which assumes the
earnings of a business constitute an annual percentage return on the
value of the business, or, that the present discounted value of the busi-
ness’s earnings into the future is the current business value;

3) the comparable sales approach, which examines the recent sales of sim-
ilarly situated businesses and utilizes actual prices, as opposed to esti-

88. Hawaii Revised Statute Section 437-58(g) is a statute under Hawaii’s Motor Vehicle In-
dustry Licensing Act and therefore not applicable to all franchises generally. Nonetheless, § 437-
58(g) is noteworthy because it is very analogous to California Business and Professions Code
§ 20035 in that it incorporates the concepts of: (1) payments at fair market value and (2) lack
of good cause to terminate or not renew. Hawaii’s general franchise law also includes a compen-
sation statute if a franchisor fails to renew or terminates a franchisee. See Hawaii Rev. Stat.
Ann. § 482E-6(3). However, that section does not differentiate between termination and
non-renewal with good cause and absent good cause, as do the California Business and Profes-
sions Code § 20035 and Hawaii Revised Statute § 437-58(g).
mates (although what is similarly situated is frequently subject to dispute). 89

These differing tests alone show that the fair market value standard for termination damages may be a recipe for lawyers and experts.

Second, the section calls for valuation not only of the franchised business, but also of “franchise assets.” There is no definition in the statute of how these two phrases differ in reality. Goodwill seems like a likely area of contention here in that the franchisee will seek personal goodwill for its business, but the franchisor will argue that it owns the institutional, corporate, and national goodwill.

From the franchisor perspective, this section does not account for the varied realities that exist in franchising. For example, this section seems to assume that the franchised business is taken away from the franchisee in its entirety by the termination—location, inventory, and all. But many terminations are essentially only a termination of the right to use the branding and the now former franchisee retains the location and the business—just under a different name and branding. Under this statute, to allow the franchisee to obtain the value of the business and assets, while still keeping them, would permit unjust enrichment, which is not permissible under California law. 90

Having recouped its entire investment, the franchisee seemingly could continue a similar business in the same place having retained good will established using the franchisor’s brand and implementing the franchisor’s business methods.

The question is left open—can franchisors draft definitions to include in their franchise agreements that would address some of the uncertainty of the statute? One possibility could be to define exactly how the business and/or assets would be valued upon such a termination. Another possibility could be that the parties agree what will not be considered in such a valuation. This is yet untested, but it seems like an area franchisors will want to explore.

D. Franchisee’s Point of View About Section 20035

The new Section 20035 is another example of the legislature’s recognition of the local and personal goodwill developed by successful franchisees and the significant investment required of such franchisees. It levels the playing field and acts as a deterrent against unlawful termination of franchisees. On the other hand, like many other aspects of the Act, it contains a material and undefined term, “fair market value,” and essentially forces franchisees to seek injunctive relief. A real problem then develops because franchisors are generally much less likely to engage in meaningful negotiation and dispute resolution once a franchisee commences a legal action, which must be disclosed

in the Franchise Disclosure Document. Franchisees then must either pay for lawyers and experts and spend considerable time and resources engaged in a legal action that might otherwise be avoided, or, if such legal action is cost prohibitive, waive the “fair market value” and/or “other damages” afforded by the law.

AB 525 as adopted in the new CFRA is the most franchisee-friendly legislation in the nation. It is not without flaws, however, and it is likely to lead to costly litigation. It also failed to provide many protections that franchisees seek: (1) it does not empower franchisee associations, (2) it does not impose a good faith requirement on all of a franchisor’s dealings with franchisees, and (3) it does not address a common problem for franchisees in the form of contractual limitations periods that essentially waive protections for franchisees. In the future, hopefully the California legislature, and legislators in other states, will further deter opportunistic behavior by franchisors, including territorial encroachment and the use of mandated suppliers. Strong state laws can level the playing field for franchisees that otherwise are bound by one-sided non-negotiable franchise agreements.

VI. Conclusion

Since AB 525 was enacted in October 2015, it has been one of the most hotly contested topics among the franchise bar. The authors expect it also will become the most hotly litigated law soon. Without the aid of court guidance, parties are already becoming entrenched in their beliefs about how the law should be applied and interpreted. And, despite its intended clarity, AB 525 is likely to drive parties into court. Like most statutes, however, as courts interpret the law, the hope is that a greater sense of clarity will arrive to provide both franchisees and franchisors with more certainty about their relationship.
Lessons from Thucydides on Distinguishing Statutory from Common Law Fraud in Franchise Disclosure Actions

Peter C. Lagarias and Bruce J. Napell

What does the study of historical predecessors of franchise disclosure laws have to do with *The Peloponnesian Wars*, written by Thucydides almost two-and-a-half millennia ago? Both tell the story of hard fought battles, between Athenians and Spartans on the one hand, and franchisors and franchisees, on the other. While Thucydides’ contemporary Herodotus wrote flowery stories replete with vivid anecdotes and won a coveted prize from the Athenians, Thucydides chose a more direct style. Thucydides sought to provide readers with an exact knowledge of the past as an aid to the interpretation of the future. Following the path of Thucydides, this article will review antecedent legislation designed to provide investors and others with enhanced protections from fraud and deceptive practices and chart their influence on the franchise disclosure statutes so that future construction of the franchise investment laws may be informed by knowledge of their past.

The statutory construction issues under the franchise disclosure statutes can be illustrated with proverbial false earnings claims or, in today’s vernacular, false financial performance representations. Suppose a franchisor decides to make no financial performance disclosure in Item 19 of its Franchise Disclosure Document (FDD). Then, a prospective franchisee asks the franchise salesman the most important question: tell me about the sales and profit information of

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1. The change in terminology occurred with the 1998 revision of the FTC Franchise Disclosure Rule.

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your franchise units?\(^2\) The franchise salesman, seeking to obtain a commission on the sale of a franchise from his or her franchisor employer, succumbs and orally gives the prospect false sales and profit information. In concluding the sale, the prospect either does not read or understand a disclaimer in the franchise agreement that no additional earnings claims were made outside the FDD or relied upon by the franchisee. The franchisor meanwhile does not monitor the sales activities of the franchise salesman. The franchisee invests based on the false sales and profit information and suffers substantial losses in the franchise business. Should the franchisee have a remedy under the franchise disclosure laws for the misrepresentations and misconduct notwithstanding the disclaimer?

State franchise disclosure laws, in the tradition of older consumer protection statutes, provide franchisees broader rights and remedies for misrepresentation claims than the common law. Eight of these statutes expressly state that “fraud” and ‘deceit’ are not limited to common law fraud or deceit.”\(^3\) Despite the enactment of the first such statute in California some forty years ago, many courts have continued to apply the common law definition of fraud when evaluating franchisees’ statutory misrepresentation claims. Only a few courts have acknowledged and examined the differences between common law fraud and statutory liability under the franchise disclosure laws.

This article first discusses elements of common law fraud claims in comparison with the broader language of statutory provisions regarding the offer and sale of franchises. Next, the article discusses how courts have interpreted the older consumer protection statutes that preceded and informed the franchise investment laws, and finally the franchise laws themselves, and concludes that franchisees are often incorrectly being deprived of protections and remedies intended by the statutes’ drafters.

I. The Many Elements and Higher Burden of Proof of Common Law Fraud Claims

Although franchise relationships are contractual, the offer and sale of franchises can be accomplished through fraud and deceit. The elements of common law fraud include in most states: (1) misrepresentation or omission of a material fact, (2) intention to deceive, (3) intention to induce reliance,
Mindful of the justified or reasonable reliance requirement of common law fraud, contract drafters have often sought to avoid fraud liability through disclaimers. Such efforts, especially in franchise agreements, often mix and match from a trio of provisions: integration clauses, no-representation clauses, and no-reliance clauses. These provisions, drafted by the stronger party and acknowledged by the weaker party, seek to undermine subsequent fraud claims. An integration clause, reciting that this is the entire agreement, seeks to prevent claims that there are unwritten promises or additional contract terms. No-representation clauses seek to bar proof of additional representations to support a fraud claim. No-reliance clauses seek to thwart establishment of the justified reliance element in fraud claims. States recognize such provisions in differing ways in deciding common law fraud claims. New York, for example, will not allow a common law fraud claim based on representations denied in a no-reliance clause. California, however, allows such claims to proceed, although the no-reliance clause may be considered by the finder of fact with other evidence regarding reliance.

When franchise disclosure statutes were initially enacted, courts sometimes invoked familiar common law fraud rules and decisions in deciding claims under the new statutory language. Master Abrasives Corp. v. Williams, one such early decision under the Indiana Franchise Act (IFA), is illustrative. The Indiana Court of Appeals addressed liability under the IFA by studying the requirements for common law fraud liability. Under existing fraud case law, false opinions of profit potential were not actionable; hence the state appellate court found the aggrieved franchisee was not entitled to recover under the IFA on that basis. Ultimately, the franchisee’s judgment based on the IFA was affirmed but due to other misrepresentations of fact that were actionable under the common law fraud decisions.

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7. Integration clauses are the foundation for parol evidence arguments that no additional contract terms may be presented in a contract claim. See Restatement (Second) of Contracts § 213 (1981). But the parol evidence rule in most states does not bar fraud or statutory claims. Id. § 214.
II. The Expansive Language of Franchise Disclosure Statutes Extends Beyond Common Law Fraud

In crafting the franchise disclosure laws, state legislatures were targeting fraudulent sales practices. In 1971, when it enacted the first franchise investment law, the California Legislature emphasized the need for truthful disclosure to prevent fraud and deception:

The Legislature hereby finds and declares that the widespread sale of franchises . . . has created numerous problems both from an investment and a business point of view . . . California franchisees have suffered substantial losses where the franchisor or his or her representative has not provided full and complete information regarding the franchisor-franchisee relationship, the details of the contract between franchisor and franchisee, and the prior business experience of the franchisor.

It is . . . the intent of this law to prohibit the sale of franchises where the sale would lead to fraud or a likelihood that the franchisor’s promises would not be fulfilled. 11

The disclosure and antifraud provisions of California’s and subsequent states’ franchise statutes establish that the legislatures both perceived the sale of franchises to encompass a serious risk of deception and that they believed the common law remedies for fraud were insufficient to protect their citizens from that risk. Franchise laws in California, Illinois, Michigan, Minnesota, North Dakota, New York, Rhode Island, and Wisconsin all provide that, as used in those statutes, the terms “fraud” and “deceit” are not limited by their common law definitions. 12 The IFA also defines statutory fraud and deceit more broadly than at common law, but without specific reference to the common law. 13 Whether the courts recognize that statutory and common law fraud are differing concepts can often mean the difference between winning and losing claims.

The Illinois Franchise Disclosure Act (IFDA) is representative of franchise laws that define fraud more broadly than the common law. The Illinois definition of common law fraud includes six classic elements:

11. CAL. CORP. CODE § 31001.
12. See supra note 4.
13. Under the IFA, fraud includes “any misrepresentation in any manner of a material fact, any promise or representation or prediction as to the future not made honestly or in good faith, or the failure or omission to state a material fact necessary to make the statements made, in the light of the circumstances under which they were made, not misleading.” IND. CODE § 23-2-2.5-1(f). Unlike at common law, future predictions are thus actionable under the IFA. Combining both approaches, the New York Franchise Sales Act (NYFSA) provides that “[f]raud,” “fraudulent practice,” and “deceit” are not limited to common law fraud or deceit, and include: (a) “any deception, concealment, suppression, device, scheme or artifice employed by a franchisor, franchise sales agent, subfranchisor or franchise salesman to obtain any money, promissory note, commitment or property by any false or visionary pretense, representation or promise; (b) “any material misrepresentation in any registered prospectus filed under this article; or (c) “the omission of any material fact in any registered prospectus filed under this article.

N.Y. GEN. BUS. LAW § 681(10).
(1) a false statement of material fact; (2) the party making the statement knew or believed it to be untrue; (3) the party to whom the statement was made had a right to rely on the statement; (4) the party to whom the statement was made did rely on the statement; (5) the statement was made for the purpose of inducing the other party to act; and (6) the reliance by the person to whom the statement was made led to that person’s injury. 14

The IFDA specifically provides that “[f]raud and deceit” under the statute are not limited to common law fraud or deceit. 15 The statute specifically prohibits fraudulent conduct in terms differing significantly from the common law definition. In connection with the offer or sale of any franchise:

[I]t is unlawful for any person, directly or indirectly, to: (a) employ any device, scheme, or artifice to defraud; (b) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or (c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person. 16

The IFDA contains at least two obvious differences from common law fraud beyond the phrase “device, scheme or artifice to defraud.” The statute broadens or supplements the false material statement element to include either by an affirmative false statement or the omission of material information that under the circumstances makes other not false statements nonetheless misleading. The IFDA also reduces the role of reliance by providing that a practice that “would operate as a fraud” is also prohibited.

III. The Antecedent Mail Fraud Statutes Extend Liability Beyond Common Law Fraud

The phrase “device, scheme, or artifice to defraud” has its genesis in the nineteenth century federal mail fraud statute, which courts have long held to expand liability to a wider variety of conduct than would be covered under common law fraud. 17 This was true even though there was no express language in the mail fraud statute distinguishing the statutory terms from their common law counterparts. In Durland v. United States, the first Supreme Court case to construe the statute, the Court instructed that the phrase “scheme or artifice to defraud” was to be interpreted broadly. 18 The Court rejected the argument that “the statute reaches only such cases as, at common law, would come within the definition of ‘false pretenses’ [for which] there must be a misrepresentation as to some existing fact and not a mere promise as to the future.” 19 Instead, the Court construed the statute

15. ILL. COMP. STAT. Ch. 815 § 705/3(11).
16. ILL. COMP. STAT. Ch. 815 § 705/6. See also note 72, listing state franchise laws with the “device, scheme, or artifice to defraud” formulation.
18. Id. at 313.
19. Id. at 312.
to include “everything designed to defraud by representations as to the past, or present, or suggestions and promises as to the future.” In a later opinion, the Court stated the words “to defraud” commonly refer “to wronging one in his property rights by dishonest methods or schemes” and “usually signify the deprivation of something of value by trick, deceit, chicane or overreaching.”

In *United States v. Woods*, the Ninth Circuit held that a defendant’s actions could constitute a scheme to defraud even without the involvement of any specific false statements:

If a scheme is devised with the intent to defraud, and the mails are used in executing the scheme, the fact that there is no misrepresentation of a single existing fact is immaterial. . . . Put another way, “[t]he fraudulent nature of the ‘scheme or artifice to defraud’ is measured by a non-technical standard. Thus, schemes are condemned which are contrary to public policy or which fail to measure up to the reflection of moral uprightness, of fundamental honesty, fair play and right dealing in the general and business life of members of society.”

More recently, in *Bridge v. Phoenix Bond & Indemnity Co.*, the Supreme Court expressly distinguished mail fraud from common law fraud, holding that reliance was not a required element of mail fraud (serving as a RICO predicate): “Congress defined the predicate act not as fraud simpliciter, but mail fraud a statutory offense unknown to the common law. In these circumstances, the presumption that Congress intends to adopt the settled meaning of common law terms has little pull.” The Court concluded that it was not at liberty to rewrite the statute to eliminate claims that the Congress had provided.

Mail fraud thus differs significantly from common law fraud. At least two of the traditional elements of common law fraud—misstatement and reliance—are altered or diminished in importance in the mail fraud statutes. The result is mail fraud liability for a larger category of misconduct than common law fraud.

20. Id. at 313 (“But beyond the letter of the statute is the evil sought to be remedied, which is always significant in determining the meaning. It is common knowledge that nothing is more alluring than the expectation of receiving large returns on small investments. Eagerness to take the chances of large gains lies at the foundation of all lottery schemes, and, even when the matter of chance is eliminated, any scheme or plan which holds out the prospect of receiving more than is parted with appeals to the cupidity of all.” Id).


22. 335 F.3d 993 (9th Cir. 2003).

23. Id. at 998 (citations omitted).


25. Id.

26. Id. at 660.
IV. The Antecedent Federal Trade Commission Act and Subsequent Authority, Including the FTC Franchise Disclosure Rule, Proscribe Conduct Beyond Common Law Fraud

Under the 1938 Wheeler–Lea amendments, the Federal Trade Commission was authorized to protect consumers as well as competitors from a more expansive universe of “unfair or deceptive acts and practices.”27 The FTC proscriptions extended beyond common law fraud to cover not only representations that deceived consumers, but also those misrepresentations that had the “capacity to deceive” consumers.28

Many states have enacted Little FTC Acts and unfair trade practices acts modeled after the FTC Act. Many of these statutes proscribe conduct beyond the elements of common law fraud.29 In Bailey Employment System, Inc. v. Hahn,30 a franchisor sought to collect an unpaid note from a franchisee for franchise fees. The franchisee defendant brought a counterclaim for breach of the Connecticut Unfair Practices Act (CUTPA),31 alleging that the franchisor’s president had misrepresented average sales volume and that the prospective franchisee could be earning a “living wage.” The franchisee defendant established that these misrepresentations had been made and that the statements and others were false, including that many franchisees had failed, a fact that was not disclosed. The U.S. District Court for the District of Connecticut awarded double the franchisee’s damages under the CUTPA, finding that “[t]he CUTPA plaintiff need not prove reliance or that the representation became part of the basis of the bargain.”32

In addition to its general proscription of unfair and deceptive acts or practices, the Commission amended its procedural rules in 1962 to provide for the enactment of industry-wide trade regulation rules.33 By 1975, partially in response to critiques by Ralph Nader and others, the Commission was granted additional authority to seek civil penalties in federal court.34

28. FTC v. Tashman, 318 F.3d 1273 (11th Cir. 2003); FTC v. NHS Sys., Inc., 936 F. Supp. 2d 520 (E.D. Pa. 2013) (actual deception need not be proven, instead the criterion is the likelihood of deception or the capacity to deceive).
32. Bailey Emp’t Sys., 545 F. Supp. at 67, citing Hinchcliff v. Am. Motors Corp., 440 A.2d 810 (Conn. 1981). In Bailey, the district court also repeatedly cited and followed FTC case law jurisprudence, including that “there is no duty resting upon a citizen to suspect the honesty of those with whom he transacts business. Laws are made to protect the trusting as well as the suspicious.” Id. at 67–68, citing FTC v. Standard Educ. Soc’y, 302 U.S. 112, 116 (1937).
Armed with new powers, the Commission completed rulemaking proceedings for such diverse business activities as the sale of used cars, the sale of products in the funeral industry, the sale of protein supplements, and the sale of franchises.

Prior to enacting the FTC Franchise Disclosure Rule in 1978 (the FTC Rule), the Commission conducted extensive hearings. The Statement of Basis and Purpose for the FTC Rule sets forth myriad misrepresentations and nondisclosures of material facts in the sale of franchises, including false earnings claims; false claims of territorial protection; false claims of franchisor experience or financial stability; and many, many more. The Commission record included academic testimony regarding not only the economic disparities between franchisors and typical franchisees, but also the inherent “informational imbalance” between the experienced franchisor, who knows almost everything about the industry and its franchise business, and the prospective franchisee, who is often a novice to business and usually knows little or nothing about the franchise business and industry.

One of the few reported cases under the FTC Rule involving franchises rather than business opportunities, FTC v. Minuteman Press, established that liability for violations of the FTC Rule extends beyond common law. The action involved claims of false earnings and profits representation in the sale of Minuteman and Speedy franchises in two established franchise systems. Following a trial, the U.S. District Court for the Eastern District of New York found both the corporate franchisors and their officers liable for multiple misrepresentations under the Rule. In particular, the false sales and profitability claims violated the FTC Act as “[s]uch misrepresentations—which tend to bear directly on economic viability of the transaction under consideration—are both likely to deceive and material.” But Minuteman Press also found liability under the FTC Rule beyond common law fraud for: (1) stating in the disclosure document that no earnings claims were being made but making such claims; (2) stating in the disclosure document that none of its officers, directors, or employees were authorized to make earnings claims while such persons made earnings claims; and (3) failing to have written substantiation for earnings claims and to provide a written earning claims

Through later legislation, the Commission was granted the authority to obtain redress for consumers following violations of the FTC Act. 15 U.S.C. § 53.

37. Professor Ozanne testified at the FTC hearings regarding “informational imbalance” that the “franchisor presents the information about the franchise and its sales and profits. Unlike the franchisee, he knows how much of the information is true and how much is puffery.” Bus. Fran. Guide (CCH) ¶ 6304.
documents to franchisees. The district court concluded: “That conflict, viz., between the disclaimers in the UFOC and the representations embodied in sales presentations, is violative of the FTC Rule.”

The Commission also sought consumer redress in *Minuteman Press*. The district court held that the standards for such relief “as part of a Section 5 [of the FTC Act] are markedly different than in a fraud action between private litigants.” The district court granted consumer redress despite defendants’ argument that the UFOC disclaimed earnings claims and the franchisees acknowledged that no such representations had been made by the franchisor. The applicable standard established in FTC case law for judging the misrepresentations was examining the “common sense net impression.” The district court found: “Here, a reasonable consumer could legitimately conclude that he or she was being furnished specific earnings information, *sub rosa*, to assist in the decision-making process notwithstanding the general disclaimers in the UFOC.”

V. The Antecedent Federal and State Securities Statutes Extend Liability Beyond Common Law Fraud

Federal and state securities laws were patterned on the federal mail fraud statute. The noted language of the mail fraud statute is also found in the anti-fraud provisions of Section 17(a) of the Securities Act of 1933 and in SEC Rule 10b-5, which was promulgated under the Securities Exchange Act of 1934. Cases interpreting Rule 10b-5 are in accord that statutory securities fraud is different from common law fraud: “We do not assume that offenses

40. Id. at 259.
41. Id.
42. Id. at 262.
43. Removatron Int’l Corp. v. FTC, 884 F.2d 1489, 1497 (1st Cir. 1989).
45. 15 U.S.C. § 78 j(b) provides in part:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce or of the mails, or of any facility of any national securities exchange—

   . . . .

   (b) To use or employ, in connection with the purchase or sale of any security registered on a national securities exchange or any security not so registered, or any securities-based swap agreement, any manipulative or deceptive device or contrivance. . . .
46. Rule 10b-5 provides:

It shall be unlawful for any person, directly or indirectly, by the use of any means or instrumentality of interstate commerce, or of the mails or of any facility of any national securities exchange, (a) [t]o employ any device, scheme, or artifice to defraud, (b) [t]o make any untrue statement of a material fact or to omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they were made, not misleading, or (c) [t]o engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person, in connection with the purchase or sale of any security.

against these provisions are, by any means, identical with common law deceit... Promissory fraud is, however, cognizable as ‘fraud’ within the meaning of the mail fraud and securities statute.”

In *Herman & MacLean v. Huddleston*, the Supreme Court held that “we have repeatedly recognized that securities laws combating fraud should be construed ‘not technically and restrictively, but flexibly to effectuate [their] remedial purposes.”

“Indeed, an important purpose of the federal securities statutes was to rectify perceived deficiencies in the available common law protections by establishing higher standards of conduct in the securities industry.”

More recently, then Circuit Judge Samuel Alito noted that it “is well known that the federal securities laws provide broader fraud protection than the common law, having been enacted in response to the common law’s perceived failure at stamping out fraud in the securities markets.”

*In re Parmalat Securities Litigation* discussed the “contours of subsections (a) and (c) of Rule 10b-5, which prohibit ‘any device, scheme, or artifice to defraud’ and ‘any act, practice, or course of business which operates or would operate as fraud or deceit upon any person’ in connection with the purchase or sale of any security.”

The *Parmalat* court noted that: “[F]or decades the distinction between the conduct covered by subsections (a) and (c) on the one hand, and subsection (b) on the other was largely insignificant. . . . It no longer is possible, however, to ignore [how 10(b) applies to conduct other than misrepresentations, omissions, and market manipulation].”

The *Parmalat* court then explained that reliance in the context of 10b-5 simply means causation:

The reliance requirement in that context has a very specific function: in the Supreme Court’s words, to “provide the requisite causal connection between a defendant’s misrepresentation and a plaintiff’s injury” or, in the formulation of the Second Circuit, “to certify that the conduct of the defendant actually caused the plaintiff’s injury.” At the same time . . . “[t]he plaintiff is not required to prove that the defendant’s act was the sole and exclusive cause of his injury; he need only show that it was substantial, i.e., a significant contributing cause.”

The Supreme Court has noted that “[a]ctions under Rule 10b-5 are distinct from common law deceit and misrepresentation claims and are in part designed to add to the protections provided investors by the common law.”

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49. *Id.* at 389.
52. *Id.* at 480.
53. *Id.* at 498.
54. *Id.* at 509 (citations omitted).
Although the federal mail fraud and securities statutes do not expressly state that fraud and deceit are not as limited as under the common law, state securities statutes often directly contain that language. The contrast with common law fraud has also been acknowledged when state courts have interpreted the statutory language that “fraud and deceit are not limited to common law fraud and deceit.” In *Bowden v. Robinson*, a state securities law case, the California Court of Appeals construed that language in the California Corporations Code. The *Bowden* court held that this language “provide[s] for actions and remedies for corporate securities victims far less burdensome than those available under common law” and acknowledged that the law created a statutory cause of action for fraud “conspicuously avoiding the requirement of ‘actual reliance.’” The court found that the legislative intent to broaden the reach of statutory fraud was clear because the Legislature included countervailing procedural and repose limitations in the statute to offset the relaxed liability standards:

Establishing a violation, and obtaining recovery, under these new sections [are] so much less difficult than establishing common law fraud, that the Legislature has imposed a statute of limitations requiring that any cause of action under section 25503 be brought within two years of the violation or within one year after discovery thereof, “whichever shall first expire.”

Other courts addressing state securities statutes have also held that a broad departure from common law fraud principles is warranted under the securities laws. One typical decision held:

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57. CAL. CORP. CODE § 25006.
58. *Bowden*, 67 Cal. App. 3d at 714. The late distinguished California law commentator, Bernard Witkin, wrote: “The basis of liability, established by Corp. C. 25401 and 25501, differs from the common law in that proof of reliance is not required although the facts must be ‘material,’ no proof of causation is required; and the plaintiff need not plead the defendant’s negligence.” BERNARD WITKIN, SUMMARY OF CALIFORNIA LAW 774 (9th ed. 1989).
In common law fraud, the plaintiff must prove that the defendant intentionally deceived him. The present statute, however, does not necessarily place this onus of dishonesty on the defendant. The intent with which the defendant makes the statement is irrelevant under the terms of the statute. The statute requires only that the statement made be false and material, or that the omission be of a material fact necessary to make true the statement made. Since “... the term ‘fraud,’ as used herein, is not the equivalent of ‘actual fraud or conscious deceit’”; (the) ... (q)uantum of proof requirements as to “actual fraud”... are not controlling in this situation.  

The legislatively created differences between statutory and common law fraud date back through state and federal securities laws and the federal mail fraud statute enacted in the late nineteenth century. These earlier consumer protection laws contain legislative recognition that the elements of common law fraud are not always suited to the realities of a modern economy. In SEC v. Capital Gains Research Bureau, Inc., the Supreme Court noted that the common law doctrines of fraud were developed to deal with transactions involving tangible goods and were ill suited to the sale of intangibles such as securities. Earlier commentators had made the same point: “Thus, the notions of ‘puffing’ and ‘sales talk’ as nonactionable comes from the doctrine of caveat emptor but properly apply only in the sale of tangibles where examination of the good would advise the purchaser of false or exaggerated statements of the seller.”

61. Treider v. Doherty & Co., 527 P.2d 498 (N.M. Ct. App. 1974) (citations omitted) (construing the New Mexico securities law, which defined as fraudulent the omission of facts necessary to make material facts provided not misleading).
63. 3 L. LOSS, SECURITIES REGULATION 1435 (2d ed. 1961). Loss continues, quoting an SEC Release:

Particularly is this true under the antifraud provisions of the securities laws, which were designed to protect against sharp and inequitable practices whether or not they meet the requisites of common law fraud. Indeed, a basic purpose of this remedial legislation was to supplement the doctrine of caveat emptor with high standards of responsibility for sellers of securities. We have repeatedly emphasized that these standards are embodied in the concept of fair dealing which is inherent in the relationship between a broker or dealer in securities and his customers. We have also pointed out that it is inconsistent with fair dealing and a violation of the antifraud provisions of the Securities Acts for salesmen to actively solicit and induce purchases of securities by means of representations unsupported by an adequate basis. Characterization of the conduct of either salesman in this case as mere “puffing” serves only to obscure the fact that they engaged in an intensive campaign to sell Allied stock with complete indifference to their obligation to deal fairly with their customers. The record establishes that registrant was
VI. Re-Examination of Franchise Disclosure Statutes and Historical Antecedents as Imposing Liability Beyond Common Law Fraud

The state franchise laws were derived from the state and federal securities laws and often modeled on the Uniform Securities Act of 1956 (USA), promulgated by the North American Securities Administrators Association, Inc. USA Section 101 is identical to the liability language of many of the state franchise statutes. It is in USA Section 401(d) that the statutory phrase “fraud and deceit are not limited to common law fraud and deceit” first appeared. The official comment explained the purpose of the section: “Sec. 401(d)—Fraud not limited to common law deceit. Section 401(d) codifies the holdings that ‘fraud’ as used in federal and state securities statutes, as well as the federal mail fraud statute, is not limited to common law deceit.” When state legislatures enact statutes based on model acts without significant alteration, courts have historically presumed that they also adopt the information necessary to make an intelligent decision regarding franchises being offered for sale (Section 702(2)(d)).

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engaged in a “boiler-room” operation in the sale of Allied stock and that Roman and Fligel were an integral part of and principal actors in that operation.

64. Keating v. Super. Ct., 645 P.2d 1192, 1199 (Cal. 1982), rev’d on other grounds sub nom, Southland Corp. v. Keating, 465 U.S. 1 (1984) (“The evidence is persuasive that in drafting the Franchise Investment Law California legislators looked to the Securities Act of 1933 as their model. Not only do the two statutes have the same purpose of protecting investors through preinvestment disclosure statements, but their parallel provisions are often expressed in identical language.”). See also Proimos v. Fair Auto. Repair, Inc., 808 F.2d 1273, 1276 (7th Cir. 1987) (“At all events, the critical portion of the [Illinois] Act (¶ 706(2)) is modeled on the SEC’s Rule 10b-5 . . .”); Bonfield v. AAMCO Transmissions, Inc. 708 F. Supp. 867 (N.D. Ill 1989) (“Modeled after the federal securities laws, the Franchise Act is intended to ‘provide each prospective franchisee with the information necessary to make an intelligent decision regarding franchises being offered for sale (Section 702(2)(d)).’”).

65. UNIFORM SECURITIES ACT (1956) (as amended), www.nasaa.org/content/Files/UniformSecuritiesAct1956withcomments.pdf. The North American Securities Administrators Association (NASAA) is the non-profit association of state, provincial, and territorial securities regulators in the United States, Canada, and Mexico. It has sixty-seven members, including the securities regulators in all fifty states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands. Formed in 1919, NASAA is the oldest international organization devoted to protecting investors from fraud and abuse in connection with the offer and sale of securities.


67. U.S.C. § 401(d). Some fifty state statutes, mostly securities statutes, include the language that fraud and deceit are not limited to common law fraud and deceit.


69. Layne–Minn. Co. v. Regents of Univ. of Minn., 123 N.W.2d 371 (Minn. 1963); see also Giguere v. SJS Family Enters., Ltd., 155 P.3d 462, 467 (Colo. Ct. App. 2006) (“We accept the intent of the drafters of a uniform act as the General Assembly’s intent when it adopts that uniform act.”); Clark v. Comm’r of Corr., 917 A.2d 1, 15 (Conn. 2007) (“In the absence of any indication to the contrary, we reasonably may presume that our legislature adopted the act for the same reasons that it was approved by the National Conference of Commissioners on Uniform State Laws.”); Thomsen v. Mercer-Charles, 901 A.2d 303 (N.J. 2006) (“Given that the New Jersey Legislature adopted the Model Act’s language, we have no reason to believe
unless its language clearly and unequivocally discloses an intention to depart from, alter, or abrogate the common law Rule concerning the particular subject matter. . . .” 70 It is indisputable that the franchise statutes expressly and intentionally abrogate the common law standards for fraud and deceit. Courts should acknowledge and implement that policy decision.

Despite the express language in the eight state statutes that distinguish statutory from common law fraud, few cases have acknowledged a difference between the elements of claims for breach of the franchise investment laws and the elements of common law fraud. And although twelve states include the phrase “device, scheme or artifice to defraud” in their franchise investment statutes, 71 many decisions have not addressed prior courts’ construction of that language in the mail fraud and securities statutes in connection with their application of the identical language in the franchise disclosure laws. Some courts instead appear to go out of their way not to compare such case law. For example, the Indiana Supreme Court stated that: “[w]e look to persuasive federal court authority interpreting parallel securities provisions only to the extent we cannot discern the meaning of our statute from its text and apparent purpose.” 72 The history and application of the antecedent statutes, as well as the adoption of nearly identical statutory language, suggest that the Indiana Supreme Court incorrectly limited its inquiry because statutory protections for franchisees are intended to cover a much broader range of misconduct than mere common law fraud.

An example of a judicial failure to examine the antecedents of the statutory language is the unpublished, but often cited, case California Bagel Co. v. American Bagel Co. 73 California Bagel involved a garden-variety California
Franchise Investment Law (CFIL) misrepresentation claim arising out of the sale of bagel franchises. In granting summary judgment to the franchisor, the district court concluded that it was proper to impose the elements of common law fraud on CFIL fraud claims:

Plaintiffs contend that requiring reliance as an element of a § 31300 claim is contrary to the legislative intent behind the CFIL. In this regard, they cite the statement in § 31001 that “it is the intent of this law to prohibit the sale of franchises where such sale would lead to fraud or a likelihood that the franchisor’s promises would not be fulfilled. . . .” Cal. Corp. Code § 31001. The statute does not compel the conclusion plaintiffs seek to have the court draw, however, since, absent some indication to the contrary, “fraud” as used in the statute must be given its common law meaning.\(^{74}\)

This last sentence shows that the district court correctly understood a legislature could properly provide statutory remedies for conduct not amounting to common law fraud. But the court seemed completely unaware of CFIL’s express command that: “‘[F]raud’ and ‘deceit’ are not limited to common law fraud or deceit.”\(^{75}\) The court also failed to address both the antecedent securities statutes and decisions and prior rulings that the statutes were to be liberally construed.\(^{76}\) These multiple oversights indicate that in this stated decision of first impression, California Bagel was incorrect on that issue.

In Spahn v. Guild Industries Corp., the California Court of Appeal approvingly noted that a jury instruction regarding fraud under the CFIL “encompassed each and every element of fraud except for the necessity of reliance by the franchisees, on the misrepresentations of the franchisors.”\(^{77}\) The court did not list the elements, but the discussion refers to the elements of common law fraud.\(^{78}\) There is no indication that the court considered that the elements of statutory fraud might differ.

In Avon Hardware Co. v. Ace Hardware Corporation,\(^{79}\) the plaintiffs brought claims for common law and statutory fraud under the Indiana Franchise Act. The fraud claims included allegations of false promises based on misleading pro forma financial statements. In upholding dismissal of the claims, the Indiana Court of Appeals analyzed the common law fraud claim at great length, including listing the elements for common law fraud liability.\(^{80}\) The court held that the false pro formas would not support a common law fraud claim because “financial projections are considered to be statements of opinion, not fact” and “representations of future income are not actionable.”\(^{81}\) In contrast, the court succinctly addressed the statutory fraud

\(^{74}\) Id.
\(^{75}\) Cal. Corp. Code § 31012.
\(^{77}\) 156 Cal. Rptr. 375 (Cal. Ct. App. 1979).
\(^{78}\) The court excused the instruction’s failure to list reliance because the verdict clearly demonstrated that the jury found actual reliance. Id.
\(^{80}\) Id. 1287.
\(^{81}\) Id. at 1288.
claims in a single paragraph and did not distinguish between the statutory and common law claims:

For similar reasons, the circuit court properly dismissed the plaintiffs’ statutory fraud claims. The Indiana Franchise Disclosure Act creates a private right of action only for acts that constitute fraud, deceit, or misrepresentation, and such claims require reasonable reliance and materiality. As we concluded in our common law fraud analysis, the plaintiffs failed to state these elements as a matter of law. Therefore, the circuit court properly dismissed counts I and II of the amended complaint under section 2-615 of the Code.82

The discussion of statutory fraud is notable not only for its brevity, but also for its lack of attention to the statute. The court relied on the rules relating to predictions and financial projections with regard to common law fraud and ignored, without comment, the Indiana Franchise Act’s express definition of statutory fraud as including “any promise or representation or prediction as to the future not made honestly or in good faith.”83

Some courts that have found that the similar language in other states’ franchise statutes does create claims distinct from common law fraud have done so without reference to the antecedent securities or mail fraud statutes. The Seventh Circuit cited the language that statutory “‘fraud’ and ‘deceit’ are not limited to common law fraud or deceit” under the Wisconsin Franchise Investment Law and accepted that the common law element of detrimental reliance “is not necessarily” an element of the statutory violation.84 But it also held that the sections of the statute imposing civil liability for damages for making misrepresentations in connection with a franchise sale “essentially write the element of detrimental reliance into the statute . . .”85

Similarly, in construing the Michigan Franchise Investment Law (MFIL), the U.S. District Court for the Eastern District of Michigan in Cook v. Little Caesar Enterprises, Inc. found that, although not constituting common law fraud, untrue statements regarding future material facts could violate the antifraud provisions of the franchise law:

Although this court found that Counts III and VI are not actionable under the common law of Michigan because they relate to future promises, it is not prepared to grant summary judgment on the same basis in Count IV. The MFIL expressly states that “‘fraud’ and ‘deceit’ are not limited to common law fraud or deceit.” See M.C.L. § 445.1503.86

The court also held that the plain language of the MFIL refers to “any untrue statement of material fact” without regard to whether it is a misrepresentation of a past or present material fact, thereby providing another rea-

82. Id. at 1290 (citations omitted).
84. Simos v. Embassy Suites, Inc., 983 F.2d 1404, 1410 (7th Cir. 1993).
85. Id.
son for not granting summary judgment on this basis. Ultimately, the Cook court found Little Caesar was not liable because the franchise agreement’s integration clause precluded justifiable reliance. Thus, while finding that the common law standards regarding the misrepresentation element were not incorporated into the statute, the court held that the contract itself required application of the common law standard to the reliance element.

In contrast, the U.S. District Court for the District of Minnesota in Randall v. Lady of America Franchise Corporation denied the franchisor’s summary judgment motion seeking to dismiss the franchisee’s misrepresentation claims under the similar Minnesota franchise statute on the ground that justifiable reliance is not a necessary element of the claim:

Nowhere does the statute mention justifiable reliance. Of course, some kind of reliance—reasonable or unreasonable—is required, because a franchisee can only recover for damages that are caused by a franchisor’s violation of the Minnesota Franchise Act. See Minn. Stat. § 80C.17. Without reliance, there can be no causation. But a franchisee could, as a factual matter, suffer damages as a result of unreasonably relying on a franchisor’s misrepresentation.

Like California Bagel, the Randall decision does not refer to either the franchise statute’s expanded definition of “fraud and deceit” or to the securities law precedents. Randall, however, acknowledges that Minnesota’s consumer protection statutes are “clearly intended to make it easier to sue for consumer fraud than it had been to sue for fraud at common law.”

VII. Pervasive Misuse of Disclaimers and Franchise Disclosure Statutes

A consequence of judicial preference for the common law fraud framework, despite the franchise statutes’ express attempts to distinguish statutory fraud, is seen in their treatment of the disclaimers which are becoming increasingly common in franchise agreements. Disclaimers come in several flavors, from generalized integration clauses to the “franchisee questionnaire,” which requires the franchisee to individually acknowledge that he or she has
not received or relied on each of several pages of specific representations. The franchisor drafters’ intent in including such disclaimers is to preclude a finding of reasonable reliance, thus defeating a fraud claim where the franchisee has acknowledged in the contract that it was not relying on the allegedly misleading information.

In Governara v. 7-Eleven, Inc., the U.S. District Court for the Southern District of New York observed “[o]rdinarily under New York law, where a party specifically disclaims reliance upon a particular representation in a contract, that party cannot, in a subsequent action for common law fraud, claim it was fraudulently induced to enter into the contract by the very representation it has disclaimed reliance upon.” This rule, which elevates certainty of contract over recognition of and protection from wrongdoing, represents a general principle of contract law in New York.

A number of cases, all cited in California Bagel, find that a franchisee cannot state a claim for statutory fraud if the alleged misrepresentations are contradicted by representations in an integrated franchise agreement because, given the language of the agreement, the franchisee could not have justifiably relied on the contradictory extrinsic misrepresentations. Bonfield v. AAMCO Transmissions, Inc., one of the few franchise cases to look to securities law decisions, finds this Rule in Seventh Circuit cases under Rule 10b-5. The case it relies on, however, Flamm v. Eberstadt, makes clear that justifiable reliance is not an element of a claim under Rule 10b-5 and instead depends on analyzing materiality and causation in relation to the misrepresentations. Although California Bagel requires common law fraud reliance, the cases it cites, like Cook, not only require reliance, but also preclude reliance as a matter of law based on the presence of an integrated agreement.

A countervailing and persuasive approach, however, rejects this caveat emptor Rule as inapplicable under the franchise statutes. The basis for this

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93. As the court notes, “[r]efusing to enforce nonreliance disclaimers would violate the sanctity of contracts and discourage their use.” Id. at *7.
94. See e.g., Cohen v. Wedbush, Noble, Cooke, Inc., 841 F.2d 282, 287 (9th Cir. 1988), overruled on other grounds by Ticknor v. Choice Hotels Int’l, Inc., 265 F.3d 931 (9th Cir. 2001) (“Although there is not complete uniformity on this issue, the traditional and, we believe, the better Rule is that reliance on a misrepresentation is not reasonable when the plaintiff could have, through the exercise of reasonable diligence, ascertained the truth of the matter. Requiring reasonable investigation by the party claiming fraud is particularly appropriate in cases where, as here, the explicit language of the contract directly contradicts the alleged misrepresentation.” Id., citations omitted). See also Cottman Transmission Sys., LLC v. Kershner, 536 F. Supp. 2d 543 (E.D. Pa. 2008); A Love of Food I, LLC v. Maoz Vegetarian USA, Inc., 70 F. Supp. 3d 376 (D.D.C. 2014).
97. 814 F.2d 1169 (7th Cir. 1987).
98. Id. at 1173.
approach is that the anti-waiver provisions in the franchise statutes in conjunction with their antifraud provisions prohibit a franchisor from using a contractual disclaimer to immunize itself from statutory fraud claims. In *Emfore Corp., v. Blimpie Associates, Ltd.*, 99 a New York appellate court found that requiring a franchisee to execute a questionnaire “concerning information supplied to it by [the franchisor] is not violative of” New York’s franchise law and indeed may help the franchisor “root out dishonest sales personnel and avoid sales secured by fraud.” 100 Nonetheless, the franchisee’s answers to the questionnaire cannot be construed “as a waiver of fraud claims. Such waivers are barred by the Franchise Act.” 101

Other courts have recognized that disclaimers in franchise agreements can be intended to circumvent the protections intended by the statutes. In *Martrano v. Quizno’s*, the U.S. District Court for the Western District of Pennsylvania denied Quizno’s motion to dismiss certain fraud claims on the basis of its franchisee questionnaire in which the franchisees disclaimed reliance on numerous extraneous contractual statements. The court, addressing the questionnaire, stated:

> [T]his Court cannot let Defendants’ invocation of the disclaimer, and particularly Defendants’ emphasis on the apparent opportunity to identify other statements relied upon, pass without commenting on the deceptive nature thereof. If, as has been alleged, Quizno’s pursued a policy of requiring all franchisees to write “none” in the blank ostensibly provided for identification of statements relied upon, then the inclusion of a blank to be filled in by the franchisee in lieu of a pre-printed provision amounts to a sham, whose apparent purpose is to mislead a subsequent reviewer, such as this Court, into believing that Quizno’s unilaterally prescribed disclaimer language was actually authored without constraint by the franchisees. 102

Even without considering these contractual provisions’ potential for enabling systemic fraud, other courts have found that franchise statutes’ anti-waiver provisions are a sufficient ground for denying motions for dismissal or summary judgment regarding statutory fraud claims against franchisors. 103 In *Coraud LLC v. Kidville Franchise Co., LLC*, 104 another case from the U.S. District Court for the Southern District of New York, the court acknowledged the differences between common law and statutory fraud, finding that the franchise agreement’s disclaimers supported dismissal of the common law fraud claim. However, disagreeing with *Governara*, the court held that the anti-waiver clause of the statute’s antifraud provision means

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100. Id.
101. Id.
that a franchisee cannot waive the franchisor’s compliance with the antifraud provision. Indeed, pointing out that New York’s franchise law “was modeled after the federal securities laws,” the court adopted securities law precedent, holding: “[t]he Court finds the First Circuit’s reasoning equally applicable here. Just as Section 29(a) [of the Exchange Act] forecloses anticipatory waivers of compliance with the duties imposed by Rule 10b–5, so too Section 687 (4) bars anticipatory waivers of compliance with the NYSFA’s antifraud provisions.” 105 Finally, the court concluded that if the disclaimer were given the effect requested by the franchisor in the motion to dismiss, it would accomplish what the New York law “aims to prevent, namely, freedom from compliance with the NYSFA’s antifraud provision.” 106

Permitting fraudulent sales practices to prevail through the inclusion of franchisor-drafted disclaimers defeats the statutory intent and exposes potential franchisees to the very abuses the franchise laws were expressly adopted to combat. One court long ago addressed the issue of verbal misrepresentations by franchise salesmen as follows:

It is human nature to use a variety of sales techniques to sell a product. The amount of possible profit, sales projections, break-even amounts and the like are of compelling importance to prospective franchisees. They need to know if this venture is going to be profitable. The first person they turn to is the salesman. Frequently, salesmen believe they are not making an earnings claim if it is not “direct.” Some may feel it can later be denied and “it’s only one person’s word against another.” There are too many persons seeking franchises at different times and under different circumstances for them all to be lying. Their testimony was, in the main, credible and direct and as specific as it could be, given the many intervening years. Although the principals and salesmen denied any such representations, there was no independent system in place to determine if the salesmen would succumb to pressure to sell and make earnings claims in spite of being told they were unauthorized and illegal. 107

Franchisors, rather than prospective franchisees who are encouraged to trust the salesmen and who are intended to be protected by the franchise disclosure statutes, should police their salesmen for misrepresentations in the sale of franchises. Many franchisors utilize inspectors and secret shoppers to police their franchisees for compliance with myriad provisions, and at least one court has commented on a franchisor’s failure to monitor the conduct of its franchise salesmen. 108

105. Id. at 622 (internal citation and quotation marks omitted).
106. Id. at 621; see also Seeger v. Odell, 115 P.2d 977 (Cal. 1941); Restatement 2d Torts § 525; 37 Am. Jur. 2d Fraud and Deceit § 23.
108. Id.; see also FTC v. Minuteman Press, 53 F. Supp. 2d 248 (E.D.N.Y 1998);
VIII. Conclusion

Fraud and artifice are as old, if not older, than mankind’s first writings. Herodotus, commenting on Homer’s *Iliad*, wrote of the trickery of the cunning Odysseus who fooled the Trojans into bringing the apparent gift of a giant wooden horse through the gates of Troy. Of course the horse contained Greek soldiers who later slipped out and opened the gates for the besieging Greek army. Likely for just as long, legislators have sought to prescribe fraud in various settings, including franchise disclosure laws. Twelve states have adopted statutes that broadly prohibit the use of fraudulent and misleading practices in the sale of franchises beyond the confines of common law fraud. The antifraud provisions of the franchise disclosure statutes were intentionally modeled on the much older mail fraud and securities fraud statutes, which have in turn been consistently interpreted as defining statutory fraud significantly more broadly than common law fraud. Statutory mail and securities fraud differ from common law fraud in two related ways. They encompass a broader class of behavior, and they are intentionally easier to prove. Misstatements regarding future performance, rather than only past or present material facts, may be actionable; reliance on the misstatements need not be reasonable or justified; and the causation element may be satisfied even if the misstatement is not the sole cause of the damage.

Beginning with the initial decisions, and continuing to date, too many courts have incorrectly grafted common law fraud elements onto statutory fraud under the franchise disclosure laws. Such decisions ignore express statutory language setting out the differences from the common law and ignore decades of decisions under the parallel anti-fraud statutes proscribing misconduct from mail fraud and securities fraud to unfair and deceptive acts and practices under the FTC Act. Misrepresentations and material omissions in the offer and sale of franchises are proscribed and illegal under the statutes. Even without anti-waiver provisions, franchisors should not be able to draft their way out of liability with fine print, disclaimers, and questionnaires provided to franchisees for acknowledgment. Of course, most franchise disclosure statutes contain anti-waiver provisions, and franchisors should accordingly not be able to avoid compliance with or liability under the statutes, including due to transgressions by their franchise salespersons.

None of the franchise disclosure statutes require reasonable reliance by a franchisee for recovery. Instead, only causation or actual reliance is specified, and the antecedent statutes have been construed to require even less. When an investor is defrauded in a securities fraud, the investor usually loses only that investment. When franchisees are defrauded, in addition to their initial investment, they often face long-term leases of real estate and equipment; ongoing cash flow shortages; and loan obligations, often threatening the loss of the livelihood they counted on the franchise business to provide. Given the magnitude of a franchise investment, franchisees as a protected
class deserve to have the franchise disclosure laws enforced as they were written. Franchise investment laws, like so many other statutes, were enacted to supplement common law fraud that was perceived as an inadequate response to many types of human chicanery. Thucydides would agree with the study of the historical precedents to inform future decisions.
The Wheels on the Bus: Is There Protection for the Franchise Operating System?

Cheryl L. Mullin and Sophilia H. Wu

A business format franchise is a license to use the franchisor’s intellectual property (i.e., trademarks and copyrights); trade secrets (e.g., recipes); and, in some instances, patentable inventions or business processes. It is also a license to use the franchisor’s operating system, i.e., access to supplier relationships; industrial design; operating procedures; processes; and marketing strategies that maximize operating efficiencies, attract customers, and drive sales. While intellectual property laws serve to protect the franchisor’s intellectual property, the franchisor’s operating system assets, which are as utilitarian as the wheels on the bus, often lie outside the protections of intellectual property law. This article analyzes the scope and limitations of intellectual property law protection as it applies to the franchise operating system and examines the role that contract law may play in enhancing protection.

I. Statutory and Common Law Intellectual Property Protection

At one end of the spectrum, trademark laws promote competition by protecting trademarks and other source identifiers, including distinctive trade dress, and copyright laws protect original works of authorship in a fixed tangible medium of expression. At the other end of the spectrum, patent laws promote new invention by providing a temporary monopoly over novel; useful; and non-obvious inventions, including some types of business methods; and trade secret laws protect qualifying “trade secret” information. We discuss, in turn, each of these laws and the protections they afford to a franchise system.

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A. Trademarks

Trademark laws protect the franchisor’s trademarks from infringing use. The Lanham Act defines the term “trademark” as any word, name, symbol, or device, or any combination thereof, which includes both traditional trademarks such as logos and slogans as well as nontraditional trademarks such as shapes (Coca-Cola bottle), sounds (NBC’s three chimes), fragrances (plumeria blossoms on sewing thread), and colors (green-gold pads for use with dry cleaning). A trademark owner has exclusive rights to its trademark and can enforce its rights against third parties that use similar trademarks that are likely to cause confusion as to the source of goods or services in the marketplace. To succeed on a claim for trademark infringement, a trademark owner must prove: (1) that it has a valid and legally protectable mark, (2) that it owns the trademark, and (3) the third party’s use of the trademark causes likelihood of confusion. Trademark enforcement rights are expanded once a mark has become “famous,” in that Section 43(c) of the Lanham Act prohibits another person from using the famous mark in a way that dilutes or tarnishes the distinctive quality of the mark.4

B. Trade Dress

Trademark law also can protect distinctive trade dress elements in a franchise system. Trade dress is the “total image” of a product or service and “may include features such as size, shape, color or color combinations, texture, graphics, or even particular sales techniques.” As the Supreme Court stated in *Qualitex Co. v. Jacobson Products Company*, “almost anything at all that is capable of carrying meaning” may be used as a “symbol” or “device” that constitutes trade dress under the Lanham Act. In the franchise sector, there are countless examples of protection afforded to distinctive building elements, such as McDonald’s Golden Arches, Pizza Hut’s rooftop, and others.

4. 15 U.S.C. § 1125(c); see, e.g., Hormel Foods Corp. v. Jim Henson Prods., Inc., 73 F.3d 497, 507 (2d Cir. 1996) (“[t]he sine qua non of tarnishment is a finding that plaintiff’s mark will suffer negative associations through defendant’s use”).
6. See *Two Pesos, Inc. v. Taco Cabana, Inc.*, 505 U.S. 763, 764 n.1 (1992). See also *Original Appalachian Artworks, Inc. v. Toy Loft, Inc.*, 684 F.2d 821 (11th Cir. 1982), involving the sale of soft-sculpture dolls through a marketing technique comprised of adoption procedures and a birth certificate. There, the Eleventh Circuit held that the adoption procedure qualified as protectable trade dress because it was part of the dolls’ “packaging,” “both in the sense that dolls are never sold without the adoption papers and birth certificate and because the adoption procedure is designed to make [the plaintiff’s] dolls distinctive in the marketplace.”). *Id.* at 831.
8. TMEP § 1202.02 (Oct. 2015).
IHOP’s blue roof, and even Apple’s minimalist retail store design. Floor cleaning franchisor, Stanley Steemer, claims trademark protection in the color of its van. Mobile ice cream franchisor, Mister Softee, claims trademark protection in its famous jingle.

To qualify as protectable trade dress, the trade dress must be distinctive. Like a trademark, it may be inherently distinctive or may acquire distinctiveness. It must also be nonfunctional. If the trade dress is not registered on the Principal Register of the U.S. Patent and Trademark Office, the person seeking trade dress protection bears the burden of proving that the trade dress is nonfunctional. If there is no registration, or if the plaintiff has only a Supplemental Register registration, the burden is on the plaintiff to prove that the trade dress is nonfunctional. A plaintiff who brings a trade dress infringement act has the burden to prove the following: “(1) the defendant’s product is confusingly similar to its product; (2) the similar features of the two products are primarily nonfunctional; and (3) the plaintiff’s product is distinctive.”

The first form of trade dress functionality (sometimes referred to as traditional functionality) says that a feature is functional if “it is essential to

9. See, e.g., Villa Enters. Mgmt. LTD. v. Fed. Ins. Co., 821 A.2d 1174 (N.J. 2002) (symbols like McDonald’s Golden Arches are trademark protected); McDonald’s Golden Arch Design, Registration No. 0893440; Pizza Hut Stylized Roof Design, Registration No. 3595346; Design and Layout of Apple Retail Store, Registration No. 1060320; IHOP Corp. v. Langley, 2008 U.S. Dist. LEXIS 112056, at *4 (E.D.N.C. Apr. 11, 2008) (fact that defendant repainted the roof of his breakfast restaurant “in the same shade of blue as is common to see on the roofs of IHOP restaurants” contributed to a finding of likelihood of confusion).

10. The color yellow-orange, which is the approximate equivalent of Pantone Matching System 143C, Registration No. 3182240.

11. Musical jingle, Registration No. 2218017.

12. Wal-Mart Stores, Inc. v. Samara Bros., Inc., 529 U.S. 205, 210 (2000) (“Although the text of Section 43(a) does not explicitly require a producer to show that its trade dress is distinctive, courts have universally imposed that requirement, since without distinctiveness the trade dress would not ‘cause confusion as to the origin, sponsorship, or approval of the goods.’”); Two Pesos, Inc. v. Taco Cabana, Inc., 505 U.S. 763 (U.S. 1992) (holding trade dress of a business may be protected under § 43(a) of the Lanham Act, based on a finding of inherent distinctiveness, without proof that the trade dress has secondary meaning); Miller’s Ale House, Inc. v. Boynton Carolina Ale House, LLC, 702 F.3d 1312, 1322 (11th Cir. 2012) (“Other trade dress, though not inherently distinctive, can become distinctive if it acquires "secondary meaning, which occurs when, in the minds of the public, the primary significance of [trade dress] is to identify the source of the product rather than the product itself” (quoting Wal-Mart Stores, Inc., 529 U.S. at 210)).

13. 15 U.S.C. § 1052(f) (prohibiting trademark registration for marks that are functional); 15 U.S.C. § 1115(b)(9) (adding to the defenses of incontestability allegations that a trademark has become functional). See also TrafFix Devices, Inc. v. Mkgt. Displays, Inc., 532 U.S. 23, 29 (2001) (holding trade dress protection may not be claimed for product features that are functional). See also Dippin’ Dots, Inc. v. Frosty Bites Distrib., LLC, 369 F.3d 1197 (11th Cir. 2004) (“Functional features are by definition those likely to be shared by different producers of the same product and therefore are unlikely to identify a particular producer.”).


15. Vuitton et Fils S.A. v. J. Young Enters., Inc., 644 F.2d 769 (9th Cir. 1981) (holding that if plaintiff has a federally registered trademark or design feature, the burden of proof on functionality shifts to the defendant).

The use or purpose of the article or it affects the cost or quality of the article.”17 The second form of trade dress functionality (sometimes referred to as competitive functionality) says a feature is functional if the “exclusive use of [the feature] would put competitors at a significant non-reputation-related disadvantage.”18 In *Abercrombie & Fitch Stores, Inc. v. American Eagle Outfitters, Inc.*, the Sixth Circuit explained the two most common methods for determining functionality under the competitive functionality test:

“The test for ‘comparable alternatives’ asks whether trade-dress protection of certain features would nevertheless leave a variety of comparable alternative features that competitors may use to compete in the market. If such alternatives do not exist, the feature is functional; but if such alternatives do exist, then the feature is not functional.” Wong, 83 CORNELL L. REV. at 1144–45 (noting that “the comparable alternatives requirement may necessitate more than the mere existence of one alternative, and may instead require a number of alternatives from which competitors may choose” (footnotes omitted). “The ‘effective competition’ test asks . . . whether trade dress protection for a product’s feature would hinder the ability of another manufacturer to compete effectively in the market for the product. If such hindrance is probable, then the feature is functional and unsuitable for protection. If the feature is not a likely impediment to market competition, then the feature is nonfunctional and may receive trademark protection. *Id.* at 1146.19

Determining the functionality of a product feature (as opposed to product or service trade dress), while not a bright line test, is fairly straightforward. In an oft-cited case involving the product design of the ice cream product known as “dippin’ dots,” for example, the Eleventh Circuit held each element of the product’s design (i.e., size, color, and shape) to be functional: the color is functional because it indicates the flavor of the ice cream (for example, pink signifies strawberry, white signifies vanilla, brown signifies chocolate);20 size is functional because it contributes to the product’s creamy taste, which would be different in a larger “dot”21; and shape is functional because “dripping the ice cream composition in the freezing chamber creates a ‘bead’ that facilitates the product’s free flowing nature.”22

Determining the functionality of product or service trade dress is not so straightforward. This is because trade dress often includes functional features that by themselves are functional, but which in combination with each other may be protectable. To further complicate the analysis, as stated by the Fifth Circuit, “a particular arbitrary combination of functional features, the combination of which is not itself functional, properly enjoys protection.”23 In other words, a competitor can use elements of another’s trade dress, but the owner can protect a combination of visual elements that, taken together, may create

18. *Id.* at 165.
20. *Id.* at 1204.
21. *Id.* at 1206.
22. *Id.*
a distinctive visual impression. Functionality in the franchising context, however, can be summarized according to four general guidance principles.

1. Trademark Law Will Not Protect a Method or Style of Doing Business

   In *Denton v. Mr. Swiss of Missouri, Inc.*, an early case involving the franchisor of fast food stores serving primarily soft ice cream and sandwiches, the district court enjoined a former licensee from using the franchisor’s trademarks and “standardized system,” defined as the “distinctive store design.” The Eighth Circuit, on appeal, reversed the district court’s order. Citing 1 J. McCarthy, *Trademarks and Unfair Competition* and the cases cited therein for the proposition that “a franchisor has no protectable interest in the mere method and style of doing business,” the Eighth Circuit remanded the case to the district court to determine, among other things, the protectability of the franchisor’s store design.

2. Trademark Law Will Not Protect the “Core Concept” of a Business

   Almost ten years after the *Denton* decision, the Eight Circuit had an opportunity to revisit the issue of trade dress functionality, this time relating to a restaurant concept. In *Prufrock Ltd., Inc. v. Lasater* which involved the trade dress utilized by the BLACK-EYED PEA and DIXIE HOUSE restaurant chains, the district court enjoined the defendants, which operated several BLACK-EYED PEA restaurants under licensing agreements with Prufrock and which had opened a third restaurant featuring a full service country cooking concept, from operating any restaurant, other than its existing BLACK-EYED PEA restaurants, using Prufrock’s “distinctive” trade dress or any trade dress confusingly similar to Prufrock’s. The district court defined Prufrock’s trade dress as follows:

   [A] full-service restaurant, serving down home country cooking, in a relaxed and informal atmosphere, with a full-service bar, and which employs all or any of the following items:

   (a) church pews or church pew replica booth seating;
   (b) small print wallpaper;
   (c) antique or antique replica wooden drop leaf tables;
   (d) exposed kitchen area;
   (e) large open dining room with booths on sidewalls;
   (f) antique or antique replica light fixtures;
   (g) antique or antique replica bar; and
   (h) country wall décor including old or antique kitchen implements, small farm implements, photographs, quilts and the like.

24. *Id.*
25. 564 F.2d 236, 1977 (8th Cir. 1977).
26. *Id.* at 237.
28. *Denton v. Mr. Swiss of Mo., Inc.*, 564 F.2d 236, 243 (8th Cir. 1977).
29. 781 F.2d 129 (8th Cir. 1986).
On appeal, the Eighth Circuit held that the district court’s protection of Prufrock’s “core concept” (i.e., “a full-service restaurant, serving down home country cooking, in a relaxed and informal atmosphere, with a full-service bar”) was in error. The court reiterated that “a franchisor does not have a business interest capable of protection in the mere method and style of doing business” and then proceeded to analyze the eight listed decor elements to determine whether they, by themselves or in combination, were protectable under Section 43(a) of the Lanham Act. After carefully reviewing the entire record, the Eighth Circuit reversed the district court’s holding and held that all of the evidence presented described a functional trade dress, supported in part by the following evidence:

Mr. Richardson, Prufrock’s Vice President of Systems and Services, testified on direct examination for Prufrock that the sole reason Prufrock uses the various appointments and décor items is to “enhance our down home country look” and to “give the customer that country feel.” Mr. Richardson testified that Prufrock used the exposed kitchen to entertain the customer as well as to show the customer the high quality of Prufrock’s food preparation. According to Mr. Richardson, the large open dining area serves the purpose of allowing the customers to see the activity of the restaurant. Indeed, Prufrock states in its brief that all of the trade dress elements were chosen to portray the down home country look to Prufrock’s customers.

As [the defendant] states in its brief, “it would be difficult to invent evidence more supportive of a finding that décor items were selected for and serve a functional purpose. They have a “clear commercial appeal.” The district court’s finding that Prufrock’s trade dress is distinctive has no support in the record and thus we find it to be clearly erroneous.

The consumer demand for the concept of “down home country cooking” includes the demand for the trade dress that creates the concept. [The defendant] and others would be severely handicapped in their ability to compete with Prufrock in the field of country cooking if they were prohibited from using any or all Prufrock’s trade dress. The [test] for nonfunctionality does not permit Prufrock to protect the trade dress which creates the informal country dining concept and which is an “important ingredient in the commercial success of the concept.”

Another case illustrating the functionality of “core concept” trade dress is *Taj Mahal Enterprises v. Trump.* There, the owners of an Indian-themed restaurant called the “TAJ MAHAL” sued the owners of the “TRUMP TAJ MAHAL,” an upscale Indian-themed casino and hotel facility in the U.S. District Court for the District of New Jersey. On motion for summary judgment, the district court refused to extend trade dress protection to the plaintiff’s Indian-themed trade dress (described as “an Indian motif, images of the eponymous Indian mausoleum, the name TAJ MAHAL set out in stylized print on signs, napkins and menus, and images of minarets”), characterizing them as “functional”:

30. *Id.* at 131–32.
31. *Id.* at 134.
33. *Id.* at 252.
In addition, much of plaintiff’s trade dress appears to be functional. To create a demand for Indian cuisine and culture, it follows that a business’s trade dress should engender images and impressions of things Indian. Accordingly, elements of a trade dress which relate to the concept or theme of a restaurant are functional as they enhance consumer demand for the restaurant’s food. . . . In this regard, we must be concerned with placing limitations on the alternative ways to communicate and promote general themes and concepts. “Any element of a restaurant’s trade dress that advances the concept cannot be protected because those elements are related to the consumer demand for the concept.”

3. Trademark Law Will Protect the Look and Feel of Business, As Distinguished from Its Core Concept, But the Elements Must Be Distinctive and Nonfunctional

In the 2011 decision, *Pure Power Boot Camp, Inc. v. Warrior Fitness Boot Camp, LLC*, the U.S. District Court for the Southern District of New York extended trade dress protection to the “military-theme” of a fitness facility, thereby distinguishing “theme” or “trade dress” from “core concept.” There, the defendants (while still employed by Pure Power) began planning their own military-themed gym—Warrior Fitness Boot Camp—which also featured a military theme. They also took Pure Power’s client list and used it to recruit clients. Pure Power sued, among other things, for trade dress infringement. At trial, Pure Power attempted to expand the description of its trade dress to include elements listed in its business plan, such as the size of fitness classes, programs, corporate team-building, and a description of consumer markets. The court characterized this attempt as “inappropriate” and reiterated that trade dress law does not “protect an idea, a concept, or a generalized type of appearance.” According to the court, the “general idea or concept of a fixed indoor obstacle course . . . is not protectable as trade dress. Rather, it is the particular ‘look and feel’ of Pure Power’s facility that is protectable as trade dress.”

The court concluded, however, that the aesthetics of the facility, including its military theme, were entitled to trade dress protection:

The “essence” of this “look and feel” . . . is a fixed indoor obstacle/confidence course, surrounded by a running track in which the floor of the obstacle course is covered in crushed shredded rubber tire material to simulate dirt, with obstacles, including military hurdles arranged in ascending order, a low crawl apparatus, scaling walls of different heights, monkey bars, a traverse wall, a rope climb, parallel or dip bars, a rope swing over a water pit, a tire run, a cargo net climb, and rolling logs used in a “belly robber,” coupled with special design features inspired by the United States Marine Corps, including green camouflage netting hanging from the ceiling, changing rooms that are World War II tents, flooring that is bordered by military-looking sandbags, eleven standing pillars stenciled with principles of leadership derived from the Marine Corps, and a life-size statue of a

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34. *Id.*
36. *Id.* at 539.
37. *Id.*
screaming marine carrying a machine gun. It is this combination of elements that defines Pure Power’s protectable trade dress, as it is this combination that a customer observes upon entering the Pure Power facility.\textsuperscript{38}

Perhaps outcome determinative in this case was that the military-themed trade dress had been registered on the Principal Register of the U.S. Patent and Trademark Office, as follows:

Word Mark: DESIRE COURAGE\textsuperscript{39}

Description of Mark:

COLOR IS NOT CLAIMED AS A FEATURE OF THE MARK. THE MARK CONSISTS OF A DRAWING OF AN EXERCISE FACILITY, STYLED TO LOOK LIKE A MILITARY BOOT CAMP TRAINING COURSE COMPRISED OF CAMOUFLAGE WALL AND CEILING DÉCOR, CRUSHED RUBBER FLOORING, A TIRE RUN, CLIMBING WALLS, CLIMBING NETS, AND HURDLES, WITH THE TERMS “DESIRE,” “STRE,” “COURAGE,” “UTY,” AND “UTY.”

In 2012, however, the Eleventh Circuit denied trade dress protection to a restaurant chain on grounds that it lacked distinctiveness. In \textit{Miller’s Ale House, Inc. v. Boynton Carolina Ale House, LLC},\textsuperscript{40} the plaintiff restaurant chain sued a licensee of a competing restaurant chain for infringement of its floor plan copyrights and unregistered trade dress. The Eleventh Circuit affirmed the district court’s grant of summary judgment on grounds that there were no protectable trade dress, stating:

We find nothing particularly unique in a restaurant fixing its name in red letters on the outside of its building and on its menu, branding items it sells with that name, dressing its staff in khakis and a polo shirt, featuring a center bar with a soffit, offering seating at “high top” tables, and paneling its walls with wood. These are the prototypical features—what we might call the “common . . . design,” \textsuperscript{41} of a standard sports bar or brew pub. The particular name affixed on the wall and to menu items, the specific color of the polo shirts, the type of wood on the walls, the placement of the “high-top” tables, and the openness of the kitchen, “even if they are in combination and could be deemed unique,” \textsuperscript{41} are all “mere refinement[s]” of this “commonly adopted and well-known form of ornamentation” \textsuperscript{41}.

Even distinctive trade dress, however, will be denied protection if the trade dress is determined to be “functional.” In \textit{Abercrombie & Fitch Stores, Inc. v. American Eagle Outfitters, Inc.},\textsuperscript{42} Abercrombie & Fitch (A&F) sued American Eagle Outfitters to stop American Eagle from infringing what A&F described as its unregistered trade dress, i.e., designs of certain articles of clothing, in-store advertising displays, and a catalog. The district court granted summary judgment in favor of American Eagle on grounds that

\textsuperscript{38} Id.

\textsuperscript{39} DESIRE COURAGE, Registration No. 3580542.

\textsuperscript{40} 702 F.3d 1312, 1324 (11th Cir. 2012).

\textsuperscript{41} Id. at 1324.

\textsuperscript{42} 280 F.3d 619 (6th Cir. 2002).
A&F sought protection of its marketing theme. The Sixth Circuit reversed the order, holding that A&F properly sought protection of trade dress elements (not its marketing theme), but further held that most of the elements for which A&F sought protection (i.e., use of the words “performance,” “authentic,” “genuine brand,” “trademark,” and “since 1892,” alone and in combination with “primary color combinations in connection with solid, plaid and stripe designs” and made from “all natural cotton, wool, and twill fabrics” as well as its in-store designs and use of college students as sales associates) were functional and thus not entitled to trade dress protection.  

The court analyzed A&F’s clothing features and concluded that “[t]here can be no dispute that preventing other producers from combining these design elements in the way A&F does would prevent them from competing effective in the market for casual clothing aimed at young people.” The court reached the same conclusion with respect to A&F’s claim of trade dress in its in-store display setups and use of college students as sales associates, holding that “[f]orbid ing clothiers to use college students to sell garments to or for college-age people indubitably prevents them from effectively competing in the market for casual clothing directed at young people.”

4. Trademark Law May Protect Marketing Themes and Sales Techniques That Directly Relate to the Product If Infringement Is Likely to Cause Consumer Confusion

Generally, a marketing theme or technique will not qualify for trade dress protection where copying does not result in consumer confusion. This is best illustrated by *Haagen-Daz, Inc. v. Frusen Gladje, Ltd.* where the plaintiff ice cream manufacturer sued to enjoin a competitor from using a similar Scandinavian marketing theme on its own ice cream product packaging. In denying the motion, the court held that the “[product] containers, as well as their trade dress, were clearly distinguishable and would appear so to all but the most obtuse consumer” and characterized the action as being “grounded in plaintiff’s failure to appreciate the difference between an attempt to trade off the goodwill of another and the legitimate imitation of an admittedly effective marketing technique.”

In a 1982 decision, *Original Appalachian Artworks, Inc. v. Toy Loft, Inc.*, the Eleventh Circuit extended trade dress protection to an adoption procedure for soft-sculpture dolls that included providing a birth certificate and “official adoption papers.” There, the defendant, after seeing the OAA’s dolls on display, copied both the dolls and OAA’s adoption procedures.

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43. *Id.* at 648.
44. *Id.* at 644.
45. *Id.*
47. *Id.* at 75.
48. *Id.*
49. *Original Appalachia Artworks, Inc. v. Toy Loft, 684 F.2d 821 (11th Cir. 1982).*
OAA sued for copyright and trade dress infringement and unfair competition. After a bench trial, the district court found, among other things, that the defendants had infringed on OAA’s copyright for the dolls and on OAA’s distinctive trade dress and thus had committed unfair competition. The Eleventh Circuit affirmed. With respect to the trade dress infringement claim, the Eleventh Circuit recognized that OAA’s adoption procedure was “truly part of the ‘packaging’ of OAA’s product both in the sense that dolls are never sold without the adoption papers and birth certificate and because the adoption procedure is designed to make OAA’s dolls distinctive in the marketplace.”

Relying on prior court decisions, which recognized that an unfair competition claim can extend to marketing techniques, the Eleventh Circuit concluded that the adoption procedures used by OAA in the sale of its dolls qualified as protectable trade dress.

In 1995, in Philip Morris Inc. v. Star Tobacco Corp., the U.S. District Court for the Southern District of New York extended trade dress protection to Philip Morris’s western marketing theme for its MARLBORO brand of cigarettes. The brand was marketed through advertising the featured cowboys in the American West since 1964, which respectively came to be known as the “Marlboro Man” and “Marlboro Country.” Phillip Morris sued its competitor, Star Tobacco Corp., which had begun marketing “GUNSMOKE” cigarettes in packs featuring an image of a cowboy holding a rifle in his right hand and his left hand resting upon a holstered pistol. The competitor’s packaging also featured the words “Western blend,” and its display advertisements featured the phrase “New Man in Town” next to the cowboy figure. One trade magazine advertisement used the phrase “Welcome to Gunsmoke Country.”

The district court found the Marlboro Country trade dress inherently distinctive, calling the juxtaposition of the product and setting arbitrary and possibly fanciful. Star conceded that the Marlboro Country theme was distinctive, but argued that there was no likelihood of confusion between it and the GUNSMOKE trade dress and advertising materials. Star argued that the differences were so vast that the only common point is the Western motif, which is so diffuse that it is not protectable. The court disagreed, characterizing Star’s argument as being “more rhetoric than substance” because the

50. Id. at 831.
53. Id. at 383.
54. Id. at 382.
55. Id.
56. Id. at 383.
57. Id.
Marlboro Country trade dress consisted of “specific manifestations of a Western motif: the picture of a cowboy on a cigarette pack; figures of cowboys who have come over time to be known as the “Marlboro Man”; and those evocative stretches of the Western landscape, not to be found on any map or ordnance survey, called “Marlboro Country.” Ultimately, the court concluded there was likelihood of confusion and granted Philip Morris’s motion for a preliminary injunction.

C. Copyright

Copyright protection may protect certain elements of a franchise system, such as the design portion of logos, design and content of the franchisor’s website and marketing materials, and even the architectural designs of rooflines and buildings. It protects “original works of authorship” that are fixed in any tangible medium of expression. Because a copyright is secured when it is in a fixed tangible medium of expression for the first time, registration is not required to secure protection. However, in order to file a copyright infringement lawsuit, the copyright must be registered. Copyright protection does not extend to ideas, and like trade dress, copyright does not protect functional elements.

Generally, copyright owners enjoy the exclusive rights to the registered work, including the right to do or authorize the following: (1) reproduce the copyrighted work; (2) prepare derivative works based on the copyrighted work; (3) distribute copies of the copyrighted work; and (4) for particular works, perform the copyrighted work in public. Copyright infringement is established by proving two elements: “(1) ownership of a valid copyright, and (2) copying of constituent elements of the work that are original.” However, not all copying constitutes infringement; the copied material must be copyrightable and the similarities between the works must be substantial from the point of view of the lay observer. If there is no direct proof of copying, “the plaintiff may show copying by demonstrating that

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58. Id. at 385.
59. Id. at 389.
62. 17 U.S.C. § 102(b) (1990). See, e.g., Ale House Mgmt. v. Raleigh Ale House, Inc., 205 F.3d 137, 143 (4th Cir. 2000) (affirming grant of summary judgment on claim that defendant copied plaintiff’s use of “an island or peninsula-shaped bar to bisect a seating area which has booths on one side and stool seating on the other” because, “at this level of generality, [plaintiff’s] design is nothing more than a concept”); Wickham v. Knoxville Int’l Energy Exposition, Inc., 739 F.2d 1094, 1097 (6th Cir. 1984) (affirming grant of summary judgment on claim that defendant infringed plaintiff’s architectural designs because “[t]he ‘idea’ of a tower structure certainly is not copyrightable”).
66. Id. at 360–61; see also Miller’s Ale House, Inc. v. Boynton Carolina Ale House, LLC, 702 F.3d 1312, 1325 (11th Cir. 2012).
the defendants had access to the copyrighted work and that the works are ‘substantially similar.’”

The medium in which the work is registered dictates the protection that is extended and the limitations of that protection. The holder of a copyright in architectural plans, for example, enjoys two types of copyright protection: protection for the constructed building design, which is protected as an architectural work; and protection for the architectural plans, drawings, or models, which are protected as pictorial, graphic, or sculptural works, but each protection requires its own copyright application. When an architectural work is registered only as a pictorial, graphic, or sculptural work, the copyright owner can prevent only the copying of the plans themselves; it cannot prevent the construction of a building based upon the registered design.

Copyright protection for architectural works extends to “the overall form as well as the arrangement and composition of spaces and elements in the design but does not include individual standard features or design elements that are functionally required.” Protection also extends to “interior architecture,” but excludes “individual standard features,” such as “common windows, doors, and other staple building components.” The Copyright Act explains that the “the overall form as well as the arrangement and composition of spaces and elements in the design” are included in the definition of “architectural work,” which indicates that Congress was aware that “creativity in architecture frequently takes the form of a selection, coordination, or arrangement of unprotectable elements into an original, protectable whole.” Although individual standard features and architectural elements that are classified as ideas are not protected by copyright, the combination or arrangements of the elements may be protected.

67. Miller’s Ale House, Inc., 702 F.3d at 1325.
68. 17 U.S.C. § 102(a)(8) (1990) (architectural works are included in scope of copyright protection); H.R. Rep. No. 101-735, reprinted in 1990 U.S.C.C.A.N. 6950 (“An individual creating an architectural work by depicting that work in plans or drawing will have two separate copyrights, one in the architectural work (section 102(a)(8)), the other in the plans or drawings (section 102(a)(5)).”); see also T-Peg, Inc. v. Vt. Timber Works, Inc., 459 F.3d 97, 110 (1st Cir. 2006) (quoting legislative history).
69. Oravec v. Sunny Isles Luxury Ventures, L.C., 527 F.3d 1218, 1228 (11th Cir. 2008).
71. Miller’s Ale House, Inc., 702 F.3d at 1324.
74. Oravec, 527 F.3d at 1225. See also Corwin v. Walt Disney World Co., 475 F.3d 1239, 1251 (11th Cir. 2007) (“[A] work may be protected by copyright law when its otherwise unprotectable elements are arranged in a unique way.”); T-Peg, Inc., 459 F.3d at 110 (noting that combination of individual standard features in architectural work may be copyrightable); Sturdza v. U.A.E., 281 F.3d 1287, 1296 (D.C. Cir. 2002) (observing that artist’s selection, coordination, and arrangement of color may be protectable, even though color itself is not).
Copyright for architectural works, however, has been compared to that afforded for compilations and characterized as “thin.” According to the Eleventh Circuit, “[s]ubstantial similarity exists only ‘where an average lay observer would recognize the alleged copy as having been appropriated from the [protectable features of the] copyrighted work.’” Further, according to the court, “in light of the limited scope of protectable expression in an architectural plan . . . modest dissimilarities are more significant than they may be in other types of art works.”

Copyright protection for architectural works also has its limitations. If the building in which the copyrighted work is embodied is “located in” or “ordinarily visible from” a public place, the copyright in the architectural work does not include the right to prevent the making, distributing, or public display of pictorial representations of the work. Thus, the owner of the architectural copyright cannot prevent others from taking pictures or producing other pictorial representations of the building. The copyright protection of an architectural work also does not give the copyright owner control over the building owner’s actions with regard to altering or destroying the building embodied in the architectural work.

Moreover, copyright law provides only thin protection for building layout and design. In Miller’s Ale House, discussed above, the plaintiff restaurant chain, which held copyrights for five different floor plans used in various locations, asserted claims of copyright infringement based on the defendant’s incorporation of “a rectangular bar at the center of the restaurant, booth seating to the left of the bar, high-top tables to the right of the bar, a kitchen and freezer area in back-right, and restrooms in the back-left.” The district court granted summary judgment on this claim after concluding that no reasonable jury, limiting its consideration to the arrangement of standard features, could find the defendant’s floor plan substantially similar to the plaintiff’s copyrighted floor plan. The Eleventh Circuit agreed, quoting the district court’s analysis:

Although both plans contain centrally located bars, for instance, the bars are in different locations relative to each restaurant’s entryway; [plaintiff’s] central bar is on the right while [defendant’s] is slightly to the left. Much of the interior seating is marked dissimilar; [plaintiff] has several columns of booth seating to the left of the entryway while [defendant] interposes a single column of tables between its booths. [Defendant] has divided its bathroom entrances from the dining area with a solid wall and [plaintiff] has not. The arrangement of the pool tables and video games inside each restaurant is distinct; [plaintiff] places its pool tables in a column between its tables, while [defendant] separates its pool tables from the

75. Miller’s Ale House, Inc., 702 F.3d at 1326.
76. Id.
77. Id.
80. Miller’s Ale House, Inc., 702 F.3d at 1312.
81. Id. at 1326.
diners and lines its video games along a wall. The outdoor areas are dramatically different; [defendant] has a separate outside corner bar and outside seating that hugs the corner of the building, and [plaintiff]’s floor plan does not specify any outdoor seating at all. 82

Although the plaintiff characterized these differences as “minor,” because of the thin protection rendered to architectural copyrights, these modest differences were held to be so significant that the court concluded that no reasonable, properly instructed jury could find the works substantially similar, and the Eleventh Circuit affirmed the grant of the defendant’s motion for summary judgment. 83

D. Business Method Patents

Business method patents may provide some protection to a franchise system, but they are difficult to obtain because the business method must meet the criteria required of all patents: it must be novel, useful, and non-obvious. Prior to 1998, the business method exception prevented patentability of a business method. In 1998, the U.S. Court of Appeals for the Federal Circuit substantially liberalized the standard for granting business method patents; 84 tens of thousands of business method patent applications were filed in the following decade. 85 There was even speculation in the franchise community that patents might provide the missing form of protection for a franchise system. Patents were granted for inventions, such as a system for “upselling” at fast-food restaurants, 86 and for methods of meal assembly for a restaurant in which raw ingredients are displayed and selected by customers for preparation. 87

In recent years, however, the patent-eligibility of business methods has again been called into scrutiny. In June 2014, the Supreme Court, addressing patent eligibility of a computer-implemented method of facilitating financial transactions, affirmed traditional patent exclusions (i.e., laws of nature, natural phenomenon, and abstract ideas) and established a two-part test for distinguishing excluded subject matter from patent eligible subject matter. 88 Under this test, first, a court must determine whether claims concern one of the ineligible concepts. Second, if the claims do concern an ineligible concept, a court must determine whether the elements of the claims transform the invention into something patent eligible. Although business methods are still patentable as “processes,” the buzz surrounding business method

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82. Id. at 1326–27.
83. Id. at 1327.
patent applications as a means to protect a franchise system has quieted down significantly.

E. Trade Secret Laws

Shortly before this article went to publication, President Barack Obama signed into law the Defend Trade Secrets Act of 2016 (DTSA). Prior to the passage of the DTSA, trade secret protection was governed solely by state law, each modeled to some extent after the Uniform Trade Secrets Act, but different in material respects.89 The DTSA does not preempt state law, but creates a federal cause of action and civil remedy for misappropriation of trade secrets, which proponents hope will create a unified approach to trade secret protection. The DTSA defines “trade secret” as “information [that] derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information.”90 Trade secrets can include “all forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, program devices, formulas, designs, prototypes, methods, techniques, processes, procedures, programs, or codes.”91 Generally, a trade secret misappropriation claim is comprised of the following elements: (1) the information in dispute must qualify for trade secret protection and cannot be generally known by the relevant industry; (2) the owner of the trade secret took reasonable precautions to prevent its disclosure; and (3) the defendant wrongfully obtained access to the trade secret.92

Unlike other types of intellectual property, trade secrets are protected by secrecy, as opposed to public disclosure through the registration process. Thus, trade secret protection is quicker and potentially cheaper and easier to obtain than patent protection.93 The scope of protectable subject matter under trade secret law is much broader than that under patent law, and the duration of protection is potentially longer—the term of patent protection is fixed by statute94 whereas trade secret protection is maintained as long as secrecy is preserved. Once secrecy is lost, however, whether it be through a third party’s independent discovery or inadvertently released, trade secret protection ends.95

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90. 18 U.S.C. § 3(B) (amended 2016); see also UNIF. TRADE SECRETS ACT (amended 1985) § 1(4)(ii).
91. 18 U.S.C. § 3 (amended 2016); see also UNIF. TRADE SECRETS ACT (amended 1985) § 1(4).
93. Id.
For some businesses, trade secret protection is the most suitable type of protection for their intellectual property. For example, one of the best-kept trade secrets in the world is the complete Cola-Cola formula. Coca-Cola’s secret combination of flavoring oils and ingredients is called “Merchandise 7X.” The formula is known by only two people at any one time, and they are the two who oversee the preparation of the formula. Coca-Cola refuses to disclose the identity of the two individuals and does not allow them to fly on the same airplane at the same time. The only written record of Merchandise 7X is kept at a security vault at a bank, which can only be opened upon a resolution from the company’s Board of Directors.

In the franchise context, however, trade secret law historically has provided little benefit because most elements of a franchise system (while valuable) do not qualify as “trade secrets.” As an illustration, in Little Caesar Enterprises, Inc. v. Sioux Falls Pizza Company, Inc., the franchisor sued a former franchisee for misappropriation of trade secrets and sought a preliminary injunction. Little Caesar’s motion for preliminary injunction was denied, however, on grounds that it was not likely to succeed on the merits of its claim that its system of producing Hot-N-Ready pizza qualified as a trade secret under the meaning of the South Dakota Trade Secrets Act. The court held that Little Caesar’s offered insufficient evidence that the system was a trade secret with independent economic value and failed to establish its reasonable efforts to maintain its secrecy.

Similarly, in I Can’t Believe It’s Yogurt v. Gunn, the court held that neither the franchisor’s business procedures nor its system constituted trade secrets within the meaning of the Colorado Uniform Trade Secrets Act. According to the court, “the information claimed to constitute trade secrets is generally known or readily ascertainable...much of the information claimed as trade secrets is taught at business schools.” In addition, the franchisor failed to show that its procedures were appreciably different from other businesses’ procedures, and the franchisor had not taken steps to guard the secrecy of the information.

Although operating and marketing procedures are not likely protectable as trade secrets (mostly because they are openly obvious and therefore not secret), certain assets of a franchise system will qualify for trade secret pro-

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97. Id. at 294.
98. Id.
99. Id.
101. Id. at *34.
102. Id. at *16.
103. Id. at *23–24.
105. Id. at *58.
106. Id. at *58–59.
tection. In *KFC Corp. v. Marion-Kay Co.*, the court held that KFC’s “secret seasonings” were trade secrets.107 In *Krehl v. Baskin Robbins Ice Cream Co.*, a case involving allegations of illegal market allocation under the Sherman Act, the court noted that the “formulae and recipes for manufacturing Baskin Robbins ice cream products are highly guarded secrets, divulged only to Baskin Robbins licensed area franchisers who are bound to maintain their confidentiality.”108 In *Great Expectations Franchise Corp. v. V.L.P. Enterprises, Inc.*, the court held that a franchisor’s service software packages and its membership data constituted protectable trade secrets within the meaning of the Uniform Trade Secrets Act.109 In *Taco Cabana International v. Two Pesos, Inc.*,110 the Fifth Circuit recognized that architectural plans and kitchen layout and design drawings may be trade secrets, provided there is sufficient and continuous secrecy attached to them to preserve their status as trade secrets.111

II. Contractual Protections

Because intellectual property laws fall short of protecting the franchise system as a whole (or even significant elements of the system), franchisors turn to contract law to enhance protection and fill in the gaps. Confidentiality agreements provide some protection against disclosure of proprietary information, which may not otherwise qualify for “trade secret” protection. Covenants not to compete and non-solicitation agreements prevent former franchisees from continuing to profit from the system by continuing to operate a similar business at or near the location of the former franchised business, servicing its former customers, or both. These types of provisions are generally regarded as agreements in restraint of trade. Enforceability of these provisions varies and is beyond the scope of this article.112

A franchise agreement often contains additional restrictions, intended to supplement or supplant traditional intellectual property laws. A typical franchise agreement, for example, prohibits a former franchisee from representing itself as a “former franchisee” of the franchise system. This provision is intended to backstop traditional trademark law and prevents a former franchisee from advertising its former association with the franchise system, regardless of whether the trademark fair use defense would provide a defense to such use.

110. 932 F.2d 1113, 1123 (5th Cir. 1991).
111. Id. at 1123.
Many franchise agreements also attempt to expand the scope of trademark protection by prohibiting a franchisee’s use, not only of the franchisor’s registered trademarks, but of certain words that the franchisor determines are uncomfortably close to the franchisor’s trademarks and/or to certain elements of the system. For example, the franchise agreement may purport to prevent a franchisee’s use of any mark “similar to” the franchisor’s trademarks or of any elements of the system.

Enforceability of these provisions, however, requires careful drafting and consideration of the laws on restraint of trade, as illustrated in the recent case of One Hour Air Conditioning, Inc. v. Dallas Unique Indoor Comfort, Ltd., decided on November 13, 2015. One Hour franchises the operation of residential heating and air conditioning services businesses that operate under the name “One Hour Air Conditioning and Heating” or “One Hour Heating and Air Conditioning.” The franchisor positioned its brand around “punctuality,” as evidenced by the adoption of the “One Hour” trademark, time piece logo, and slogan “Always on Time . . . Or you Don’t Pay a Dime!” in advertising and marketing materials as well as in its telephone greeting. In 2003, One Hour entered into a franchise agreement with Dallas Unique, which had previous experience in the residential heating and air conditioning services business. During pre-sale negotiations, One Hour agreed to eliminate the post-termination covenant not to compete.

The franchise agreement, however, contained other provisions restricting the franchisee’s post-termination activities. Specifically, Section 16.6 of the Franchise Agreement (Franchisee’s Obligations on Termination or Expiration) provided that:

Franchisee shall forthwith cease to be a franchisee of Franchisor and shall immediately:

D. cease to operate the Franchised Business under the System or otherwise and thereafter not, directly or indirectly, represent to the public that such Franchised Business is operated in association with Franchisor or the System, or hold itself out as a present or former franchisee of Franchisor;

E. cease to use, directly or indirectly, in advertising or in any other manner whatever any of the Licensed Marks, any name or mark similar to any of the Licensed Marks, any other identifying characteristics or indicia of operation of the System, and any confidential standards, methods, procedures and specifications associated with the System.

In the initial complaint, One Hour asserted claims of trademark infringement and breach of contract. The trademark infringement claims were voluntary dismissed before trial, and the breach of contract claims were the subject of a three-day bench trial. At issue was whether the former franchisee’s

114. Id. at *2–3.
115. Id. at *10.
116. Id. at *1.
use of the name “On Time Experts” and “Clock-Themed Logo” violated the
prohibition against use of “any name or mark similar to the Licensed Marks”
and whether its use of certain performance methods (including use of an “on
time” guaranty; advertising that its technicians are background-checked,
drug-tested, trained, and EPA certified; and that its technicians wear protec-
tive covers on their shoes and use drop cloths to protect the floors) violated
the prohibition against use of “other identifying characteristics or indicia of
the system.”117

After a bench trial, the court concluded that One Hour failed to establish
that the “On Time Experts” name and “Clock-Themed Logo” were “simi-
lar” to the Licensed Marks (within the meaning of Section 16.E of the Fran-
chise Agreement). Although the court agreed with One Hour that customer
confusion was not an element of a breach of contract claim, it reasoned that
Section 16.E. was a restraint on trade and, therefore, should be construed
narrowly in accordance with trademark law principles:

Florida makes clear that any agreement in “restraint of trade” is “in derogation of
common law and must be strictly construed against the alleged restraint.” See
Weintraub v. Roth, 617 So. 2d 1158, 1159 (Fla. 4th DCA 1993); see also Fla.
Stat. Sec. 542.335. [The post term franchise agreement provision] is clearly an at-
ttempt to operate as a restraint on trade because it controls the terms under which
Dallas Unique can operate a competing business. Thus, under a strict construc-
tion of the franchise agreement, the word “similar” must be construed narrowly.
That is, Dallas Unique’s competing operation cannot be “similar” to the extent
that it is confusingly similar or harmfully similar.118

With respect to the other alleged breaches—specifically, the former fran-
chisee’s use of “on time” guaranties and other performance methods, the
court held that:

the evidence did not establish that any of these best practices are unique to One
Hour, in other words, they are not “identifying characteristics” or “indicia of op-
eration of the system” because they are standard best practices as taught by [the
franchisor’s affiliated cooperative] and others. Simply put, they are all character-
istics of a professional HVAC operation. They may be part of a “sauce,” but
that sauce is certainly not “secret” as One Hour contends.119

In conclusion, the district court stated that “any construction of Section 16.6(E)
that permits a finding of a breach in the absence of some customer confusion
risks turning this clause into a generalized form of a noncompetition clause.”120
Accordingly, the court ruled that there had been no breach of contract.

117. Id. at *17–20.
118. Id. at *18.
119. Id. at *19.
120. Id. at *20–21.
III. Best Practices and Conclusion

Protecting a franchise system requires a careful analysis of the elements of a system and a deliberate and intelligent effort to protect those elements (as opposed to the broad-sweep approach often found in “form” franchise agreements). The following are some to points to consider.

1. Protect the franchisor’s principal trademark in standard characters (obviously) and protect design marks and slogans.

2. Analyze trade dress elements that may deserve protection. Registering a trademark (particularly, items of trade dress) can take some time. But if ever necessary to pursue a claim for trade dress infringement, the chances of success are far greater with a Principal Register trademark registration. Examples of registered trade dress include the following:

a. Registered to Chipotle Mexican Grill, Inc. in connection with restaurant services; take-out restaurant services. The mark is described as follows:

   Color is not claimed as a feature of the mark. The mark consists of the three dimensional configuration or “trade dress” of the appearance and design of the interior of a restaurant, specifically including lighting mounted on a gooseneck-shaped arm affixed to the side of the table, relief images on stone or concrete or stone-look-a-like, wall panels drilled with variable-sized perforated holes, and marshmallow-style seating. The matter shown in broken or dotted lines is not part of the mark and serves only to show the position or placement of the mark.121

b. Registered to Potbelly Sandwich Works, LLC in connection with restaurant services. The mark is described as follows:

   Color is not claimed as a feature of the mark. The mark consists of trade dress for the appearance and design of the interior of a restaurant produced by a combination of a tin ceiling, open duct work, wainscoting and a floor having a wood section and a hard surface section. The solid lines show the positioning of the mark in connection with the restaurant and those features claimed by the applicant as its mark.122

c. Registered to In-N-Out Burgers Corporation in connection with food preparation; restaurant services. The mark is described as follows:

   The color(s) red, white and silver is/are claimed as a feature of the mark. The mark consists of a three-dimensional trade dress depicting the interior of a restaurant. The interior includes white sectional dividing walls having horizontal rows of red stripes. The interior also includes clear glass panels positioned above parts of the dividing walls. The interior also includes a customer seating area with booths, barstools and chairs, wherein the chairs are red, the barstools are white, and the booths

121. Chipotle Mexican Grill Trade Dress, Registration No. 4075479.
122. Potbelly Trade Dress, Registration No. 3494209.
have red upholstery, and white countertops and tablespots. The interior further includes a customer ordering area with sections of red tile walls and white tile walls around the customer ordering area and a silver counter. The matter shown in broken lines is not part of the mark and serves only to show the position of the mark. 123

3. Develop a list of trade dress items and maintain it as part of a de-identification policy.

4. Define important terms in the franchise agreement and/or use contractual terminology otherwise found in the law. Undefined terms require judicial interpretation. Undesired interpretations can often be avoided through careful drafting. Keep in mind that restrictions that are viewed as anti-competitive will likely be enforced consistent with any other provision that constitutes a restraint on trade so they should be drafted specifically, and limitations on time and geography may be appropriate.

5. Consider strategic use of contractual acknowledgments (e.g., franchisee acknowledges that “consumers associate the franchisor’s marketing theme, consisting of [insert description of marketing theme] to identify, exclusively, services offered by businesses operating under the system and trademarks”). Acknowledgments in a formal contract have been characterized as the “best kind of evidence” and may constitute an estoppel by contract. 124

6. Require franchisees and their employees to sign confidentiality agreements.

7. Restrict disclosure of confidential information to individuals on a need-to-know basis.

8. Keep the operations manual password-protected.

9. Change passwords when the franchise relationship ends or when key persons leave.

10. Have proprietary ingredients, mixes, sauces, marinades, spices, etc. manufactured under a confidential manufacturing or licensing agreement rather than sharing recipes with franchisees.

Intellectual and competition laws serve to promote competition. From these laws’ perspective, wheels on the bus “go round and round,” regardless of how pretty or expensive the wheels may be and regardless of whether they

123. In-N-Out Burgers Corp. Trade Dress, Registration No. 4839216.
are attached to the first bus or the last bus in line. Therefore, it is impractical to rely on these laws, alone or in connection with the most perfectly written contract, to protect elements of a franchise system that are not secret, that are not distinctive, or that are functional. The best way to protect these elements of a franchise system is through control of information and access to the system’s benefits.
Technical Terms for Comparative Trademark Analysis

David Gurnick

Trademarks are important in franchising. The trademark has been said to be franchising’s cornerstone.1 Franchise systems want to protect their trademarks, particularly against infringements by others.2 Conversely, those accused of infringement, have an interest in disproving this allegation.

The test for infringement between trademarks is likelihood of confusion.3 Likelihood of confusion can be summarized, or “recast as the determination of whether the similarity of the marks is likely to confuse customers about the source of the products.”4 Analysis of likelihood of confusion involves an assessment of several factors.5 Key among them are comparisons of similarities and differences in appearance and sound and


2. Cases are legion in which franchisors seek to protect their trademarks against infringement by others, not only against continued use by former franchisees, but also against use by unaffiliated third parties of confusingly similar words, phrases, and other marks. See, e.g., La Quinta Worldwide LLC v. Q.R.T.M., S.A. de C.V. 762 F.3d 867 (9th Cir. 2014) (trademark infringement action by franchisor/owner of “La Quinta” as a trademark for hotels against Mexican hotel chain seeking to establish “Quinta Real” hotels in the United States).

3. 15 U.S.C. §§ 1114(1) and 1125(a) (2012)


5. The Second and Ninth Circuits use similar eight factor tests. The Ninth Circuit assesses (1) similarity of the marks, (2) relatedness of the two companies’ goods or services, (3) marketing channels used, (4) strength of senior user’s mark, (5) intent of junior user in selecting its mark, (6) evidence of actual confusion, (7) likelihood of expansion into other markets, and (8) degree of care likely to be exercised by purchasers. AMF Inc. v. Sleekcraft Boats, 599 F.2d 341, 348–49 (9th Cir. 1979). The Second Circuit assesses: (1) strength of the senior mark, (2) degree of similarity between the marks, (3) competitive proximity of the products, (4) likelihood that the prior owner will bridge the gap between the products, (5) actual confusion, (6) defendant’s good faith in adopting its mark, (7) quality of defendant’s product, and (8) sophistication of buyers. Polaroid Corp. v. Polarad Elecs. Corp., 287 F.2d 492, 495 (2d Cir.), cert. denied, 368 U.S. 820 (1961). The Fourth Circuit uses

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meaning of the respective marks. This article discusses some tools that are readily available, but surprisingly underutilized, that can help lawyers and courts compare, understand, and articulate similarities and differences in the appearances and sounds of trademarks.

An important task in comparing and contrasting two trademarks is to explain their similarities and differences. Sometimes, this task can be easy. For example, if trademarks are displayed in different colors, say one trademark is red and the other is blue, or two trademarks have different shapes, say one is a triangle and the other is a circle, it is easy to describe the difference by identifying the respective colors or shapes. Based on these descriptions, it is simple for a judge or jury to understand the differences.

But in other respects, similarities and differences between trademarks may be harder to articulate. For example, it may be difficult to describe in words the differences between two trademarks that consist of almost the same words, with just one or two different letters among the words. Say one trademark is the acronym “FIU” and another trademark is the acronym “FNU.” Stating the difference as “one mark uses the letter “I” but the other uses the letter “N” is true, but not particularly descriptive or useful. The similarities and differences in these marks could be described in much more detail.

Various tools are available to lawyers and courts to compare the appearance, sounds, and meanings of trademarks. When it comes to the meanings of word marks, parties and courts may look at dictionary definitions as well as other information sources, such as public perception, expert testimony, and the context of presentation of a mark, including advertising.

a similar nine factor test. George & Co., LLC v. Imagination Entm’t Ltd., 575 F.3d 383, 393 (4th Cir. 2009).

6. See, e.g., Brookfield Comm’ncs v. W. Coast Entm’t Corp., 174 F.3d 1036, 1054 (9th Cir. 1999) (“The similarity of the marks will always be an important factor. . . .” [T]he more similar the marks in terms of appearance, sound, and meaning, the greater the likelihood of confusion.”); George & Co., LLC v. Imagination Entm’t Ltd., 575 F.3d 383, 393 (4th Cir. 2009) (in assessing similarity of marks “we focus on whether there exists a similarity in sight, sound, and meaning which would result in confusion”).

7. See, e.g., In Re Boulevard Entm’t., Inc., 334 F.3d 1336, 1340–41 (Fed. Cir. 2004) (dictionary evidence alone can satisfy PTO’s burden of proof as to scandalous meaning of a mark, justifying denial of registration); Harley–Davidson, Inc. v. Grottanelli, 164 F.3d 806, 810 (2d Cir. 1999) (“[D]ictionary definitions of a word to denote a category of products are significant evidence of genericness.”); Mil–Mar Shoe Co. v. Shonac Corp., 75 F.3d 1153, 1158 (7th Cir.1996) (“Because generic use implies use consistent with common understanding, we have often looked to dictionaries as a source of evidence on genericness.”).

8. See, e.g., Boston Duck Tours, LP v. Super Duck Tours, LLC, 531 F.3d 1, 18 (2006) (presence or absence of a word in the dictionary and its corresponding meanings are evidence of how public perceives a term but only one of many factors to consider; touchstone is the phrase’s primary significance to the relevant public).

9. See, e.g., Best Buy Warehouse v. Best Buy Co., 751 F. Supp. 824, 826 (W.D. Mo. 1989), aff’d, 920 F.2d 536 (8th Cir.1990), cert. denied, 501 U.S. 1252 (1991) (in granting summary judgment, court relied partly on expert affidavit that term “best buy” is generic, noting “while such opinions are not determinative, they do bolster defendant’s contention that the general buying public understands ‘best buy’ to merely describe a general retail practice of touting particular products”).

10. Elvis Presley Enters., Inc. v. Capece, 141 F.3d 188, 197 (5th Cir. 1998) ("the context of the presentation of a mark, including advertising, is relevant to the meaning that the mark conveys").
With regard to word marks, lawyers and courts can see and hear similarities and differences between the appearances and sounds of words and phrases. But it is harder to describe the similarities and differences. For example, it can be difficult to articulate the difference in sound between an “m” and an “n” or between a “b” and a “d”—other than to say, “one mark has an ‘m’ and the other uses an ‘n.’” A few cases illustrate the problems that lawyers and courts face in addressing these issues.

Recently, the U.S. District Court for the Southern District of Florida compared shorthand names of two universities, “FIU” (abbreviation for Florida International University) and “FNU” (abbreviation for Florida National University).11 The court lacked a lexicon to articulate the differences in sound and appearance, instead reverting to the obvious, stating: “only one letter separates “FIU” and “FNU.”12 In another case, the U.S. District Court for the Central District of California compared the sound and appearance of the words “Echo Drain” and “Echobrain.” The depth of the court’s analysis or articulation of the differences was to state: “[b]ecause “-brain” and “Drain” are different words and are phonetically different, the two marks also sound different.” 13 Similarly, the Trademark Trial and Appeal Board, and the U.S. District Court for the Eastern District of Virginia compared the sound and appearance of “Swatch” and “Swap.” 14 The court stated:

With regard to sound, the TTAB held the identical first three letters, SWA—“results in some similarity in sound, especially if the marks are not articulated clearly so that the differences in the final consonants are not noted.” . . . “However, the marks are dissimilar in appearance in that [SWAP] also contains the fourth letter—P while [SWATCH] contains the additional three letters—TCH.” 15

The TTAB and court lacked a vocabulary to articulate anything more than the obvious: that where letters were similar the sound was similar, and one word had a “P” while the other had a “TCH.”

But in each of these cases, the decision makers did not articulate differences in any greater depth. It may seem to lawyers and courts that there is not a readily accessible legal lexicon to describe the sounds and appearances of words and phrases. However, this is a misconception.

Counsel, if seeking to emphasize differences in appearances, might have noted that in FIU, the “capital I” appears as a single vertical mainstroke or stem, extending from the baseline to the capline, while in FNU the capital “N” has a stressed angular arm that connects the vertical stems to form two acute crotches.16 Similarly, if emphasizing the differences in sound, counsel

12. Id. at 1277.
15. Id. at 750.
16. See Appendices I & II.
could have explained that in FIU the middle vowel is a *voiced* (the vocal chords vibrate) *glottal* (that is, articulated in the throat) *diphthong* (involving a change in tongue position to create the sound) expressed *orally* (articulated in the mouth without involvement of the nasal cavity), whereas the “n” in FNU is a *voiceless* (the vocal chords do not vibrate) *alveolar* sound (formed with the tip of the tongue touching the bone behind the upper teeth).

Counsel in the *Swatch* case might have pointed out that in the word “swap” the last letter’s *stem* is a *descender* that extends below the *baseline* and includes an *ear* (its projection) in the form of a *closed bowl*, whereas the word *swatch* ends with a combination of three letters, none with any *descender* but rather all three remaining within the *baseline* and *capline*, no *closed bowl*, but with one letter (the “t”) including a *cross stroke* and *counters* (partially enclosed spaces) in two of the letters (the “c” and “h”). Similarly, counsel might have noted that a speaker ends the word “swap” by uttering a *labial* (formed at the lips) *plosive* (a sound made with a blockage followed by a burst of air), while “swatch” concludes with a *dental* (sound made by holding the tip of the tongue against the back of the upper teeth) *affricate* (a sound made by stopping air, followed by air flow through a narrow gap with friction).

As the above examples illustrate, two well-established disciplines provide vocabularies that lawyers and courts can apply in comparing and contrasting the appearance and sounds of trademarks. One is the field of printing or typesetting, which has a vocabulary for the visual elements of letters. The other is the field of linguistics, and particularly, the subfield of articulatory phonetics (which concerns production of sounds) and auditory phonetics (which concerns perception of sounds). These fields have extensive vocabularies describing the sounds of letters and words.

By applying the vocabularies of typesetting and linguistics, lawyers, parties, judges, and juries can better evaluate and understand whether and how two words being compared appear similar or different and sound similar or different.

Given this, it is somewhat surprising that only occasionally does terminology from these disciplines appear in trademark infringement decisions. For example, the Seventh Circuit in 1959 used some of this vocabulary in concluding that the word “Bonamine” was confusingly similar to “Dramamine” as a trademark for a pill to ease motion sickness.17 In reversing the lower court, the Seventh Circuit noted:

That part of the finding which states Dramamine and Bonamine are unlike is clearly erroneous. Dramamine and Bonamine contain the same number of syllables; they have the same stress pattern, with primary accent on the first syllable and secondary accent on the third; the last two syllables of Dramamine and Bonamine are identical. The initial sounds of Dramamine and Boanamine (“d” and “b”)

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are both what are known as “voiced plosives” and are acoustically similar; the consonants “m” and “n” are nasal sounds and are acoustically similar. The only dissimilar sound in the two trademarks is the “r” in Dramamine. Slight differences in the sound of similar trademarks will not protect the infringer.18

In this and a relatively few other decisions,19 the typesetting and linguistic vocabulary was beneficial in that it provided an analytic framework for comparing the appearance and sound of marks, words for articulating similarities and differences, and economy of argument and opinion writing.

Use of these vocabularies can thus, in appropriate cases, help advocates persuade fact finders, and help fact finders understand, through explanation of how and why two marks that are ostensibly different, are actually quite similar, or how and why two marks comprised of ostensibly similar words, are actually quite different in appearance and sound.

As an example, imagine two trademarks at issue in an infringement action: one is comprised of the initials “mcl” and the other of the initials “rnd.”20 One advocate argues the claim is meritless because the sounds and how these words are produced are different. The “m” in “mcl” is bilabial, produced by using both lips, contrasted with the retroflex “r” in “rnd,” produced by curling the tip of the tongue toward the hard palate area at the roof of the mouth. And although the “c” and “l” in “mcl” and “n” and “d” in “rnd” are all alveolars (all formed by placing the tip of the tongue at the bone plate behind the upper teeth), the “c” is a sibilant, fricative sound (generated by air passing through the gap between the tip of the tongue and teeth) and the “l” is a liquid, lateral sound (the front of the tongue has contact with the alveolar ridge just behind the upper teeth, but the sides of the tongue are down, letting air escape through the sides of the tongue.). In “rnd,” the “n” is nasal (produced with air escaping through the nose as well as the mouth) and the “d” is an affricate (produced by a stop in the flow of air, followed by a release of air). The advocate asserts that there is no similarity.

But the advocate claiming infringement might use typesetting terms to describe how, in appearance, the marks are so similar as to be almost

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18. Id. at 387.
19. See, e.g., Original Appalachian Artworks, Inc. v. Topps Chewing Gum, Inc., 642 F. Supp. 1031, 1037 (N.D. Ga. 1986) (“The “C” of Cabbage and the “G” of Garbage are phonetically similar in that they are both velar plosives.”); Pro-Phy-Lac-Tic Brush Co. v. Hudson Prods., 86 F. Supp. 859, 861 (D.N.J. 1949) (“It does not seem likely that . . . a purchaser, using the ordinary attention displayed by even the casual buyer of merchandise, would become so confused as not to be able to distinguish between the bisyllabics ‘Poli’ and ‘Perma.’ Aurically they are sharply distinct, despite the fact that they begin the same lene consonant, the voiceless labial mute, P.”); Alexander Young Distilling Co. v. Nat’l Distillers Prods. Corp., 40 F. Supp. 748, 757 (E.D. Pa. 1941), aff’d, 127 F.2d 727 (3d Cir. 1942) (“I can conceive of an element of confusion in names such as P. & G. and B. & G. because both names consist of two letters, and the first letters in each, both being labials, may easily be mistaken for each other; as might, for instance, the names Rinex and Pinex.”).
20. Currently at the U.S. Patent & Trademark Office, eleven federally registered trademarks consist of or include the initials “mcl” (see, e.g., MCL, Registration No. 77406363 (reg. Feb. 24, 2009, for jewelry)), and eleven federally registered trademarks consist of or include the initials “rnd” (see, e.g., RMD, Registration No. 4000777 (reg. July 26, 2011, for clothing)).
duplicates. The descender lines of the “m” in “mcl” and the “r” and “n” in “rnd” duplicate each other. The arc of the stem in the “r,” being adjacent to the “n” forms an appearance duplicating the arches of the “m.” So, rather than just stating that the “rn” resembles the “m,” this use of terminology explains how and why to aid the fact finder’s understanding and analysis. Similarly, the open bowl of the “c” in “mcl” situated next to the main stroke or stem of the “l” forms an appearance that duplicates the closed bowl and main stem of the “d” in “rnd.” This is why the “cl” and “d” look almost alike. This explanation tells in detail why “rnd” in appearance is almost an exact duplication of “mcl.”

Linguistic terms help to explain how and why these two hypothetical trademarks sound different, whereas typesetting terms explain how and why they are similar in appearance.

Use of these vocabularies in pursuing or defending claims of trademark infringement may present additional tactical benefits. An obvious benefit is that explanation through proper vocabulary promotes better understanding of that which is being described. Use of terms from the typesetting and linguistic disciplines can also help establish the need and justification for testimony from experts from these fields. That is, when possibly technical terminology appears in cease and desist demands (and responses), pleadings (complaints and answers), and discovery responses, the court may be more inclined to admit testimony of experts versed in the fields that generated these vocabularies. These experts may be able to further explain similarities and differences to fact-finding judges and juries.

Appendix I is a glossary of selected printing/typesetting terms. Appendix II is a glossary of selected linguistic terms. The practitioner can apply these and other terms from these fields as aids to describe appearance and sounds in comparing and contrasting trademarks. These glossaries are not exhaustive or definitive. Academic literature and a variety of online sources provide additional resources for terms in these fields. Glossaries of typesetting terms can be obtained by entering the phrase “typesetting terms” into an online search engine. Likewise, the phrase “linguistic terms” can be entered into a search engine to generate glossaries of linguistic terms.

APPENDIX I

Selected Typesetters/Printer Terms

Apex: Where strokes come together at the uppermost point of a character, such as the tip of the letter “A.” An apex can be rounded, pointed, hollow, flat, or extended.

Arc of the Stem: A curved stroke that is continuous with a straight stem, not a bowl. Examples: the bottom of a “j, t, f, a, and u.” Also called a shoulder.

Arm: The short, upward sloping stroke or horizontal projection of characters such as “X” and “L.”

Ascender: The part of a lowercase letter that rises above the main body of the letter (as in “b,” “d,” and “h”).

Ascender Line: An imaginary horizontal line that represents the uppermost point of an ascender. A line marking the topmost point of the cap line.

Ascent: A font’s maximum distance above the baseline.

Baseline: An imaginary line on which text rests. The line along which the bases of all capital letters and most lowercase letters are positioned. Descenders extend below the baseline.

Bowl: The enclosed oval or round curve of letters such as “D,” “g,” “b,” and “o.” In an open bowl, the stroke does not meet with the stem completely (e.g., the lower bowl in the letter “g” in some fonts of type, in which the lower bowl is not closed); a closed-bowl stroke meets the stem.

Cap Height or Cap Line: A line marking the height of uppercase letters within a font. An imaginary line which represents the uppermost part of capital letters and some character’s ascenders.

Counter: The enclosed or partially enclosed space within letters such as “c,” “e,” “S,” “H,” and “g.” Not to be confused with bowl.

Cross Bar: The horizontal bar connecting two strokes of a letter, as in “H” and “A,” where the ends are not free.

Cross Stroke: The part of a letter that cuts horizontally across the stem, as in “t” and “f.”

Crotch: The pointed space where an arm or arc meets a stem; an acute crotch is less than 90 degrees, and an obtuse crotch is more than 90 degrees.

22. Except where indicated otherwise, these definitions appear in or are adapted from a glossary of typography terms posted on the ProximaSoftware website, www.proximasoftware.com/fontexpert/terms (last visited Feb. 6, 2016).
Illustration of Selected Typesetting Terms

**Cursive:** Typefaces that resemble informal handwriting, often, although not always, with joining strokes; often with an angle from the vertical.²³

**Descender:** The lowest portion of letters such as “g,” “j,” “p,” “q,” and “y” that extends below the baseline or reading line of type. The portion of a lowercase letter that extends below the baseline of the letter.

**Descender Line:** The lowest line that a character’s descender extends to, such as in the bottom stem of the lowercase “j” and “y.” A line marking the lowest point of the descenders within a font.

**Descent:** A font’s maximum distance below the baseline.

**Ear:** The projection on letters, such as the lowercase “g” and “p.”

**Loop:** A rounded form in a letter that is not closed and is less circular than the bowl of a letter. An example is the lower section of a lowercase “g.”²⁴

**Main Stroke:** See Stem.

**Resonance:** Overtone of a typeface design based on connotative experience with it. For example, historic, romantic, businesslike, exotic, etc.

**Sans Serif:** A typeface without serifs.

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²³ Definition adapted from fonts.com, www.fonts.com/content/learning/fontology/glossary/c.
²⁴ Partially adapted from definition at fonts.com, id.
Script: Script letters are joined. This contrasts with cursive, which are not connected.

Serif: Small, finishing strokes on the arms, stems, and tails of characters.

Shoulder: See Arc of the Stem.

Slant: The angle of a font’s characters, which can be italic or roman (no slant).

Spur: A finishing stroke, such as the ones on the uppercase “G” in some fonts.

Stem: The upright element of a letter or character. Also called the Main Stroke.

Stress: The vertical, horizontal, or diagonal emphasis on the stroke of a letter.

Stretched Text: Widening text characters, not the spacing between the characters.

Swash Capitals: Uppercase letters that have flourishes added to them.

Tail: A character’s downward projection, such as on the letter “Q.”

Terminal: Not serifs, but ends of certain letter shapes such as the letters “f,” “j,” “y,” “r,” and “a.”
APPENDIX II

Selected Linguistic Terms

_Affricate:_ A phonetic segment consisting of a stop in the flow of air, followed immediately by a fricative, for example, the first “ch” in church or the first “j” in judge.

_Alveolar:_ Sounds formed at the bone plate behind the upper teeth, called the alveolar ridge. These sounds form with the tip or blade of the tongue. Examples are “t,” “d,” “s,” “z,” “l,” and “n.”

_Ambi-dental:_ The manner of articulation of the fricatives such as “think” or “that.” The tongue is not between the teeth for these sounds.

_Bilabial:_ A sound produced using both lips. For example, “p” or “m.”

_Dental:_ Articulation characterized by the tip of the tongue held against the back of the upper teeth. For example, the initial sounds in “this” or “think” are dental fricatives, although ambi-dental also applies as the tip of the tongue is then in the region of the teeth.

_Diphthong:_ A vowel sound made by combining two vowels, with a change in tongue position between the beginning and end. For example, the “oy” sound in “boy” or “toy” or the “ou” sound in “out” or “loud” where the sound and tongue positioning starts with the positioning for “o” and moves to the positioning for “y” (toy and boy) or the positioning akin to a “w” sound (out or loud).

_Discrete:_ A characteristic where no continuous transition occurs from one unit to another. For example, the sounds “p” and “b” are each separate, discrete sounds. A speaker pronounces one sound or the other but not something intermediary between the two.

_Fricative:_ A sound characterized by air passing a constriction somewhere between the glottis and lips, for example, “x,” “s” or “f.” Turbulence arises when air flows through a narrow gap and this causes the noise typical of fricatives. Fricatives can be voiced or voiceless. Also sometimes referred to as _spirant._

_Glide:_ A sound that lies between a vowel and a consonant, for example, “j” and “w.” It is formed with little friction and has a high degree of sonority, which is why glides are found near the nucleus of syllables. Also sometimes called a semi-vowel.

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25. Many of these definitions are adapted from the _Glossary of Linguistic Terms_ at the website of the University of Duisburg–Essen, www.uni-due.de/ELE/LinguisticGlossary.html (last visited Feb. 6, 2016).

26. See www.uni-due.de/SVE/SNDS_ENG_Fricatives.htm.
Glottal: A sound produced at the gap in the vocal folds. These sounds can be stops or fricatives and can be voiceless or voiced. For example, the “a” sound in “ant” (which is a voiced glottal fricative) or the “h” sound in “hat” (which is a voiceless glottal fricative) or in the word “Hawai’i,” the stop at the apostrophe (which is a voiced glottal stop).

Homophone: A set of words pronounced the same way but having different meanings. For example, poor, pore, and pour; pray and prey; and two, too, and to.

Homorganic: A set of sounds articulated at the same point in the vocal tract. For example, “m,” “p,” and “b,” which are each pronounced using both lips, or “t,” “d,” “s,” and “z,” “n” and “l,” which are each pronounced by touching the tip of the tongue to the upper gum. Sounds not articulated from the same place are called heterorganic.

Intonation: The part of the sound system of a language that involves the use of pitch to convey information, including accent in an individual word and sentence melody in word groups.
**Labial**: Reference to a sound formed at the lips. This includes *bilabials* such as “p” and “m” and *labio-dentals* such as “f” and “v.”

**Labio-dental**: A consonant formed by the lower lip making contact with the upper teeth as in “f” and “v.”

**Labio-velar**: A consonant made at two places of articulation, or articulated by constriction at the velum with rounding of the lips at the same time, for example, the sound of a “w.”

**Liquid**: A flow of air with some obstruction in the mouth, but not enough to cause friction.

**Lateral**: The flow of air when the tongue has contact with the alveolar ridge just behind the upper teeth, but the sides of the tongue are down, letting air flow through the sides of the tongue.

**Manner of Articulation**: One of the three conventional parameters (along with place of articulation and voice) used to specify how a sound is produced. Common types are *plosives*, *fricatives*, and *affricates*.

**Minimal Pair**: Any two words which are distinguished only by different sounds in a single position. These word pairs are used in traditional phonology to determine the status of sounds as phonemes, for example, railing and sailing.

**Monophthong**: Vowel articulated with the tongue in a constant position; that is, its articulation at both start and end is relatively fixed and does not glide up or down toward a new position of articulation. Examples include the short vowel sounds in “pap,” “pep,” “pip,” “pop,” and “pup,” or “bed.”

**Nasal**: A sound, vowel or consonant produced by opening the nasal cavity so that some air flows through the nose.

**Oral**: Articulated in the mouth. This term usually implies that the nasal cavity is not involved.

**Organs of Speech**: Parts of the human anatomy used in speech production. For example, the glottis, velum, palate, alveolar ridge, lips, and tongue.

**Palatal**: A place of articulation at the hard palate in the center of the roof of the mouth.

**Phone**: Any human sound not otherwise classified in the phonology of a language.

**Phoneme**: The smallest unit in language that distinguishes meaning, for example, the “k” sound in coat or “g” sound as goat.

**Place of Articulation**: The point in the vocal tract where a sound is produced. This can be anywhere from the lips at the front to the glottis (gap be-
between the vocal folds) in the glottal area of the throat. The most common place of articulation is the alveolar ridge just behind the upper teeth.

**Plosive**: A sound produced with a complete blockage of the pulmonic airflow followed by a burst of air. This is also called a stop, for example, “p,” “t,” and “k.”

**Postalveolar**: Sounds formed with the hard palate as passive articulator and the blade of the tongue as active articulator. Examples are “shill,” “chill,” “vision,” and “fill.”

**Prosody**: A term referring to all the suprasegmental properties of language such as pitch, loudness, tempo, and rhythm.

**Retroflex**: Sound pronounced with the tip of the tongue curled up toward the hard palate at the roof of the mouth, for example, the sound of the letter “r” in “rigid.”

**Rhythm**: The patterns of strong and weak syllables in a language. The rhythm of English is characterized by the foot, which consists of a stressed syllable and all unstressed syllables up to the next stressed one.

**Segment**: A unit of speech that is identifiable and separate from others. It contrasts with the term suprasegmental, which refers to aspects of phonetic structure above the level of individual sounds.

**Sibilant**: A sound pronounced with clear, hissing friction such as the initial consonant sound in “sip,” “zip,” “ship,” or “chip” or the “s” sound in “vision.”

**Stop**: A consonant formed by blocking the airstream completely, for example, the sound of “p,” “t,” or “k.” It contrasts with a fricative which does not involve interruption of the airstream. Also sometimes called plosive.

**Stress**: The acoustic prominence of a syllable in a word. Physical correlates of stress can vary. Typically it involves raising the frequency and/or volume matched by prolonging the syllable involved.

**Structure**: A network of connections between elements of a system. For example, syllable structure is the set of relations between parts of a syllable.

**Suprasegmental**: A reference to phenomena that do not belong to the sound segments of language but typically are spread over several segments. For example, intonation, stress, and tempo.

**Syllable**: A unit of sound or sounds grouped together in a nucleus of acoustic prominence.

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27. See https://en.wikipedia.org/wiki/Postalveolar_consonant.
Tongue: The most frequently used active articulator. The tongue can be divided into several areas: tip or apex, blade or lamina, and back or dorsum. The distinction between tip and blade is important for producing dental and alveolar sounds. The tongue may also show a groove, for instance with palato-alveolar fricatives. The tip can be made to roll in the escaping airstream as is the case with the apical rolled “r” of Romance languages. The root of the tongue can be retracted to constrict the larynx as with the emphatic sounds of Arabic.

Uvular: Sound articulated with the back of the tongue and the uvula, such as the hard “k” in “king” or the sound of the “q” in “queen.”

Voiced: Spoken with simultaneous vibration of the vocal folds.

Voiceless: Spoken without the vocal folds vibrating. The folds can be open or closed with the compression of air between them and the supra-glottal stop position producing sounds which are called ejectives.
ANTITRUST


An automobile dealer’s price discrimination claims against Chrysler Group LLC were dismissed for a third time, but with prejudice.

Plaintiff Mathew Enterprise, Inc., a long-time franchise dealership of Chrysler in San Jose, California, filed suit after Chrysler established a second dealership, San Leandro Chrysler Jeep Dodge and Ram, in the same geographic area. Although San Leandro was owned by another entity, Ytransport, LLC, it was located on land owned by Chrysler. The San Leandro agreement contained terms for the sale of vehicles by Chrysler to San Leandro and lease provisions, including rental incentives. According to the plaintiff, the rental incentive payments, which Chrysler made to San Leandro but not to the plaintiff, constituted disguised price reductions in violation of Section 2(a) of the Robinson-Patman Act (RPA). In other words, the “dominant nature” of the payments was to reduce the price San Leandro paid Chrysler for vehicles, not rent.

The court dismissed the plaintiff’s price discrimination claim in July 2014 and again with prejudice in January 2015. In dismissing with prejudice, the court was persuaded by Chrysler’s representation that, due to the high cost of establishing new dealers and the risks involved, Chrysler needed to condition certain incentives for dealers operating on land leased by Chrysler Realty to ensure that the realty was only being offered to viable
dealers. The court also considered the terms of the San Leandro agreement, which showed that “the sales-based incentives were not provided on a per-vehicle basis.” Based on the defendant’s representation, the court therefore found that the dominant nature of the payments related to the lease, not the vehicles. Because the RPA cannot apply to a leasehold, the court dismissed the plaintiff’s § 2(a) claim with prejudice. However, the court modified its dismissal to be without prejudice after the plaintiff discovered in a related state action that, contrary to Chrysler’s representation to the court, the defendant provided payments to a dealership in Valencia, California, that did not lease Chrysler-owned realty. Accordingly, the plaintiff filed its second amended complaint on June 12, 2015, adding new allegations related to the Valencia dealership, bookkeeping practices suggesting that neither Chrysler nor San Leandro considered the payments to San Leandro rent-related, and the lack of restrictions by Chrysler on how San Leandro could use the payments. Chrysler once more moved to dismiss the § 2(a) claim.

Section 2(a) of the RPA makes it “unlawful for any person engaged in commerce . . . to discriminate in price between different purchasers of commodities of like grade and quality.” The RPA covers only transactions involving commodities: sales of goods, wares, or merchandise, not rent. Where a party alleges a transaction that involves both commodities and a service, courts in the Ninth Circuit employ a “dominant nature” test to determine if the transaction is for a sale of services or goods. Given the plaintiff’s new allegations, the plaintiff was required only to allege facts that made it plausible that the “dominant purpose” of the alleged agreement was to discount vehicles (a good) rather than rent (a service). Although the court previously found the plaintiff’s characterization of the payments implausible, it did so based on Chrysler’s representation that the payments were provided only to dealerships located on land leased from Chrysler Realty and the plain language of the agreement. However, the Valencia allegations now cast doubt upon Chrysler’s new explanation that the payments related to rent, whether or not the dealership was located on land owned by Chrysler Realty, and also conflicted with the plain language of the San Leandro agreement. As a result, the court found that further development of the factual record would be necessary to determine the dominant nature of the payments and dismissal based on the dominant nature of the payments was inappropriate. Nonetheless, the court granted dismissal with prejudice based on the contemporaneous customer requirement of § 2(a). Under that requirement, the plaintiff had to allege that it and San Leandro were contemporaneous customers of Chrysler but failed to do so. Instead of alleging that the two dealerships commenced business at the same time in order to meet § 2(a)’s requirement, the plaintiff alleged only that the two dealerships were in business at reasonably contemporaneous times. Because that was insufficient as a matter of law, the court dismissed the plaintiff’s price discrimination claim with prejudice.
In 2011, steel distributor MM Steel, L.P. was formed and its founders began contacting steel manufacturers in an attempt to serve the Gulf Coast region. In 2011, MM signed a supply agreement with manufacturer JSW Steel (USA), Inc. The founders of MM were former salesmen for steel manufacturers American Alloy (AmAlloy) and Chapel. Representatives of AmAlloy and Chapel allegedly were not pleased that the founders were now competing against them and were determined to threaten steel manufacturers that if they did business with MM, AmAlloy and Chapel would no longer do business with them. The manufacturers contacted by AmAlloy and Chapel included Nucor Corporation and JSW. In April 2012, MM filed a lawsuit against, among others, AmAlloy, Chapel, Nucor, and JSW, alleging violation of § 1 of the Sherman Act as to all defendants and breach of contract as to JSW.

In a six-week jury trial, the jury heard evidence suggesting that the defendants entered into a “horizontal group boycott” in violation of the Sherman Act by seeking to drive MM out of business through cutting off its access to steel manufacturers. The jury found in favor of MM on both the Sherman Act claim and the breach of contract claim. Nucor and JSW appealed to the Fifth Circuit. On appeal, the court analyzed whether there was substantial evidence supporting the jury’s finding. To establish a claim under the Sherman Act, the evidence was required to show not only a conspiracy to boycott MM, but that the particular defendant knowingly joined the conspiracy. An independent refusal to deal with a particular party is not sufficient.

The court first analyzed Nucor’s assertion that it did not knowingly join the conspiracy, but rather refused to deal with MM as part of its “incumbency practice” to do business only with long-standing distributors. The court held that MM had failed to put on evidence supporting its argument that when Nucor first refused to do business with MM, Nucor was aware of an agreement among distributors to keep MM out of the market. Moreover, the court held that Nucor’s conduct was otherwise as consistent with permissible competition as it was with illegal conspiracy, and therefore the conduct did not support an inference of anti-competitive behavior. The court therefore reversed the judgment as to Nucor.

The court then turned to JSW. The court applied the “rule of reason” to determine whether the evidence supported a finding that there was an unreasonable restraint on trade. If the evidence showed a group boycott, that would lead to a per se finding of an unreasonable restraint. The court also noted that the group boycott at issue was horizontal because it was among distributors that normally competed against each other. Vertical agreements to refuse to deal with parties (i.e., between manufacturers and customers) are not per se unreasonable. The court concluded that MM had provided suffi-
cient evidence to support the judgment that JSW violated the Sherman Act and also breached its contract with MM.

Rochester Drug Co-Operative, Inc. and Biogen Idec U.S. Corp. were parties to a distribution agreement under which Rochester distributed pharmaceuticals manufactured by Biogen, including a drug for the treatment of multiple sclerosis called Avonex. Rochester distributed Avonex in four states pursuant to the distribution agreement for more than six years. In contrast to regional distributors such as Rochester, the pharmaceutical market is dominated by three national drug wholesalers known in the industry as the Big Three. In March 2015, Biogen informed Rochester that it was terminating the distribution agreement and that, going forward, Biogen would make Avonex available for purchase only from the Big Three.

Rochester thereafter filed suit against Biogen in the U.S. District Court for the Western District of New York, alleging that Biogen’s termination of the distribution agreement violated the New York antitrust statute (the Donnelly Act), seeking injunctive relief, and also alleging breach of contract and breach of the covenant of good faith and fair dealing. Biogen moved to dismiss the suit under Federal Rule of Civil Procedure 12(b) for failure to state a claim. The court analyzed whether Rochester had pled facts sufficient to state a claim under the Donnelly Act. The court determined that stating such a claim would require a showing of a “contract, arrangement, or combination” between Biogen and the Big Three to restrain trade or commerce. Put another way, Rochester was required to show that there was a “reciprocal relationship or commitment” between Biogen and the Big Three. The court held that Rochester had failed to plead facts sufficient to state such a claim. The court noted that a “unilateral exertion of power” as expressed in Biogen terminating the distribution agreement was not a violation of the Donnelly Act. The court further noted that, although the Big Three were tangentially involved in that Biogen was choosing to do business with them going forward, there were no facts pled supporting an actual agreement or understanding. The court also refused to consider hypothetical schemes put forth by Rochester suggesting that such an agreement “must have” been in place because no facts supported the hypotheticals. The court therefore dismissed the suit for Rochester’s failure to state a claim under either the Donnelly Act or its other claims.

This case is discussed under the topic heading “Statute of Limitations.”
ARBITRATION


The Wisconsin Court of Appeals declined to overturn a lower court judgment compelling arbitration following termination of three franchises. The plaintiffs’ owner, Matthew Everett, had been owner of three franchises (Building Werks). Following termination of one franchise by franchisor Paul Davis, Everett transferred ownership of the terminated franchise to his wife, who continued operating it outside the Paul Davis banner. Paul Davis then terminated the other two franchises on the basis of Everett’s continued involvement in the previously terminated and now-competing franchise.

Building Werks brought claims in respect of all three franchises, alleging violations of Wisconsin’s Fair Dealership Law, intentional misrepresentation and fraud, and violations of the Wisconsin Franchise Investment Law. Paul Davis sought to enforce arbitration provisions in each of the franchise agreements, and the court granted its motion compelling arbitration.

On appeal, Building Werks sought to challenge the enforceability of the arbitration clauses, arguing the arbitration system (in which the panel was composed of fellow franchisees) was biased in favor of Paul Davis, that the arbitration provisions were inoperative because the franchise agreements were invalid because they were induced by fraud, and that the arbitration provisions were unconscionable.

The court held that it was not in a position to rule on the composition of the panel prior to the arbitration hearing and that Building Werks could seek relief following the arbitration if it still felt the award must be vacated under law. Regarding Building Werks’ arguments that the contract was invalid, the court found that, unless the challenge was to the arbitration clause itself, the issue of the contract’s validity should be considered by the arbitrator. Because Building Werks had challenged the validity of the contract as a whole, it would be appropriate for the issue to be considered by the arbitrator as opposed to the court.

Regarding Building Werks’ unconscionability claim, the court rejected its arguments as speculative because they were based on predictions about the composition, conduct, and decision of the arbitration panel. The court found Building Werks had not established procedural unconscionability because Everett was an experienced businessperson, and in any case, disparity in bargaining power alone would generally be insufficient to make out procedural unconscionability. The court also held BuildingWerks had not established substantive unconscionability, which turns on the terms of the contract rather than their implementation, because Building Werks had not argued the arbitration provisions on their face were commercially unreasonable.

The court concluded by rejecting Building Werks’ request to reverse the circuit court’s ruling so that it could have additional opportunities for
discovery to demonstrate the alleged unfairness inherent in the Paul Davis arbitration system. Again, the court held that Building Werks’ arguments were too speculative and that, because arbitration had not yet begun, the desired discovery would, at best, indicate a risk that Building Werks would be treated unfairly.


The U.S. District Court for the Eastern District of Kentucky allowed a franchisor’s motion to compel arbitration, rejecting arguments from the franchisee that the arbitration provision was unconscionable. The plaintiff, franchisee LeafGuard of Kentuckiana, Inc. (LeafGuard K), was entitled to manufacture, sell, and install defendant’s LeafGuard of Kentucky, LLC (LeafGuard) gutter system pursuant to a distributor agreement. Following poor sales by the franchisee, the parties entered into a purchase agreement pursuant to which the franchisor was to buy the franchisee’s territory and assets. The defendant franchisor subsequently decided it did not want to go forward with the transaction and, when the plaintiff refused to return an escrow deposit held by its attorney, terminated the distributor agreement on the basis of the franchisee’s failure to meet its annual sales targets and pay royalties. The franchisee sued for breach of contract and sought injunctive relief enforcing the terms of the two agreements. The franchisor moved to compel arbitration, pursuant to an arbitration provision in the distributor agreement.

The plaintiff sought to rely on Kentucky law; the defendant argued the distributor agreement stipulated that New Jersey law would apply to questions regarding contract formation. Based on New Jersey having a substantial relationship to the parties, where the defendant was headquartered and incorporated, and after deciding the results of proceeding in either New Jersey or Kentucky would be the same, the court chose to apply New Jersey law.

Noting that Section 4 of the Federal Arbitration Act requires courts, not arbitrators, to address any challenge to the arbitration clause itself, the court found the plaintiff had been careful to attribute unconscionability to the arbitration clause itself, rather than to the whole agreement. Because the plaintiff had opposed enforcement of only the arbitration clause and not the contract as a whole, the court undertook to apply state law to determine whether the arbitration agreement was valid and binding.

The plaintiff contended that the arbitration provision was unconscionable because the agreement was obtained through economic duress under the threat that the defendant would revoke its license and distributor rights. The plaintiff also asserted that the distributor agreement was substantively unconscionable because it required the plaintiff to forfeit its right to seek punitive damages, exemplary damages, and injunctive relief.

The court held that in order to prove unconscionability, the plaintiff needed to show some obligation imposed as a result of a bargaining disparity
between the parties or such patent unfairness that no person not acting under duress would accept the terms of the contract. It noted that the plaintiff was a sophisticated businessman and had failed to submit any evidence that any personal characteristics prohibited or impaired his ability to make wise business decisions. The arbitration clause was not hidden in the contract, nor was it difficult to understand. The court held that the enticement of continuing to operate a distributorship did not constitute economic duress.

The court also held that substantive unconscionability existed only where the exchange of obligations was so one-sided that it would shock the court’s conscience. It found that waiver of punitive and exemplary damages was neither one-sided nor shocking to the conscience and disagreed that the distributor agreement would bar the plaintiff from seeking injunctive relief.


Claims brought by various Dickey’s Barbecue Restaurants, Inc. franchisees against the franchisor alleging fraud and violations of California’s Franchise Investment Law (CFIL) and Unfair Competition Law (UCL) were required to be arbitrated, held the U.S. District Court for the Northern District of California.

The plaintiffs, all California residents, sought to represent a class of current and former owners of Dickey’s Barbeque Pit franchises in California. They all purchased a Dickey’s franchise after receiving Dickey’s franchise disclosure document (FDD) and signing a franchise agreement. The franchise agreements, which were approximately sixty pages long and printed in small type, contained: (1) a dispute resolution provision; (2) terms permitting Dickey’s, but not its franchisees, to bring certain claims in court without participating in mediation or arbitration; (3) a Texas choice-of-law provision; and (4) a venue clause. The dispute resolution provisions, however, were different in the franchise agreements signed by the plaintiffs. For one set of plaintiffs (the Toff plaintiffs), the provision required that disputes first be resolved through non-binding mediation in Collin County, Texas, and, if mediation failed, through binding arbitration at the American Arbitration Association (AAA) office nearest to Dickey’s corporate headquarters in Plano, Texas. The provision defined “disputes” as “all disputes, controversies, claims, causes of actions and/or alleged breaches or failures to perform arising out of or relating to this Agreement (and attachments) or the relationship created by this Agreement.” For the other set of plaintiffs (the Meadows plaintiffs), however, the provision defined “disputes” to include all disputes “arising from, or with respect to (1) any provision of this Agreement or any other agreement related to this Agreement between the parties; (2) the relationship of the parties; and (3) the validity of this Agreement or any other agreement between the parties, or any provisions thereof.” Like the Toff plaintiffs’ provision, the Meadows plaintiffs’ provision also required
non-binding mediation first, but in Dallas. Both provisions provided that the
proceedings “shall be conducted in accordance with the then current com-
mercial arbitration rules.”

In their suit, the plaintiffs alleged that the FDDs contained several mis-
representations and that Dickey’s employees made additional misrepresenta-
tions outside of the FDDs. They also sought a declaration that the dispute
resolution provision requiring that all disputes be resolved through arbitra-
tion was unenforceable. In response, Dickey’s filed a motion to compel arbi-
tration of all of the plaintiffs’ claims, stay the litigation pending completion
of the arbitrations, and strike the plaintiffs’ class allegations. The plaintiffs
argued that the arbitration provision was unconscionable as a whole. Dickey
replied that the court lacked jurisdiction to consider the plaintiffs’ uncon-
scionability argument because the plaintiffs were required to arbitrate
whether the arbitration provision itself was enforceable.

The court first addressed whether the court or an arbitrator should decide
the question of arbitrability. It noted that arbitrability “is an issue for judicial
determination unless the parties clearly and unmistakably provide other-
wise.” The court then applied federal arbitrability law because the franchise
agreements’ choice-of-law provision did not expressly state that Texas law
governed the question of arbitrability. As to the Meadows plaintiffs, the
court agreed with Dickey’s that because the arbitration provision required
that disputes regarding the validity of any provision in the agreement must
be sent to arbitration, there was “clear and unmistakable language indicating
that the threshold issue of arbitrability is delegated to an arbitrator.” The
only question, then, for the court to consider was whether the delegation
clause was itself unconscionable as to not be enforced under the Federal Ar-
bitration Act (FAA). The court held that because the Meadows plaintiffs
challenged the entire arbitration provision, not the specific delegation clause,
as unconscionable, the unconscionability challenge was for the arbitrator to
decide.

The conclusion was different, however, for the Toff plaintiffs. Their ar-
bitration provision did not contain the same language delegating decisions
about the validity of the franchise agreement or any of its provisions. Al-
though the language that disputes “arising out of or relating” to the franchise
agreement was so broad that it could theoretically encompass the threshold
issue of arbitrability, the court found that such language did not “rise to the
level of clear and unmistakable evidence of delegation required to defeat the
presumption that the court, not the arbitrator, will decide the issue of arbit-
rrability.” Nor did incorporation of the AAA rules in the arbitration provisions
supply such clear and unmistakable evidence. Although Rule 7(a) of the AAA
Commercial Rules delegates all jurisdictional questions, including arbitrabili-
ity, to the arbitrator, under Ninth Circuit law, incorporating the AAA rules
into an agreement can evince a “clear and unmistakable” intent to delegate
only when all the parties to the arbitration agreement are sophisticated. Here, the plaintiffs were “far less sophisticated than Dickey’s[]”; therefore,
as to the Toff plaintiffs, it was up to the court to decide the question of arbitrability.

Next, the court analyzed the Toff plaintiffs’ defense that the arbitration provision was unenforceable. It first decided whether to enforce the Texas choice of law chosen by the parties based on California’s conflict of law rules. Under California’s choice of law framework, which followed the Second Restatement of Conflict of Laws, the court had to determine whether (1) Texas had a substantial relationship to the parties or their transaction, or (2) there was any other reasonable basis for the parties’ choice of law. If neither test was met, the court need not enforce the parties’ choice of law. But if either test was met, the court had to then determine whether Texas law was contrary to a fundamental policy of California. Applying this framework, the court enforced the parties’ Texas choice of law. In so doing, it discarded the plaintiffs’ argument that there was no meeting of the minds because the FDD they received before signing their franchise agreements stated that the choice of law clause “may not be enforceable.” Although the FDD contained that statement, it also included other statements making clear that Dickey’s would insist on the application of Texas law, including a statement on the cover page of the FDD in all caps and bold lettering that “[t]he Franchise Agreement states that Texas law governs the Franchise Agreement, and this law may not provide the same protections and benefits as your local law. You may want to compare these laws.” Moreover, there was a substantial relationship between Texas and the parties because Dickey’s headquarters were in Plano, and payments under the franchise agreements were due to Dickey’s in Texas. Finally, the court determined that applying Texas unconscionability law was not contrary to a fundamental public policy of California. The court was not convinced by the plaintiffs’ argument that the arbitration provision violated the CFIL because it limited punitive damages, which the CFIL expressly allowed. According to the court, Dickey’s arbitration provision did not “contract around that policy” because, although it did state that punitive damages were waived, such waiver was only “to the fullest extent permitted by law.” In addition, another section of the franchise agreement specified that when a state’s controlling law is inconsistent with the franchise agreement, state law governed. In sum, because the arbitration provision did not eliminate the ability to recover punitive damages under CFIL, the Toff plaintiffs failed to identify an actual conflict with California policy and Texas law applied.

Last, applying Texas law, the court held that the arbitration provision in the Toff plaintiffs’ franchise agreements was neither procedurally nor substantively unconscionable. As to procedural unconscionability, although there was a disparity in bargaining power between plaintiffs and Dickey’s and Dickey’s did offer the contracts on a take-it-or-leave-it basis, an “imbalance in the relative sophistication of the parties” was not sufficient to render the agreement to arbitrate unconscionable under Texas law. Nor did the argument that the arbitration provision was buried near the back of a
sixty-page agreement save the plaintiffs because the provision was not hidden and plaintiffs were presumed to have read the contracts they signed. The arbitration provision also was not substantively unconscionable because it did not waive the plaintiffs’ ability to obtain punitive damages under CFIL. In sum, the Toff plaintiffs’ arbitration provision was enforceable and their claims were subject to arbitration.

Based on the foregoing, the court granted Dickey’s motion to compel arbitration and stay the litigation. As to the Meadows plaintiffs, the court stayed the litigation to permit arbitration of the “gateway” issues and then, if permissible, to arbitrate the substantive claims. The Toff plaintiffs, however, were to arbitrate their substantive claims.

**BANKRUPTCY**


In 2009, General Motors and Chrysler were able to avoid liquidating in their bankruptcy cases due in large part to $38 billion in financing provided by the federal government as part of the Automotive Industry Financing Program (AIFP). The funding was conditioned on GM and Chrysler agreeing to cancel a large number of their franchise agreements, resulting in more than 2,000 dealership closures. Several GM and Chrysler former franchisees filed suit against the federal government in the U.S. Court of Federal Claims, arguing that the forced cancellation of their franchise agreements constituted a taking without just compensation in violation of the Fifth Amendment.

The court initially denied the government’s motion to dismiss the plaintiffs’ claims. The government filed an interlocutory appeal to the Federal Circuit, which held that the plaintiffs had, in fact, alleged a valid property interest in the franchise agreement and that therefore the case should go forward. However, upon remanding, the Federal Circuit made clear that the plaintiffs were required to amend their complaint to provide specific evidence that they suffered economic loss. The standard for such a showing was that the “franchise agreements would have retained value in a scenario known as the ‘but-for world’ in which the government did not enter into an agreement with the manufacturers to provide financing, conditioned upon close dealerships, to save the company.”

The government took the position that the plaintiffs’ franchise agreements would have zero value in the but-for world because the manufacturers would have failed. The plaintiffs challenged this standard, arguing that the correct but-for world would be one where the government provided the AIFP financing, but did not condition the financing on closing dealerships. The court held that based on a prior decision by the U.S. Federal Circuit in *A&D Auto Sales v. United States*, 784 F.3d 1142 (Fed. Cir. 2014), the plain-
tiffs’ but-for world was not the proper standard. Rather, the plaintiffs had to accept the fact that the AIFP funds were contingent on closing dealerships. The plaintiffs could, however, assume that smaller December 2008 bridge financing in the amounts of $17.4 billion would have been made because that bridge financing was not conditioned on closing dealerships. The court ultimately concluded that the plaintiffs would be permitted to put on evidence that their franchise agreements would have retained value under certain scenarios, and therefore the government’s motion to dismiss would be denied. Those scenarios were: (1) Chrysler survived without government assistance (GM’s survival without government assistance was deemed too speculative); (2) Chrysler merged with either Fiat or Daimler (again, a GM merger was deemed too speculative); and (3) the dealerships would have retained some value in an orderly wind down and liquidation of either Chrysler or GM.

BUSINESS OPPORTUNITY LAWS


Thirty-three groups of franchisees consisting of over one hundred individuals filed suit against Curves International, Inc. in state court on June 1, 2015. The matter was thereafter removed to the U.S. District Court for the Eastern District of Missouri. The plaintiffs’ claims included breach of contract, violation of the Texas Business Opportunity Act (TBOA), and violation of the Texas Deceptive Trade Practices Act (DTPA). The allegations underlying the plaintiffs’ claims broke down into three separate groups. First, certain plaintiffs (Group A) alleged that Curves knowingly made misrepresentations relevant to the financial prospects of a franchise in the course of inducing the franchisees into purchasing or renewing a franchise. Second, certain plaintiffs (Group B) alleged that Curves made unanticipated demands upon the franchisees regarding additional required payments. Third, certain plaintiffs (Group C) alleged that Curves imposed unanticipated obligations upon franchisees. Curves filed a motion seeking to dismiss the suit because the claims were filed after the applicable four-year statute of limitations. Curves also sought to enforce a forum selection clause requiring such an action to be brought in the U.S. District Court for the Western District of Texas.

The court first addressed the statute of limitations arguments. It held that the franchise agreements were not installment contracts and therefore the statute of limitations began to run upon the opening of a particular franchise as to Group A. As to Group B, the statute of limitations began to run on the particular dates that the alleged misrepresentations were made. The court did not rule with respect to Group C because no time frame relating to the alleged breaches was provided.
The court also addressed Curves’s assertions that neither the TBOA nor the DTPA applied in the case. Curves argued that the statutes were designed to protect consumers rather than people who are renewing ongoing, long-time contractual relationships. The court found the argument unavailing and noted that Curves had the burden to show that the statutes did not apply (rather than the plaintiffs being required to show they do apply). The court therefore refused to dismiss on those grounds.

The court lastly addressed the forum selection clause in light of the Supreme Court’s decision in *Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas*, 134 S. Ct. 568 (2013). The court noted that a forum selection clause would not be enforceable if it was the product of fraud or conversion. Because the plaintiffs had made only general allegations of fraud and had not shown any extraordinary circumstances, the court held that the clause would be enforced. The court therefore dismissed certain claims on statute of limitations grounds and transferred the remaining matters to the U.S. District Court for the Western District of Texas.

**CHOICE OF FORUM**


Ajax Holdings, LLC was a franchisee of Comet Cleaners Franchise Group, LLC. Ajax alleged that soon after taking over certain dry cleaning stores, it learned that the stores had serious problems, including allegedly being much less profitable than Comet Cleaners represented. Ajax filed suit in Arkansas state court alleging that Comet Cleaners violated the Arkansas Franchise Practices Act (AFPA) by its alleged misrepresentations, fraudulent acts, and intentional omissions. Comet Cleaners moved to dismiss the case on the grounds that Ajax failed to attach copies of applicable written agreements in violation of Arkansas procedural rules. Comet Cleaners also filed a motion removing the case to the U.S. District Court for the Eastern District of Arkansas based on diversity jurisdiction and a motion to transfer venue to the Northern District of Texas based on a forum selection clause. Ajax sought remand, arguing that Comet Cleaners had waived its right to remove based on taking substantial action in the state court through the filing of the motion to dismiss. Ajax also argued that the state court should address the state issues in the case.

The court held that Comet Cleaners’s motion to dismiss was based on a procedural issue and did not rise to the level of participation that would lead to waiving a removal right. The court also held that in cases based on diversity jurisdiction, arguing that state law matters are not an appropriate basis for remand. As to the motion to transfer venue, the court quoted at length the Supreme Court case *Atlantic Marine Construction Co. v. U.S. District*
Court for the Western District of Texas, 134 S. Ct. 568 (2013), for the proposition that forum selection clauses should generally be enforced. The court held that none of the arguments presented by Ajax rose to the level of “the unusual case where the forum-selection clause should not control.” The court therefore denied Ajax’s motion to remand and transferred the case to the Northern District of Texas.


Red Wing Shoe Company, Inc. is a manufacturer of footwear and holds trademarks associated with products that it licenses to manufacturers and distributors. B-Jays USA, Inc. was party to a contract with Red Wing, which included a trademark license, that authorized B-Jays to manufacture, market, and sell Red Wing’s shoes. The contract also included a forum selection clause providing that the parties would submit to the exclusive and personal jurisdiction of the state and federal courts in Ramsey County, Minnesota, for the resolution of any dispute.

In March 2015, B-Jays filed suit against Red Wing in the U.S. District Court for the District of New Jersey, alleging various claims including breach of contract, breach of the implied covenant of good faith and fair dealing, and a violation of the New Jersey Franchise Practices Act (NJFPA). Red Wing sought to transfer venue to Minnesota. Red Wing acknowledged that forum selection clauses are void against public policy under the NJFPA, but argued that the NJFPA did not apply in this case and that the elements for transferring venue otherwise weighed in favor of Red Wing.

The court first analyzed whether the NJFPA applied. NJFPA applies to a franchise:

1. the performance of which contemplates or requires the franchisee to establish or maintain a place of business within the state of New Jersey; 2. where gross sales of products or services between the franchisor and the franchisee covered by such franchise shall have exceeded $35,000 for the 12 months preceding the institution of suit pursuant to this act; and 3. where more than 20 percent of the franchisee’s gross sales are intended to be or are derived from such franchise.

The court concluded that the NJFPA did not apply because, although B-Jays showed it had annual gross revenue well in excess of $35,000, nothing in the record indicated that there were sales in excess of that amount between B-Jays and Red Wing. The court therefore concluded that the NJFPA prohibition on forum selection clauses did not apply. Nevertheless, the court went on to hold that the matter should be transferred to Minnesota because public interest factors weighed in favor of transfer, including that if B-Jays prevailed it would be easier to obtain a judgment over Red Wing and that the courts in Minnesota could accurately and completely apply Minnesota state law.

The U.S. District Court for the District of Maine transferred a machinery dealer’s Maine dealership law claim to the U.S. District Court for the Northern District of Ohio based on the venue provision of the parties’ distributor agreement and dismissed the dealer’s contentions that the Maine dealer law’s jurisdiction and antiwaiver provisions prohibited such a transfer.

Chadwick-BaRoss, Inc. (C-B), a Maine corporation that sold industrial, construction, commercial, forestry, and business equipment and machinery, entered into a distribution agreement with Doppstadt US LLC to purchase certain Doppstadt products for resale to its customers. Doppstadt later merged with Ecoverse Industries, Ltd., an Ohio limited liability company, resulting in Ecoverse succeeding to all of Doppstadt’s rights and liabilities, including the distributor agreement. C-B sued Ecoverse in Cumberland County Superior Court, alleging violations of the Maine’s Farm Machinery, Forestry Equipment, Construction Equipment and Industrial Equipment Dealerships Act (Maine Dealerships Act). Ecoverse removed to the U.S. District Court for the District of Maine and then moved to transfer venue to the U.S. District Court for the Northern District of Ohio. C-B opposed.

To decide the venue question, the court analyzed the applicability of the forum selection clause in the distributor agreement and the effect of the Maine Dealerships Act on that clause. Under the applicable law and venue provision of the distributor agreement, venue was in Ohio, but the court stated,

[i]n the event that a law of the State in which the Distributor has its place of business or in a State of the Territory where Distributor is conducting business [Maine] is deemed to apply and said law conflicts with any provision of this Agreement, this Agreement shall be construed and enforced to be consistent with any such conflicting law, including its venue provisions.

C-B argued that the Maine Dealerships Act conflicted with the venue provision of the distributor agreement because the Act’s jurisdiction provision conferred jurisdiction upon the Maine courts. Ecoverse countered that conferring jurisdiction is different than predetermining venue. The court agreed, finding that the Act simply vested jurisdiction in Maine’s trial courts but did not explicitly mention or require that all actions under the Act be brought in Maine. Therefore, the parties’ selection of an Ohio forum in the distributor agreement did not conflict with the Maine Dealerships Act.

The court then moved on to apply the Supreme Court’s analysis in Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas, 134 S. Ct. 568 (2013), to evaluate whether this was one of the “unusual cases” where the parties’ choice of venue should not be honored. Under Atlantic Marine, a case falls into this category only if the plaintiff meets that
high burden of “show[ing] that public-interest factors overwhelmingly disfa-
vor a transfer.” Such factors include “the administrative difficulties flowing
from court congestion; the local interest in having localized controversies
decided at home; [and] the interest in having the trial of a diversity case in
a forum that is at home with the law.” C-B argued that the antiwaiver section
of the Maine Dealerships Act demonstrated that Maine’s public policy was
strong enough to defeat the parties’ forum selection clause. That section
stated that the provisions of the Act are “deemed to be incorporated” into
every agreement between a dealer and a supplier, “control all other provi-
sions of the agreement,” and cannot be waived or varied. The court was
not persuaded, however, because the section did not explain what public in-
terest concerns would be compromised by litigating a suit under the Act in
Ohio. Moreover, C-B failed to point to any unusual complications in the
Maine Dealership Act that would require analysis by a Maine court and
the Act’s jurisdiction provision did not establish an overriding interest in
having such disputes adjudicated solely in Maine. Finally, the Act did not
contain a “dealers’ choice” provision, which if combined with an antiwaiver
provision could demonstrate a public policy strong enough to defeat the
forum selection clause. Accordingly, the court granted Ecoverse’s motion
to transfer venue to the Northern District of Ohio.

(CCH) ¶ 15,616, No. 2:15-cv-04191-ODW (PJW), 2015 WL 6036273
(C.D. Cal. Sept. 16, 2015)
The U.S. District Court for the Central District of California held that the
forum selection clause in a license agreement that required all actions be-
tween the parties to be litigated “in the appropriate district court in the
city or county of Los Angeles, California” meant that venue was proper in
both state and federal courts in Los Angeles. Therefore, the franchisee’s mo-
tion to remand its action against the franchisor to a Los Angeles state court
from the federal district court was denied.

Plaintiff Jenhanco, Inc. entered into a license agreement with Dollar
Rent A Car, which through a series of mergers and acquisitions became a
wholly owned subsidiary of Hertz. Under the agreement, the plaintiff paid
a certain percentage of its gross revenue in exchange for, among other things,
first right over any other entity to expand its rental car operation within the
plaintiff’s operating locality. When the defendants allegedly denied the
plaintiff the opportunity to expand its operation for the benefit of the defen-
dants’ other non-franchise subsidiaries, the plaintiff sued in Los Angeles Su-
perior Court for breach of contract, fraud, breach of the covenant of good
faith and fair dealing, and tortious interference with prospective economic
relations. The defendants removed to the U.S. District Court for the Central
District of California based on diversity jurisdiction and the plaintiff moved
to remand based on the forum selection clause in the license agreement.
In its motion, the plaintiff argued that the action should be remanded to the Los Angeles Superior Court because the language in the forum selection clause calling for litigation “in the appropriate district court in the city or county of Los Angeles, California” meant that litigation had to be in state courts. The defendants disagreed, arguing that the action was properly removed to the Central District of California because (1) the plain meaning of the phrase “appropriate district court” included both state and federal district courts in Los Angeles, and (2) this interpretation was consistent and harmonized with another provision of the agreement. The court agreed with the defendants. Starting its analysis with the plain language of the forum selection clause, the court was guided by case law finding that although the phrase “courts of” a state refers only to state courts, the phrase “courts in” a state (as here) imposed a geographic limitation and included any court within the physical boundaries of that limitation. Therefore, the forum selection clause here provided venue in both the state and federal courts located within the City or County of Los Angeles. This conclusion was further supported by the cardinal principle of contract interpretation that a document should be read to give effect to all of its provisions and render them consistent with each other. Here, another provision of the parties’ agreement expressly provided for service of process “in any state or federal court in the State of California,” which, read consistently with the forum selection clause, made clear that both provisions included both state and federal courts in Los Angeles. Accordingly, the court denied the plaintiff’s motion to remand to state court.


Franchisor Noble Roman’s, Inc. sued its franchisee, B&MP, LLC and its two owners, Bradley and Leslie Perdriau, for breach of contract and deception, alleging they had continued to operate the franchise following B&MP’s dissolution. It argued B&MP had violated several terms of the franchise agreement, including failing to pay royalties, misreporting sales to avoid paying royalties, purchasing Noble Roman’s ingredients for non-Noble Roman’s products, and violating the noncompetition clause. B&MP and one of its owners sought to transfer venue from the U.S. District Court for the Southern District of Indiana to the Northern District of Illinois; the remaining defendant did not object to the transfer.

The Southern District of Indiana allowed the motion to transfer pursuant to 28 U.S.C. § 1404(a), which provides that “[f]or the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought.” The court found that, regarding the convenience evaluation, the location of the material events weighed in favor of transferring the case because the
franchises were located in and the alleged wrongful acts all took place in the Northern District of Illinois.

The interests of justice factors also weighed in favor of granting the motion to transfer. Those factors included: (1) docket congestion and likely speed to trial in each forum, (2) each court’s relative familiarity with the relevant law, (3) the respective desirability of resolving controversies in each locale, and (4) each community’s relationship to the controversy. The court found that docket congestion weighed in favor of the Northern District of Illinois because the Southern District of Indiana had more docket congestion and was in a judicial emergency. Regarding the courts’ familiarity with the relevant law, the court found that factor neutral because the state law applicable in this case was neither unique nor complex. However, the fact that the controversy arose because of activities conducted in Illinois and the strong interest of the Illinois Franchise Disclosure Act of 1987 in protecting its residents who become franchisees meant that the last two factors weighed in favor of transferring venue. Finding that the defendants’ delay was not sufficient reason to deny the motion to transfer, the court allowed the case to be transferred to the Northern District of Illinois.

CHOICE OF LAW


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

CONTRACT ISSUES


The Ohio Court of Appeals affirmed summary judgment in favor of a Buffalo Wings & Rings franchisee and its guarantors on the franchisor’s claims for breach of contract, breach of guaranty, quantum meruit, and money owed on account because the claims were time barred under the franchise agreement’s one-year limitation applicable to such claims.

In March 2008, M3 Restaurant Group, LLC entered into a franchise agreement with Buffalo Wings & Rings, LLC for the operation of a restaurant, which M3’s owners guaranteed. In March 2011, the defendants sent a letter to Buffalo Wings outlining their disputes with Buffalo Wings and proposed ending the business relationship. When Buffalo Wings did not reply, the defendants sent a second letter in April 2011, stating that they assumed the failure to reply meant that Buffalo Wings did not object to the termination. On November 1, 2012, Buffalo Wings filed suit against the defendants
for breach of contract, breach of guaranty, quantum meruit, and money owed on an account.

In January 2014, both parties filed motions for summary judgment, with each arguing that the other party’s claims were barred by the one-year limitations period provided in Section 19.9 of the agreement. That section prohibited either party from bringing a claim more than one year after the party discovered the facts relevant to such claim unless the claim fell within one of three exceptions: (1) claims against the franchisee for underreporting of net sales and corresponding underpayment of royalty and advertising fees; (2) claims against the franchisee relating to third party claims brought against Buffalo Wings as a result of the franchisee’s operation of the franchised restaurant; and (3) “claims for injunctive relief to enforce the provisions of this Agreement relating to,” among other things, the franchisee’s use of the franchisor’s trademarks, the franchisee’s obligations upon termination or expiration of the agreement, or an assignment of the agreement. Although the parties agreed that exceptions (1) and (2) did not apply, they disagreed as to the third exception. On one hand, Buffalo Wings interpreted the third exception to mean that the phrase “claims for” modified the enumerated list and “injunctive relief” pertained only to claims relating to the use of the franchisor’s trademarks. On the other hand, the defendants argued that the phrase “claims for injunctive relief to enforce the provisions of this Agreement relating to” modified the four items that followed; in other words, the third exception applied to four different types of claims for injunctive relief. The defendants argued this was the only logical reading of § 19.9(iii); otherwise the second, third, and fourth subparts of § 19.9(iii) would belong in § 19.9(i) or (ii), which are the exceptions that relate to “claims against franchisee.” The trial court agreed, finding the provision unambiguous. Because Buffalo Wings was on notice of the facts giving rise to the defendants’ claims as of their April 2011 letter, the November 2012 complaint, which did not include any claim for injunctive relief, was therefore time barred by § 19.9.

On appeal, the court agreed with the trial court’s reading of § 19.9(iii). It, too, concluded that the language of § 19.9(iii) was unambiguous and that Buffalo Wings’ reading “would result in awkward phrasing, at best, and nonsensical phrasing, at worst.” To the contrary, the defendants’ reading was grammatically correct in structure and meaning and reflected “the most natural reading of the provision.” For these reasons, the appellate court affirmed the trial court’s judgment against the franchisor and in favor of the franchisee and its guarantors.


Plaintiff Burger King Europe GMBH filed suit in the U.S. District Court for the Northern District of Texas against Christian Groenke to recover on a
guaranty agreement executed by the defendant. The court concluded that the plaintiff established that the defendant was liable under the guaranty, that the defendant failed to meet his burden of proof on affirmative defenses, and that the plaintiff had established the amount of its damages.

The plaintiff, through an affiliate, franchised Burger King restaurants throughout Europe. The defendant, through a corporate entity, operated approximately eighteen Burger King franchises in and around Berlin. The defendant signed the guaranty that guaranteed the performance and obligations, including payment, of the applicable Burger King restaurants. The plaintiff alleged that the franchise agreements were breached, thus entitling the plaintiff to collect damages under the guaranty from the defendant. The plaintiff sought summary judgment on the issues of breach and the amount of damages.

The defendant raised the following affirmative defenses: (1) failure of consideration, (2) the plaintiff made misrepresentations causing its claims to be barred, (3) the plaintiff’s claims were barred because of its contributory negligence, (4) the plaintiff’s claims were barred pending resolution of a related insolvency proceeding in Germany, (5) setoff, (6) the plaintiff had written off the debt, and (7) frustration of purpose.

The court addressed each of the defenses. As to failure of consideration, the court held that the Burger King restaurants and the related development agreement were sufficient consideration. As to the alleged misrepresentations and contributory negligence, the court characterized the defenses as a form of setoff and held that the setoff bar in the Guaranty was enforceable. As to the German insolvency proceeding, the court relied upon expert testimony provided by the plaintiff stating that the proceeding did not affect the plaintiff’s rights against the defendant. As to writing off the debt, the court held that writing off or depreciating a debt in one’s internal records does not constitute a waiver of the principal obligation. As to frustration of purpose, the court considered the defendant’s testimony that he would not have signed the guaranty if the plaintiff had not allegedly promised him additional restaurants and development agreements in the future. The plaintiff denied making such a promise. The court did not find the defendant’s testimony credible and, even if such verbal promises were made, they were not sufficiently definitive to permit a frustration of purpose defense. The court therefore entered judgment in favor of the plaintiff.

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

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

The defendant Safeguard Business Solutions, Inc. (SBS) provided business management solutions to small businesses, including printing, promotional products, business apparel, and web services. SBS was acquired by Deluxe Corporation, also named as a defendant. Greg and Vicki Schob, and Schob, Inc. were distributors for the defendants and parties to the distribution agreement with the defendants.

In May 2015, the Schobs brought various claims against SBS, Deluxe, and other defendants for breaches of the distribution agreement. The claims included a request for declaratory judgment and claims for breach of contract, breach of the covenant of good faith and fair dealing, tortious interference with contractual relations, intentional interference with prospective economic advantage, intentional misrepresentations, negligent misrepresentation, conversion, and accounting. The defendants subsequently brought a motion to dismiss the plaintiffs’ amended complaint pursuant to the Federal Rules of Civil Procedure.

The court granted with prejudice the defendants’ motion to dismiss the plaintiffs’ claim for declaratory judgment, the defendants’ motion to dismiss the Schobs’ claim for tortious interference with contractual relations and intentional interference with prospective economic advantage, and the defendants’ motion to dismiss the Schobs’ claim for conversion. It also denied the defendants’ supplemental request for judicial notice, the defendants’ motion to dismiss for lack of personal jurisdiction regarding certain defendants, and the defendants’ motion to dismiss the Schobs’ claim for breach of the implied covenant of good faith and fair dealing, breach of contract, intentional misrepresentation, negligent misrepresentation, and accounting.

In accordance with the governing law provision in the distribution agreement, the contractual dispute was decided under Pennsylvania law. In dismissing the majority of the Schobs’ breach of contract claims, the court noted that under Pennsylvania law, a party’s conduct does not constitute a breach of contract unless there is a violation of an express duty stated

This case is discussed under the topic heading “Oral Agreements.”
within the contract, as stated in the holding in *Gallo v. PHH Mortgage Corp.*, 916 F. Supp. 2d 537 (D.N.J. 2012). Since the Schobs failed to plausibly allege a breach of an express duty for several of their claims, they were unable to plausibly allege a breach of contract claim. The court found that the Schobs failed to point to any language in the distribution agreement to support the argument that practices, such as SBS having arbitrarily increased shipping and handling costs for its own profits, amounted to a breach of the contract.

Although the court rejected the majority of the plaintiffs’ breach of contract claims, it allowed the plaintiffs’ breach of contract claims premised on alleged breaches of Schobs’ “Customer Protection rights.”

Regarding good faith and fair dealing, the court found that Pennsylvania law recognizes a claim for breach of the implied covenant of good faith and fair dealing as an independent cause of action separate from a breach of contract claim. However, it clarified that a prerequisite for a breach of the implied covenant of good faith and fair dealing claim is that the plaintiff has also brought a valid breach of contract claim. The court disagreed with the defendants’ argument that *McHale v. NuEnergy Group*, No. 01-4111, 2002 WL 321797 (E.D. Pa. Feb. 27, 2002), stood for the proposition that Pennsylvania law does not “recognize a claim for breach of the implied covenant of good faith and fair dealing as an independent cause of action separate from a breach of contract claim, because the actions forming the basis of the contract claim are essentially the same as the actions forming the basis of the bad faith claim.” It found that because the Schobs had properly brought a valid breach of contract claim, their claim for a breach of the implied covenant of good faith and fair dealing was properly advanced.


This case is discussed under the topic heading “Statute of Limitations.”

**DAMAGES**


The U.S. District Court for the District of New Jersey denied a motion to amend an order to include liquidated damages. The plaintiff, Days Inns Worldwide Inc. (DIW), had previously been granted default judgment against the defendants, JPM, Inc. and Jayantilal Shah. The prior order awarded DIW damages for unpaid recurring fees, attorney fees, and costs,
but denied DIW an award for liquidated damages. DIW brought this motion to amend the order to include liquidated damages.

DIW entered into a license agreement with Shah for the operation of a guest lodge facility. Pursuant to the agreement, Shah was required to make recurring payments to DIW for royalties, service assessments, taxes, interest, reservation system user fees, and other fees. JPM agreed to pay interest on any delinquent payments under the franchise agreement. Moreover, under the agreement, JPM agreed to pay liquidated damages upon termination in accordance with a formula set out therein. The defendants failed to pay the recurring fees. As a result, DIW terminated the franchise agreement.

DIW filed a complaint seeking to recover liquidated damages, recurring fees, and attorney fees in accordance with the terms of the license agreement and the assignment and assumption agreement whereby JPM Inc. assumed all of Shah’s rights and obligations under the license agreement. The defendants failed to answer, and the court entered a default judgment against them on July 26, 2013. The court ordered payment of the recurring fees and attorney fees, but denied the request for liquidated damages on the grounds that DIW had not adequately explained the reasonableness of its liquidated damages claim or its calculation, as required by New Jersey law.

DIW brought a motion to amend the order on November 17, 2014, explaining that it had simply used the wrong date to calculate prejudgment interest. DIW asserted that this flaw in its calculation constituted a “clerical error,” and the order should therefore be amended.

The court considered DIW’s request in light of timelines imposed by Federal Rule of Civil Procedure 7.1(i), which requires that a motion for reconsideration be filed within fourteen days after the entry of the order or judgment, and Rule 59(e), which requires that a motion to alter or amend a judgment be filed twenty-eight days after the entry of the order or judgment. Because DIW’s motion was filed more than three months after the entry of the judgment, neither of these rules permitted the court to amend the order. The court noted that corrections of substantive errors in judgments are subject to these short time limits to ensure finality.

The court then considered a third provision, Rule 60(a). This rule allows the court to correct clerical mistakes that arise from oversight or omissions whenever one is found in a judgment. The court noted that case law has confined the application of Rule 60(a) to the correction of mechanical errors apparent on the record that do not involve an error of substantive judgment. Mistakes that are merely clerical, however, can be corrected pursuant to this rule, without reopening the substantive merits.

DIW sought to correct an error in its own papers, which, if remedied, might have led the court to make a different decision. The court held that the error at issue was DIW’s presentation of its liquidated damages. The court held that this was a substantive inadequacy that was more than a clerical error. As such, the court could not review the order under Rule 60(a) and denied the motion.
Defendant Patton Wallcoverings, Inc., a wallpaper manufacturer, allegedly breached its distributing contract with plaintiff Elite International Enterprise, Inc. by refusing to supply Elite with certain products. Elite and Patton formalized their agreement in March 2011. Under the agreement, Elite was designated as an exclusive sales agent and a distributor of Patton products. Elite sold Patton’s products at an average sale price of $15 per wallpaper roll. In August 2011, Patton sent Elite an email explaining that Elite would be limited to selling only existing product lines. Elite sued for breach of contract and obtained a grant of summary judgment as to liability on that claim. The U.S. District Court for the Eastern District of Michigan, however, granted partial summary judgment to Patton on the remainder of Elite’s claims, including the claim that Elite had an exclusive distribution agreement that Patton also breached by selling directly and through another distributor in the Middle East market. DID Wallcoverings became a manufacturer and a distributor of Patton products in 2010. Under that agreement, DID was allowed to sell Patton products in Asia and the Middle East but prevented from selling to other Patton distributors, like Elite.

After a bench trial on damages, the district court awarded Elite $222,465.18 in lost profits. The district court based its award on the assumption that if Elite were still operating optimally and able to freely place orders with Patton or DID for products for sale in the Middle East, it would have a two-thirds chance of being the buyer for every sale that DID made in the Middle East and then turning around and successfully reselling the product at the $15 average sales price. Using this method, the district court awarded Elite $222,465.18 in damages, reflecting 74,493 rolls of wallpaper sold by DID in the region at Elite’s $15 average sales price, with a 50 percent profit margin and a 66.6667 percent sales probability, minus Elite’s average annual fixed costs over the three year term of the contract ($150,000). Both parties, dissatisfied with the award, appealed.

On appeal, Patton assigned three errors to the district court: (1) the district court erroneously awarded Elite lost profits, (2) the district court’s calculation of lost profits was improper, and (3) the district court abused its discretion in finding that Elite reasonably mitigated its damages. Elite, for its part, argued that the court erred in granting partial summary judgment to Patton on Elite’s additional contract claim and in failing to award greater damages.

The Sixth Circuit first considered Elite’s claim that Patton also breached the distribution agreement by selling in the Middle East both directly and through DID. Affirming the district court’s grant of partial summary judgment to Patton on this claim, the Sixth Circuit agreed with the lower court that the agreement between Elite and Patton did not name Elite as the exclusive distributor of Patton products in the Middle East. The parties’
contract used the word “exclusive” but only in reference to Elite’s status as sales agent and not its status as distributor of Patton. Nor did Elite’s exclusive agency grant it an exclusive right to sell. Patton, therefore, did not breach the parties’ contract by selling products in the Middle East.

Next, the Sixth Circuit considered the parties’ challenges to the damages award. Employing the abuse-of-discretion standard of review applicable to damages awards, the court noted that in order to recover prospective profits, a plaintiff must prove lost profits “with a reasonable degree of certainty.” Patton first challenged the district court’s lost profits award to Elite precisely on the basis that it was based on mere speculation, not reasonable certainty. According to Patton, the evidence, including Elite’s tax returns, supported the district court’s finding that Elite ran a profitable business and that its sales declined following the breach. Therefore, the district court did not abuse its discretion in concluding that Elite suffered some lost profits.

With respect to the district court’s calculation of lost profits, the Sixth Circuit agreed with Patton and found that the district court committed error by (1) concluding that DID and Elite were sufficiently similar to allow the court to use DID’s sales figures; and (2) treating DID as a supplier rather than a direct competitor of Elite, even though DID was contractually prohibited from selling to Elite. According to the Sixth Circuit, the district court should have used Elite’s actual sales data to estimate lost profits. Instead, the evidence, including Elite’s tax returns, supported the district court’s finding that Elite ran a profitable business and that its sales declined following the breach. Therefore, the district court did not abuse its discretion in concluding that Elite suffered some lost profits.

Based on the foregoing, the Sixth Circuit affirmed the district court’s award of partial summary judgment to Patton but vacated the damages award and remanded to the district court for recalculation of damages using Elite’s own sales data.

The plaintiff, Super 8 Worldwide, Inc. (SWI), moved under Federal Rule of Civil Procedure 55 for default judgment against the defendants. SWI filed this action alleging that the defendants breached a franchise agreement. The defendants failed to plead or otherwise defend the lawsuit. The court granted the motion for default judgment after considering the factors outlined in Chamberlain v. Giampapa, 201 F.3d 154 (3d Cir. 2000).

SWI entered into a franchise agreement with the defendant, JJC Corporation, for the operation of a seventy-four-room Super 8 guest lodging facility. Pursuant to the agreement, the defendant was required to make certain periodic payments to SWI for royalties, system assessment fees, taxes, interest, reservation system user fees, and other fees. The franchise agreement further provided that SWI could terminate the franchise agreement with notice to the defendant upon: (1) failure to pay any amount due under the franchise agreement; (2) failure to remedy any default within thirty days after receipt of written notice from SWI; and (3) receipt of two or more notices of default under the franchise agreement, whether the defaults were cured. In this case, the defendants repeatedly failed to meet their financial obligations under the agreement. As a result, SWI terminated the franchise agreement.

SWI then filed a complaint in the U.S. District Court for the District of New Jersey seeking amounts owing under and damages due to breach of the franchise agreement. The summons and complaint were served on one of the defendants, Rejendra Patel, who had provided SWI with a guarantee of JJC’s obligations under the franchise agreement. Patel failed to plead or otherwise defend the action. The clerk of the court entered default against the defendants. SWI therefore brought a motion for default judgment against the defendants.

The court outlined the three factors from Chamberlain for evaluating a motion for default judgment under Rule 55: (1) whether there is prejudice to the plaintiff if default is denied, (2) whether the defendant appears to have a litigable defense, and (3) whether defendant’s delay is due to culpable conduct.

SWI’s action was based on breach of contract, and the elements of the claim were met: (1) there was an agreement and guaranty between the parties, (2) the defendants breached the agreement by failing to meet their financial obligations, (3) damages flowed therefrom, and (4) SWI had performed its own contractual obligations.

The court determined that SWI would suffer prejudice if default was denied because it had already waited over three years for amounts to which it was entitled based on breach of contract. None of the defendants had put forward a defense or presented any facts suggesting that they had a defense. They had also failed to retain counsel in the nearly twenty-month period since the filing of the complaint. In granting the motion for default judgment, the court also noted that the amounts requested by SWI in its submissions accurately represented the amounts owed.
DEFINITION OF FRANCHISE


Masterbrand Cabinets, Inc. is a manufacturer of cabinets. Rogovsky Enterprises, Inc. is a franchisor of kitchen and bath design and home remodeling businesses called Kitchen & Home Interiors (KHI). In December 2011, Masterbrand and Rogovsky entered into a distribution agreement under which Rogovsky agreed to require that all KHI franchisees purchase cabinets exclusively from Masterbrand. The agreement also obligated Rogovsky to, among other things, use its best efforts to actively pursue new KHI franchisees. In addition, Rogovsky was prohibited from distributing or selling any products in a particular territory that Masterbrand reasonably determined were in competition with Masterbrand.

Rogovsky thereafter began selling KHI franchises in Florida. In October 2013, Masterbrand gave Rogovsky written notice stating that, pursuant to the parties’ agreement, Rogovsky could not sell any more franchises in Florida because Masterbrand determined that the KHI Florida franchises were competing with Masterbrand dealers. Rogovsky responded by filing a thirteen-count complaint against Masterbrand in the U.S. District Court for the District of Minnesota, including breach of contract, tortious interference with contractual relations, and alleged violations of various state franchise statutes. The district court first determined that the agreement at issue did not constitute a franchise contract under the Minnesota Franchise Act because it did not involve a franchise fee. The court thereafter transferred the matter to the U.S. District Court for the Southern District of Indiana pursuant to a forum selection clause in the agreement for further consideration of the other claims.

The Indiana district court considered a motion to dismiss filed by Masterbrand on the ground that Rogovsky had failed to state a claim. The court first addressed whether the Minnesota court’s determination regarding the agreement was considered “law of the case” and thus binding. The court determined that the decision was law of the case because Rogovsky had the opportunity to participate in oral argument on the matter and the decision was otherwise “highly persuasive and well-reasoned.”

The court next addressed whether the agreement was an “area franchise” under applicable state statutes. The court concluded it was not because KHI franchises were not sold under the Masterbrand name. The court therefore granted Masterbrand’s motion to dismiss on those counts. The court then considered whether the agreement was a franchise agreement under other state laws. The court noted that a franchise agreement must have: (1) a franchise fee; (2) a trademark license; and (3) the right of the franchisor to exert significant control over the franchisee’s business. As to the franchise fee, the court held that the $300,000 spent by Rogovsky for remodeling costs of Rogovsky’s Florida facility to feature Masterbrand products did not qualify as a franchise fee.
franchise fee for several reasons, including the fact that the expenditure was not required under the agreement. The court also refused to consider Rogovskys promise to exclusively sell Masterbrand products as non-monetary consideration because a franchise fee must be an actual fee or charge. Rogovskys also argued that amounts he spent on training constituted a franchise fee. Again, the court disagreed on the grounds that the agreement did not actually require Rogovskys to spend those amounts.

The court next addressed whether Rogovskys was granted the use of Masterbrands trademarks in such a way to meet the second element for a franchise. The court noted that Rogovskys had the right to use Masterbrands mark to advertise the sale of Masterbrand products. Rogovskys was not granted a license to use Masterbrands mark to promote KHI franchises. The court therefore concluded that the element was not met. The court also addressed the issue of Mississippi state law, which does not require a franchise to be associated with a trademark. Applicable Mississippi law also does not include an antiwaiver provision. The court therefore held that language in the agreement waiving the right to argue that the agreement was a franchise was binding on the matter.

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

ENCROACHMENT

This case is discussed under the topic heading “Statutory Claims.”

FRAUD

The franchisee plaintiffs and various associated persons filed suit against the franchisor defendant Wireless Toyz following a breakdown in the relationship. The plaintiffs alleged that Wireless Toyz Franchise, LLC had failed to disclose certain costs and expenses related to operating the franchise, committing “silent fraud” by failing to disclose “chargebacks” and “hits” associated with the business. On May 13, 2014, the Michigan Court of Appeals found that Wireless Toyz had engaged in silent fraud. Wireless Toyz sought leave to appeal. On November 4, 2015, the Michigan Supreme Court, after
hearing oral argument on the application for leave to appeal, denied leave to appeal without giving detailed reasons. However, Justice Zahra wrote a dissenting opinion on the basis that the decision of the court below “cutter against a fundamental tenet of [the] Court’s jurisprudence that requires the enforcement of unambiguous contracts freely executed by the parties.”

Justice Zahra asserted that the plaintiffs and defendants entered into unambiguous written agreements containing broad disclaimers. For example, he pointed to a development agent agreement that explicitly acknowledged that Wireless Toyz had not made any “representations or projections of potential earnings, sales, profits, costs, [etc.] . . . .” Additionally, a similar disclaimer was included in the franchise agreement. Both the duty to disclose under Michigan Comprehensive Laws § 445.1505 of the Michigan Franchise Investment Law and the law of silent fraud require a prior representation in order for an omitted material fact to render an otherwise truthful representation misleading. Justice Zahra opined that, as a matter of contract, the parties had agreed that no prior representations had been made and held that the decision by the Michigan Court of Appeals should be reversed.

This case is discussed under the topic heading “Statute of Limitations.”

GOOD FAITH AND FAIR DEALING

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

This case is discussed under the topic heading “Unfair Competition and Unfair and Deceptive Practices.”

INJUNCTIVE RELIEF

The U.S. District Court for the Northern District of Illinois denied the plaintiffs’ motion to stay the enforcement of a preliminary injunction pending interlocutory review. The court ruled that the plaintiffs had not established that they had a significant probability of success on the merits of
the appeal, that they would suffer irreparable harm absent a stay, that a stay would not injure the defendants, or that a stay was in the public interest.

IHOP terminated its franchise agreement with the plaintiff franchisees following a series of failed operational evaluations with respect to their IHOP franchise in Arlington Heights, Illinois. Both parties filed motions for preliminary injunctions. IHOP’s motion was granted and Chaudhry’s motion was denied. Chaudhry then filed a motion to stay the enforcement of the preliminary injunction.

The court found that the evidence submitted by Chaudhry did not establish a significant probability of success on the merits of the appeal. Chaudhry introduced declarations from various individuals in an effort to undermine the integrity of the restaurant inspection reports and therefore the legality of IHOP’s termination of the franchise agreement. However, as the declarations came from individuals who were not actually present for any of the restaurant inspections and they did not provide information to challenge the accuracy of the results, the court held this evidence was not relevant. Additionally, Chaudhry introduced evidence to suggest that the franchise agreement was not lawfully terminated and therefore this constituted a defense to IHOP’s allegations. However, the court clarified that improper termination of a franchise agreement is not a defense to a trademark infringement.

The court also clarified that allegations of bad faith are not relevant to a motion for a preliminary injunction to enforce a termination of contract based on a material breach of the franchise agreement. Given this, Chaudhry’s evidence of improper termination was irrelevant. As such, Chaudhry had failed to provide evidence to establish a significant probability of success on the merits of the appeal. The court also dismissed Chaudhry’s argument that it would be irreparably harmed absent a stay of the preliminary injunction. The court noted that Chaudhry provided no argument in this respect aside from the reference to In re A&F Enterprises, Inc. II, 742 F. 3d 763 (7th Cir. 2014), in which the previous order had concluded was inappropriate and unpersuasive.

In addition, the court found Chaudhry had failed to establish that a stay would not injure the opposing party or that it would be in the public interest. The court found that pursuant to the previous order, there was an established potential harm to IHOP as a result of customer confusion and potential injury to IHOP’s goodwill and reputation. Further, although the court agreed there was a public interest in protecting Illinois franchisees from abuse and unscrupulous franchisors, Chaudhry had not provided evidence to show that had occurred in this case.
the Lanham Act, based on Zeal’s operation of a hotel in Myrtle Beach. Zeal was never a Choice franchisee, but rather an assignee of the hotel premises by a former Choice franchisee. Following the assignment, Zeal rebranded the hotel from Econo Lodge Inn & Suites to Econo Studios Inn & Suites. Choice argued that, even after the change in name, the new name violated Choice’s trademarks and created a likelihood of consumer confusion. The U.S. District Court for the District of South Carolina took the matter up on Choice’s motion for an injunction and summary judgment.

The court noted the following elements that Choice was required to meet to show infringement under the Lanham Act: (1) that it owns a valid mark; (2) that Zeal used the mark in commerce without Choice’s authorization; (3) that Zeal used the mark (or an imitation of it) in connection with the sale, offering for sale, distribution, or advertising of goods or services; and (4) that Zeal’s use of the mark is likely to confuse consumers.

The court focused its analysis on an in-depth review of whether Zeal’s use of Econo Lodge Inn & Suites was likely to confuse consumers. The court followed the nine-factor test cited in Perini Corp. v. Perini Construction, Inc., 915 F.2d 121, 127 (4th Cir. 1990): (1) the strength or distinctiveness of the plaintiff’s mark as actually used in the marketplace; (2) the similarity of the two marks to consumers; (3) the similarity of the goods or services that the marks identify; (4) the similarity of the facilities used by the mark holders; (5) the similarity of advertising used by the mark holders; (6) the defendant’s intent; (7) actual confusion; (8) the quality of the defendant’s product; and (9) the sophistication of the consuming public.

The court determined that Choice’s marks were commercially strong because, even if the marks could be described as descriptive (as opposed to suggestive, arbitrary, or fanciful), Choice had used the marks for a long period of time in commerce. Moreover, Zeal had failed to meet its burden of establishing genericide, meaning that the public’s pervasive use of a mark caused it to lose its trademark significance. The court went on to analyze elements two through five based on the similarity of the applicable hotel names. The court held that Choice was not required show that the names were identical and that all the relevant facts support similarity. As to intent, the court held that there were insufficient facts to establish that Zeal intended to infringe. The court next addressed customer confusion, noting that Choice provided the following examples: (1) Choice being named in a lawsuit by a former guest of Zeal, and (2) a Zeal guest who called Choice’s customer service line to complain. Zeal argued that two examples were insufficient to create customer confusion. The court found the examples sufficient, noting that for every customer that either files a lawsuit or calls to complain, there may be “countless” other customers who walk out of the hotel and warn their friends and family not to stay at the chain. Finally, the court found elements 8 and 9 not applicable.

The court thus found that Zeal’s hotel name created a likelihood of consumer confusion and that Zeal had infringed on Choice’s marks. The court
also held that the same elements established Choice’s other claims for unfair competition under the Lanham Act and a common law trademark infringement claim. The court moved on to the remedies available to Choice. First, the court determined that Choice was entitled to injunctive relief because it had suffered an irreparable injury (likelihood of confusion and actual confusion), that Choice lacked an adequate remedy at law because Zeal’s actions showed that the risk of a lawsuit and monetary damages would not deter it, that the balance of hardships weighed in favor of Choice, and that an injunction would serve the public interest because it would prevent consumer confusion in the marketplace. As to monetary damages, the court noted that the Lanham Act provides that a plaintiff establishing trademark infringement is entitled to: (1) the defendant’s profits, (2) damages sustained by the plaintiff, and (3) the costs of the action. Choice demonstrated that Zeal had failed to respond to discovery that would substantiate Choice’s damages. The court stated that Zeal’s failure to respond and otherwise the way it handled the litigation was “baffling.” The court stated that the damages could be up to $3 million, but determined to allow Zeal a final opportunity to explain its actions and seek a lower amount prior to a ruling. Therefore, the court entered summary judgment in Choice’s favor, entered an injunction prohibiting Zeal from using Choice’s marks and requiring Zeal to remove all Econo Studios Inn & Suites signage and ordered the parties to submit briefing relating to damages.


The U.S. District Court for the Southern District of Indiana granted a non-medical home care franchisor’s motion for preliminary injunction enjoining a former franchisee’s use of the franchisor’s name and licensed marks and requiring it to return all materials relating to the operation of the former franchise to the franchisor, but denied the franchisor’s request to enforce the noncompete against the former franchisee and its guarantors.

Defendant Home Instead, Inc. provides non-medical care to senior citizens through independently owned franchises. On October 16, 2006, plaintiff Elder Care Providers of Indiana, Inc. entered into a franchise agreement with Home Instead to operate a Home Instead business in Indianapolis for ten years. Elder Care’s sole shareholders, Anthony and Georgette Smith, personally guaranteed the franchise agreement. Elder Care provided non-medical home care to seniors and was not allowed by its franchise agreement and Indiana licensure restrictions to provide any medical care because it was licensed as a personal service agency (PSA) rather than a home health agency (HHA).

In November 2011, the Smiths formed Home Again Senior Care, Inc., a separately licensed HHA corporation through which medical home health care was provided to clients referred by both Elder Care and other area
Home Instead franchises that could not provide medical care. Home Instead first learned of Home Again’s operations in March 2013. Concerned about possible confusion resulting from the name Home Again, given its similarity to Home Instead as well as potential competition, Home Instead undertook a twenty-month investigation into Home Again’s operations, focusing on whether Elder Care was diverting business to Home Again to the detriment of Home Instead. Concluding that the operation of Home Again was a breach of the franchise agreement’s competitive restrictions and infringement on Home Instead’s trademark, Home Instead terminated the franchise agreement with Elder Care in November 2014. Elder Care, however, continued to operate its Home Instead franchise until the first week of February 2015. Elder Care claimed that it returned all Home Instead proprietary materials immediately after discontinuing operations. In May 2015, Elder Care transferred all of its patients to a neighboring Home Instead franchisee. In August 2015, Home Again changed its legal business name to Purpose Home Health, Inc.

Elder Care filed suit in the U.S. District Court for the Southern District of Indiana on November 8, 2014, alleging that Home Instead’s termination breached the franchise agreement and violated the Indiana Deceptive Franchise Practices Act. Home Instead counterclaimed against Elder Care, Home Again, and the Smiths for breach of contract, civil conspiracy, misappropriation of trade secrets, unfair competition, and trademark infringement. Elder Care filed its motion for preliminary injunction in February 2015, asking the court to order the Smith parties to cease using the Home Instead name; comply with their post-termination covenants, including their nondisclosure and noncompetition covenants; and return to Home Instead all materials relating to the operation of Elder Care’s business. After a hearing, the court issued its order granting in part and denying in part Home Instead’s motion for preliminary injunction. The court granted the motion as it pertained to the Smith parties’ use of Home Instead-related names and return of all Home Instead-related documents used in the operation of the Elder Care franchised business but denied the motion as to enforcement of the noncompete.

As to the former, the court first found that Home Instead had a reasonable likelihood of success on the merits of its claims for trademark infringement and breach of contract related to the failure to return confidential information. Although the parties hotly contested whether termination of the franchise agreement was proper—with Home Instead claiming it had the right to terminate immediately after its twenty-month investigation and the Smith parties contending that Home Instead waived the right to terminate based on its delay and that termination was in bad faith—the court concluded that Home Instead could show “a better than negligible chance of succeeding on its claimed breach of Franchise Agreement that permitted its lawful termination[,]” The evidence demonstrated that the Smith parties had in
fact continued to use the name “Home Instead” after termination of the franchise agreement and, without Home Instead’s permission, used that name in conjunction with Home Again in an attempt to market the two companies together. The Smith parties even intertwined the operations of the two businesses, rebutting their argument that Home Instead terminated the agreement in bad faith. Moreover, the Smith parties continued to use Home Instead’s name and marks after termination in emails, Elder Care’s bank account listing “DBA Home Instead Senior Care” after its name, and Home Again’s workers’ compensation policy listing Mr. Smith’s email as ‘homeinstead.com.” Lastly, the court found that the Smith parties’ use of the names “Home Instead” and “Home Again” caused confusion between the marks, as evidenced by a phone call to a neighboring Home Instead franchise asking for an employee of Home Again. Therefore, Home Instead had a reasonable likelihood of succeeding on the merits of its claims. The court also found that Home Instead met its burden of showing that absent a preliminary injunction it would suffer irreparable harm and lacked an adequate remedy at law. Not only is there a well-established presumption that injuries arising from Lanham Act violations are irreparable, but Home Instead also submitted evidence of the strength of its marks; of the significant time, effort, and resources it expended to perfect its business system and establish customer goodwill; and of its efforts to keep its system and confidential information secret from competitors and the public. Lastly, the court determined that the balance of the harms favored issuing an injunction because by ceasing use of the Home Instead name and marks and returning Home Instead’s confidential information, the Smith parties were merely ordered to do what they had agreed to do in the franchise agreement and claimed they had already done.

However, the court denied Home Instead’s motion with respect to enforcement of the post-termination covenant not to compete because of the near two-year delay by Home Instead in requesting injunctive relief and the fact that the alleged competing business fell outside the scope of the non-compete. The court found that Home Instead’s near two-year delay in seeking to halt Home Again’s business with a two-year noncompete was inconsistent with a claim of irreparable injury. Nor could Home Instead show a reasonable likelihood of success on the merits of the claim because Home Again’s business provided medical-based home health care, which the non-compete did not prohibit. Instead, the noncompete prohibited Elder Care from operating, or having any financial or beneficial interest, in a “non-medical companionship and domestic care service business” in its former exclusive territory that would be of a character and concept similar to a Home Instead Senior Care. The concepts were simply not similar here. Finally, the balance of the harms weighed strongly against enjoining the operation of Home Again because doing so would deprive 230 patients of continuity of care and 124 employees could potentially be out of work.
Int’l Franchise Ass’n, Inc. v. City of Seattle, Bus. Franchise Guide (CCH) ¶ 15,606, 803 F.3d 389 (9th Cir. 2015)
This case is discussed under the topic heading “Labor and Employment.”

The U.S. District Court for the District of New Jersey granted Jackson Hewitt Inc.’s motion for a preliminary injunction against a former franchisee, enjoining him from operating competing tax preparation businesses in violation of a covenant not to compete and enforcing other post-termination obligations under the parties’ franchise agreements.

Plaintiff Jackson Hewitt Inc. entered into four franchise agreements with defendant David Cline for the license and operation of income tax preparation businesses within defined geographic territories in Arizona and California. In a letter dated June 10, 2014, Jackson Hewitt notified Cline that he was in default of the franchise agreements for failure to pay his financial obligations as required under the agreement and that failure to cure by June 20, 2014, could result in termination of the agreement. Cline failed to cure, and in a letter dated August 25, 2014, Jackson Hewitt informed Cline that it was terminating the franchise agreements effective immediately. Notwithstanding termination and in violation of his post-termination obligations under the franchise agreements, Cline continued to operate competing income tax return preparation businesses under the names “Classic Accounting” and “Abacus Accounting” in at least three of his former franchise territories in Arizona and California, in the same exact locations as his former Jackson Hewitt franchised locations, and using the same employees he used as a Jackson Hewitt franchisee. In addition, Cline ran advertising directed at Jackson Hewitt clients promoting his tax preparation services under the “Classic Accounting” name. He also retained and made use of client files and the telephone numbers associated with Cline’s former Jackson Hewitt franchised locations.

Jackson Hewitt filed its complaint for various breaches of the franchise agreements in November 2014 and its motion for a preliminary injunction compelling Cline to adhere to his post-termination obligations under the franchise agreements in March 2015. Jackson Hewitt sought an order compelling the defendant to: (1) adhere to the two-year, ten-mile radius noncompete provision of the franchise agreements; (2) return to Jackson Hewitt all client files; (3) return all trade secret, confidential, and proprietary information; and (4) transfer all telephone numbers associated with the franchised Jackson Hewitt businesses to Jackson Hewitt and notify the telephone companies that the defendant no longer had the right to use such telephone numbers. Cline denied any wrongdoing, except to admit that he prepared individual tax returns to earn a living, but claimed that the noncompete was an undue hardship because Arizona is a right to work state. The court was unpersuaded by the defendant’s argument and granted the preliminary in-
junction enforcing defendant’s post-termination obligations, including the covenant not to compete.

According to the court, Jackson Hewitt demonstrated a likelihood of success on the merits by showing that Cline breached the franchise agreements by: (1) operating competing tax businesses in violation of the covenants not to compete; (2) failing to comply with his post-termination obligations; and (3) soliciting, or assisting in the soliciting, of customers, or otherwise using client files and telephone numbers associated with Cline’s former franchised Jackson Hewitt businesses. The court noted that, although Cline denied certain of Jackson Hewitt’s factual allegations, he offered no evidence in support. For example, Cline argued that he did not own or manage tax preparation firms operating in his former locations, but Jackson Hewitt presented evidence from the Arizona Corporation Commission website showing that Classic Accounting remained an active corporation at the same address as one of Cline’s former Jackson Hewitt locations. Moreover, Jackson Hewitt need only show a “reasonable probability” of prevailing in the litigation, and it did so here. With respect to irreparable harm, the court found that Jackson Hewitt met its burden based on Cline’s possession, use, and/or “inevitable disclosure” of its confidential information (i.e., client files). That such unlawful retention and potential use or “inevitable disclosure” constitutes irreparable harm is not only recognized by New Jersey law, but was expressly recognized by both parties in the franchise agreements. The court also found that the balance of the hardships and the public interest warranted entry of a preliminary injunction. The noncompete agreement’s two-year and ten-mile restrictions were reasonable and the hardship to Jackson Hewitt from Cline’s improper retention and use of client files was significant. Lastly, the public interest was best served by holding the defendant to the reasonable terms of his post-termination obligations under the franchise agreements. Jackson Hewitt’s motion for preliminary injunction was therefore granted.

The U.S. District Court for the Western District of Washington entered a final injunction enjoining a former dealer and its vice-president from selling competing products and services in violation of the noncompetition and nonsolicitation clauses in the parties’ dealer agreement.

Plaintiff MetroPCS Pennsylvania, LLC is a wireless telephone carrier that focuses on offering prepaid plans and relies on its dealers to market and sell its products and provide service to its customers. MetroPCS entered into a dealer agreement with City Wireless, Inc. (CWI) in February 2014. Aimen Arrak, CWI vice president, signed the agreement on behalf of CWI. Pursuant to the agreement, CWI agreed not to solicit or divert MetroPCS customers during the term of the agreement and for six months after its termination. CWI further agreed not to compete with MetroPCS within a
two-mile radius of CWI’s MetroPCS storefronts during the same period. MetroPCS asserted that those provisions were critical to its business because it invested substantial resources in training and supporting dealers and was vulnerable to having its customers poached while it attempted to reestablish a presence in a particular area after its relationship with a dealer ended.

In late 2014, CWI breached the dealer agreement and MetroPCS terminated the agreement effective February 20, 2015. When, despite termination, CWI continued to operate and sell competing wireless services for Boost Mobile, a competitor of MetroPCS, MetroPCS filed suit seeking permanent injunctive relief. MetroPCS also promptly moved for a preliminary injunction to stop the defendants’ unlawful competition and solicitation, which the court granted after finding that MetroPCS satisfied all four elements of the traditional preliminary injunction test. Because 142 days remained in the period of restriction under the noncompete and nonsolicitation provisions at the time MetroPCS discovered defendants’ violations, the court granted a preliminary injunction on June 24, 2015, for 142 days or until trial, whichever occurred first. The defendants, however, failed to comply and were held to be in contempt after MetroPCS moved for an order to show cause and they failed to appear. Although MetroPCS also moved to extend the term of the preliminary injunction, the court directed MetroPCS to file a motion for final injunction instead.

In its motion for final injunction, MetroPCS asked the court to enjoin the defendants for an additional 142 days based on their refusal to comply with the agreement and the court’s preliminary injunction order. The court held that MetroPCS met each of the elements necessary for a grant of a permanent or final injunction: (1) actual success on the merits; (2) that it suffered an irreparable injury; (3) that the remedies available at law are inadequate; (4) that the balance of hardships justified a remedy in equity; and (5) that the public interest would not be disserved by the injunction. First, MetroPCS succeeded on the merits because the dealer agreement’s noncompete and nonsolicitation provisions were enforceable and the defendants were violating them by selling competing products and services. Under Washington law, both provisions were enforceable because they were reasonably necessary to protect MetroPCS’s business, particularly in terms of maintaining its customer base and preventing appropriation of and damage to its goodwill. As to the second and third prongs, MetroPCS suffered irreparable harm and remedies at law would be inadequate because the nature of its business made it vulnerable to losing customers after its relationship with a dealer ended and such losses were difficult, if not impossible, to remedy with a monetary award. Fourth, the balance of hardships justified a final injunction because MetroPCS remained at risk of losing customers and sustaining damage to its goodwill absent an injunction, while an injunction threatened defendants only with the inability to compete with MetroPCS within a small area for a few months. Finally, the public interest would
not be disserved by a final injunction because of the limited scope of the restrictions at issue. Accordingly, the court granted MetroPCS’s motion for final injunction and ordered defendants to comply for 142 days following entry of the order.


The U.S. District Court for Southern District of New York denied the defendant’s motion for preliminary injunction and temporary restraining order. Three findings were central to the court’s ruling: the dealership/licensee agreement was no longer in effect, the agreement was not inadvertently converted into a franchise agreement, and the defendant had not demonstrated irreparable harm.

The defendant argued (1) that the agreement between the parties remained in effect and the plaintiff was breaching the agreement; and (2) the agreement was inadvertently converted into a franchise agreement, which would therefore entitle the defendant to notice before the plaintiff could terminate the agreement.

The court disagreed, holding that the agreement was no longer in effect. The agreement, whose initial term had expired in May 2014, contained a renewal option for two additional five-year terms upon written notice by the defendant, to be provided no less than ninety days prior to the end of the term. The defendant conceded it did not provide written notice within the required time frame, but argued these terms created an automatic renewal of the agreement absent termination. The court found this interpretation to be “wholly inconsistent with a plain reading of the agreement” and concluded the agreement had expired without renewal.

The court also disagreed that the agreement had been inadvertently converted to a franchise agreement, noting that for a franchise relationship to exist (1) the franchisor must exhibit a significant degree of control over the franchisee, and (2) the franchisee must pay a franchise fee. The court ruled that the defendant had not established the plaintiff had exhibited a sufficient degree of control over the defendant’s business. Further, the defendant conceded it did not have evidence of payment of a franchise fee.

Finally, the court went on to note that even had the defendant succeeded in proving the earlier arguments, it had not demonstrated irreparable harm. In particular, the defendant attempted to establish irreparable harm solely through “generalized and conclusory statements concerning the termination of employees and the ultimate demise of its business.” Citing AFA Dispensing Group B.V. v. Anheuser-Busch, Inc., 740 F. Supp. 2d 465 (S.D.N.Y. 2010), the court found these statements were, as a matter of law, insufficient to demonstrate the harm required for an award of injunctive relief.
Plaintiff Baskin-Robbins Franchising, LLC brought a declaratory judgment action against defendant Alpenrose Dairy, Inc., seeking a declaration that the territorial franchise agreement (TFA) between Baskin-Robbins and Alpenrose had expired. Alpenrose moved to dismiss the action for lack of personal jurisdiction in Massachusetts or, in the alternative, to transfer venue to the Western District of Washington. The U.S. District Court for the District of Massachusetts determined that Alpenrose did not purposefully avail itself of the privilege of conducting activities in Massachusetts and, accordingly, granted Alpenrose’s motion to dismiss the action for lack of personal jurisdiction.

The parties executed the TFA in California in 1965 with Alpenrose as the sub-franchisor to Baskin-Robbins in Oregon and Washington and, subsequently, in Idaho and Montana. In accordance with a provision of the TFA, the agreement was renewed every six years since it was executed until the end of 2013, when Alpenrose gave notice that it would not renew after the term expired in December 2014. Alpenrose’s principal place of business was Oregon. Although Baskin-Robbins’ principal place of business moved from California to Massachusetts in the late 1990s, Alpenrose continued to send notices of renewal to Baskin-Robbins.

In order for Massachusetts to exercise personal jurisdiction over Alpenrose, Baskin-Robbins needed to show that: (1) its claim “arose out of or is related to Alpenrose’s activities in Massachusetts;” (2) that the defendant “purposefully availed itself of the privilege of conducting activities in Massachusetts;” and that (3) the “exercise of jurisdiction in Massachusetts is reasonable” in light of the “Gestalt factors.”

The court noted that the fact that a non-resident has entered into a contract with a resident of Massachusetts is not, on its own, sufficient to establish jurisdiction and that the manner in which the parties carried out the agreement must be examined. The TFA’s geographical scope did not include Massachusetts nor was it the principal place of business of either of the parties when the TFA was made. Although Baskin-Robbins relocated to Massachusetts, the notices of renewal sent by Alpenrose were for the purpose of ensuring it could continue to do business in the Pacific Northwest. Thus, nothing suggested that Alpenrose “intended to purposefully avail itself of the privilege of conducting business within Massachusetts.” Further, the “Gestalt factors” weighed against finding jurisdiction because Massachusetts does not have a strong interest in adjudicating a dispute involving a contract performed in the Pacific Northwest. The court therefore did not exercise jurisdiction and accordingly granted Alpenrose’s motion to dismiss the action.

The U.S. District Court for the Western District of Oklahoma held that personal jurisdiction existed over a German distributor in Oklahoma in an action alleging Lanham Act trademark infringement and unfair competition claims by an Oklahoma City based manufacturer.

Plaintiff Hetronic International, Inc., a manufacturer of radio remote controls for use in heavy industrial equipment, entered into a distribution agreement with defendants Hetronic Germany GmbH (H-Germany) and Hydronic-Steuersysteme-GmbH (Hydronic), pursuant to which the defendants served as Hetronic’s distributor and assembler in Germany and a number of central eastern European countries. This action arose out of the termination of the distribution agreement following the defendants’ alleged material breaches. Hetronic alleged that after termination of the agreement, Albert Fuchs, the former CEO of Hydronic, incorporated other entities, including ABI Holding GmbH (ABI), with the Abitron name to wrongly compete with Hetronic. Hetronic filed suit, alleging contract, tort, and Lanham Act claims, in the Western District of Oklahoma against H-Germany, Hydronic, Fuchs, ABI, and other entities. The defendants moved to dismiss based on lack of personal jurisdiction and also moved to dismiss Hetronic’s claims for failure to state a claim.

Under Oklahoma’s long-arm statute, personal jurisdiction exists where the defendant has sufficient “minimum contacts” with Oklahoma and the exercise of personal jurisdiction over the defendant does not “offend ‘traditional notions of fair play and substantial justice.’” International Shoe Co. v. Washington, 326 U.S. 310, 316 (1945). Sufficient “minimum contacts” can be established if the defendant either has continuous or systematic contacts with the forum state or has purposefully directed its activities at residents of the forum and the litigation results from alleged injuries arising out of or relating to those activities. If a foreign defendant does not have sufficient minimum contacts to support personal jurisdiction, then Federal Rule of Civil Procedure 4(k)(2) may apply to act as a federal long-arm statute. When a claim arises under federal law, personal jurisdiction can be established over a defendant if: (1) the plaintiff’s claim arises under federal law, (2) the defendant is not subject to jurisdiction in any state court of general jurisdiction, and (3) the exercise of jurisdiction comports with due process.

Applying these principles to this case, the court found that: (1) Hetronic asserted a claim under federal law, i.e., the Lanham Act; (2) the defendants failed to indicate another state in which personal jurisdiction would be proper; and (3) the only issue was whether the exercise of personal jurisdiction in Oklahoma over defendants comported with due process. Because the defendants purposefully directed their activities at the United States and Hetronic’s injuries arose out of those activities, the court concluded that
personal jurisdiction existed over defendants. Specifically, Fuchs traveled to the United States and engaged a Massachusetts company to obtain certifications from the Federal Communications Commission that were necessary for the Abitron entities to sell products in the United States. Fuchs also traveled to Las Vegas to meet with, and sent over twenty emails to, Hetronic’s former president seeking information to compete with Hetronic. Taking all of these allegations as true, Fuchs purposefully directed his activity at competition with the plaintiff in the United States and had sufficient minimum contacts to be haled into court in Oklahoma. In addition, ABI also purposefully availed itself to the United States when it filed a trademark application for the Abitron entities and entered into a consulting agreement, for which it paid $40,000, with a U.S.-based company owned by Hetronic’s former president to obtain market research and directly compete with Hetronic. Based on these facts, sufficient minimum contacts existed over ABI as well. And although much of the allegedly fraudulent conduct by Fuchs and ABI occurred outside Oklahoma, the court held that, applying Federal Rule of Civil Procedure 4(k)(2), Oklahoma had personal jurisdiction over both. In an attempt to avoid liability, Fuchs alleged that Oklahoma law, 12 Oklahoma Statutes § 682(B), barred any claims against him as a mere shareholder and/or officer of a potentially liable company. But because plaintiff asserted specific wrongdoings committed by Fuchs, the statute did not bar Hetronic’s claims.

Lastly, the court rejected the defendants’ argument that Hetronic’s contributory trademark infringement claim failed as a matter of law and should be dismissed. Contributory infringement occurs when the defendant either (1) intentionally induces a third party to infringe on the plaintiff’s mark; or (2) enables a third party to infringe on the mark while knowing or having reason to know that the third party is infringing, yet failing to take reasonable remedial measures. The defendants argued that they could not be both contributory infringers and infringers under law. Although the court agreed that one cannot be both a direct and contributory infringer, it held that it was too early in the litigation to make factual determinations as to who committed which portion of the infringing. Even so, Hetronic provided sufficient factual allegations to state a contributory trademark infringement claim because it alleged that Fuchs and ABI supplied H-Germany, Hydronic, and Abitron with the means to infringe on Hetronic’s trademarks, thus inducing the other defendants to infringe on Hetronic’s trademarks. And because alternative pleading is allowed under Rule 8, it was proper for Hetronic to plead claims for direct and contributory trademark infringement in the alternative. Accordingly, the court denied the defendants’ motion to dismiss in its entirety.


This case is discussed under the topic heading “Choice of Forum.”
A member of a joint venture lacked standing to sue another member individually and was required instead to sue derivatively on behalf of the joint venture because he failed to plead an injury distinct from that suffered by the joint venture, the U.S. District Court for the Eastern District of Missouri held.

Plaintiff Sasso USA, Inc., an Illinois corporation and subsidiary of Sassomeccanica, S.r.l., a multinational corporation that designs and manufactures stone finishing, cutting, and polishing products, entered into an operating agreement with defendant Zein Investments, LLC. That agreement formed Sasso America, LLC (the Company) as a joint venture for the purpose of selling, distributing, and maintaining the stone manufacturing equipment sold to the Company by Sasso. Sasso and the Company also entered into a distribution and licensing agreement under which the Company was given the exclusive right to sell and market Sassomeccanica products, using the Sassomeccanica trademark, in the United States. Under the distribution agreement, Sasso retained possession of its intellectual property; the Company, along with its owners, directors, officers, and managers, agreed not to compete with Sasso. In January 2013, the parties terminated both the operating and distribution agreements. However, after termination, Zein and its organizer continued to represent themselves as distributors for Sassomeccanica products and to use Sassomeccanica’s trademarks, contacts, and customers list to promote a competitor’s products.

In March 2015, Sasso brought this lawsuit in the U.S. District Court for the Northern District of Illinois against Zein, its organizer, and the competitor, all based in Missouri, asserting fourteen counts, including (1) breach of the operating agreement by Zein arising out of its misuse of Company property to market rival products; (2) breach by Zein of the distribution agreement by selling the competitor’s products; (3) misusing Sasso’s trademarks, trademark infringement, and cyberpiracy breach under the Lanham Act; (4) breaches by Zein and its organizer of their duties of care and loyalty to Sasso and the Company in violation of the Missouri Limited Liability Company Act and common law; (5) tortious interference with Sasso’s existing and prospective business relationships; and (6) unjust enrichment. The defendants moved to dismiss for lack of personal jurisdiction. The Northern District of Illinois agreed and, finding venue and jurisdiction proper in the Eastern District of Missouri, transferred the case sua sponte. The defendants then moved to dismiss Sasso’s amended complaint for lack of standing and failure to state a claim.

The defendants argued that Sasso lacked standing because Missouri law required that, as a member of a Missouri limited liability company, Sasso’s claims against other members of the LLC had to be brought as a derivative action on behalf of the LLC. Sasso contended it had standing because it
alleged an injury distinct from the injury incurred by the Company. The court noted that, although an individual shareholder generally may not bring an action in his own name to recover for wrongs done to the corporation, an individual rather than a derivative action is allowed where the plaintiff suffered a distinct injury from that suffered by the corporation. The court found that Sasso failed to plead an injury resulting from the defendants’ alleged misconduct that was distinct from that incurred by the Company. Instead, the alleged actions necessarily harmed the Company and only indirectly impacted Sasso in its capacity as a member of a LLC. Thus, any action seeking relief had to be brought derivatively on behalf of the Company. The court therefore granted the defendants’ motion to dismiss but granted Sasso leave to amend its complaint to allege a derivative action.

LABOR AND EMPLOYMENT

*Int’l Franchise Ass’n, Inc. v. City of Seattle*, Bus. Franchise Guide (CCH) ¶ 15,606, No. 15-35209, 803 F.3d 389 (9th Cir. 2015)

The Ninth Circuit affirmed a federal district court’s denial of the International Franchise Association’s (IFA) motion to preliminarily enjoin a Seattle ordinance that would treat franchisees of systems with 500 or more employees as “large” employers subject to an expedited schedule to raise the minimum wage to $15 per hour for all employees.

The Seattle City Council unanimously passed an ordinance in June 2014 raising the minimum wage to $15 per hour in two stages for large and small employers. The ordinance classified franchisees as large employers, meaning a business with 500 or more employees, regardless of the number of employees employed by the particular franchisee in Seattle. When categorized as “large” employers, franchisees are subject to a three-year phase-in schedule under the ordinance, while “small” employers, businesses with fewer than 500 employees, have seven years to phase in the wage increase. The IFA brought this action to enjoin the City of Seattle from treating franchisees as large employers. The IFA argued that the ordinance put franchisees at a competitive disadvantage with their competitors and violated the Equal Protection and dormant Commerce Clauses of the U.S. Constitution, was preempted by the Lanham Act and Employment Retirement Income Security Act (ERISA), and deprived franchisees of their privileges and immunities rights under the Washington state constitution. The district court denied the motion for a preliminary injunction, finding the IFA failed to meet its burden of showing a likelihood of success on the merits, irreparable harm, balance of equities, and public interest factors. The IFA appealed, although it did not raise the ERISA claim on appeal, and the Ninth Circuit affirmed the district court’s ruling.

The Ninth Circuit first addressed the IFA’s argument that the Seattle ordinance violated the dormant Commerce Clause, which bars state and local
governments from erecting taxes, tariffs, or regulations that favor local businesses at the expense of interstate commerce. The court assessed whether the ordinance discriminated against out-of-state businesses on its face and decided it did not because “[a] distinction based on a firm’s business model . . . does not constitute facial discrimination against out-of-state entities or interstate commerce.” In other words, the IFA did not establish that Seattle franchisees that pay local taxes and have local representation are out-of-state entities. Nor did it establish that franchises have “such unique links to interstate commerce relative to non-franchises that the ordinance facially discriminates against interstate commerce.” Next, the court analyzed whether the ordinance had a discriminatory purpose and found that, although the record contained some evidence that Seattle officials and advocates questioned the merits of the franchise model, including some anti-franchise emails, such statements were part of the legislative dialogue and were insufficient to show a discriminatory purpose. The distinction between large and small businesses was also legitimate. The city council viewed franchisees as more akin to large employers than small businesses in their ability to accommodate increased costs. The court found no discriminatory motive in the ordinance’s text, context, and structure. Finally, the IFA did not meet its burden of showing that the ordinance would have a discriminatory effect on out-of-state businesses. “The IFA’s showing that 96.3 percent of Seattle franchisees are affiliated with out-of-state franchisors and that in-state franchisees will be placed at a competitive disadvantage does not prove that the ordinance will have a discriminatory effect on out-of-state firms,” according to the court. If anything, the ordinance’s effect was to harm in-state firms, the court noted. The court also found that the IFA had failed to present evidence of the ordinance’s effect on out-of-state firms, such as through “diminished franchisor royalties or profitability or show that future franchise development in Seattle will be impaired.” “The only thing the affiliation rate shows is that most in-state franchisees have out-of-state relationships and are subject to a disparate minimum wage requirement[,]” but that was not evidence of discriminatory effects on out-of-state firms. In sum, the evidence did “not show that interstate firms will be excluded from the market, earn less revenue or profit, lose customers, or close or reduce stores. Nor does it show that new franchisees will not enter the market or that franchisors will suffer adverse effects.” Accordingly, the Ninth Circuit determined that the district court did not err.

Second, the court dismissed the IFA’s arguments that the ordinance violated the Equal Protection Clause. The court agreed with the district court that the ordinance must be upheld as long as there is “any reasonably conceivable state of facts that could provide a rational basis for the classification.” Here, the district court weighed the affidavits of experts and franchisees explaining “the economic benefits flowing to franchisees” from a franchise system and the ability of franchisees to “handle the faster phase-in schedule.” The Ninth Circuit held that the district court did not err in
Third, the IFA contended the ordinance discriminated on the basis of protected speech under the First Amendment because two of the three definitional criteria for franchises are based on speech and association: (1) operating under a marketing plan prescribed by a franchisor and (2) associating with a trademark or other commercial symbol. The Ninth Circuit found this construction of the ordinance unpersuasive. As the court noted, the First Amendment does not prevent restrictions directed at commerce or conduct from imposing incidental burdens on speech. The threshold question is whether conduct with a “significant expressive element drew the legal remedy or the ordinance has the inevitable effect of singling out those engaged in expressive activity.” According to the court, “Seattle’s minimum wage ordinance is plainly an economic regulation that does not target speech or expressive conduct.” Even though franchisees are part of a franchise system associated with a trademark or brand, the ordinance applies to businesses that have adopted a particular business model, not to any message the businesses express. “It is clear that the ordinance was not motivated by a desire to suppress speech, the conduct at issue is not franchisee expression, and the ordinance does not have the effect of targeting expressive activity.” Accordingly, the district court did not err in finding that the IFA did not show a likelihood of success on this claim.

Fourth, the IFA argued the Lanham Act preempted the ordinance because it interfered with the use of trademarks. The district court rejected that argument, and the Ninth Circuit affirmed, because the Lanham Act does not expressly preempt state law and the Seattle ordinance, which relates to wages to be paid to employees, falls within the ambit of traditional state regulation. Moreover, the ordinance did not interfere with a franchise’s ability to maintain quality, compromise the public’s confidence in trademarks, allow misappropriation, or directly interfere with or regulate marks as to be preempted by the Lanham Act.

Fifth, the IFA invoked the privileges and immunities clause of the Washington State Constitution to argue that it guaranteed the IFA’s members’ fundamental right to carry on business in the state. The court held that the privileges and immunities rights were not implicated “anytime the legislature treats similarly situated businesses differently.” Here, all businesses eventually had to pay $15 per hour, and the court repeated that the legislature had reasonable grounds to treat franchise systems with more than 500 employees as large employers for the phase-in schedule.

Despite finding the IFA failed to demonstrate a likelihood of success on the merits on any of its theories, the court went on to address the remaining prongs of a preliminary injunction. It held that the district court erred in evaluating the IFA’s evidence of competitive injury and finding no irreparable harm. The IFA had put forth evidence by way of franchisees’ declarations indicating that they would face higher labor costs or lose the flexibility to pay...
workers the wage rate required of non-franchisees as a result of the ordinance. The ordinance’s plain text also supported these findings. Therefore, the allegations of competitive injury were neither conclusory nor without factual support, as the district court found. Nonetheless, the IFA did not show that franchisees faced irreparable harm as a result of losing customers or goodwill. The court also concluded that the district court erred in finding that the IFA did not demonstrate that the balance of hardships tipped in its favor. While franchisees would face a higher wage requirement than their competitors if the ordinance went into effect, the city did not make a persuasive showing that it would experience hardships from the issuance of an injunction. The district court, however, correctly concluded that the public interest disfavored an injunction. Not only would many workers receive reduced wages, but Seattle voters would see an ordinance passed as a result of an election enjoined.

Finally, the Ninth Circuit addressed whether it should apply the “serious questions test.” Under that test, a plaintiff is entitled to a preliminary injunction by raising “serious questions going to the merits and showing a balance of hardships that tips sharply in the plaintiff’s favor, a likelihood of irreparable injury, and that an injunction serves the public interest.” The Ninth Circuit deemed it unnecessary to apply this test because the IFA did not raise serious questions going to the merits on any of its claims nor did it show that an injunction was in the public interest. In sum, because the district court correctly denied the IFA’s motion for injunctive relief, the Ninth Circuit affirmed.

The U.S. District Court for the Northern District of California dismissed several claims against McDonald’s Corp. by employees of its franchisee on the basis that McDonald’s was not the plaintiffs’ employer, but allowed a claim to proceed that McDonald’s was liable as an ostensible agent.

The plaintiffs, past and present employees at a McDonald’s franchise, sued both the employer franchisee and McDonald’s for violations of the California Labor Code and common law negligence. McDonald’s sought summary judgment dismissing the action as against it on the basis that McDonald’s was not the plaintiffs’ employer.

In striking the plaintiffs’ Labor Code claim, the court found that, although McDonald’s had the ability to exert considerable pressure on its franchisees, the franchisee and its managers had the sole authority to make hiring, firing, wage, and staffing decisions. It found that although McDonald’s provided detailed recommendations on crew scheduling and staffing, these were just suggestions, and found other system involvement, such as training franchisees’ managers, being the primary leaseholder for the restaurant, requiring franchisees to make purchases through approved vendors, and requiring installation of “bump bars” for employee time tracking were not
of the type required to find that McDonald’s “exercise[d] control over . . . wages, hours or working conditions.” The court similarly found that McDonald’s ability to convince an employer to carry out certain acts by threatening economic sanctions did not make it an employer.

The court also found, however, that a jury could reasonably conclude that McDonald’s and the franchisee shared an ostensible agency relationship on the basis that the plaintiffs believed McDonald’s was their employer because they wore McDonald’s uniforms, served McDonald’s food in McDonald’s packaging, received pay stubs and orientation materials marked with McDonald’s name and logo, and applied for the job through McDonald’s web site.

The court thus dismissed the plaintiffs’ claim for negligence on the basis of California’s “new right-exclusive remedy” doctrine because the negligence claims sought to duplicate theories of liability asserted under the California Labor Code.


The Commonwealth Court of Pennsylvania agreed with Saladworks, LLC that it was not a statutory employer under Section 302(a) of the Pennsylvania Workers’ Compensation Act because its relationship with its franchisee was that of a franchisor and franchisee, not of a contractor and subcontractor.

Guardioso, a former employee of a Saladworks’ franchisee, petitioned for benefits against the franchisee employer following a workplace injury. Guardioso then filed a separate claim against the Uninsured Employers Guaranty Fund (UEGF), which filed a joinder petition alleging Saladworks was “an additional employer, agent, statutory employer of the Claimant” and thus jointly and severally liable. Saladworks moved that the joinder petition be dismissed or stricken.

The workers’ compensation judge (WCJ) granted the motion to strike on the basis that Saladworks did not know who the employees of any individual franchisee were; had no contact or control over individual franchisee employees; and did not hire, fire, set the hours of, or have any control over any of the franchisee’s employees, who were controlled by the franchisee. This decision was reversed on appeal to the Workers’ Compensation Appeal Board, which held that the proper test for a statutory employer was not that of an actual employment relationship, but rather to be determined in accordance with § 302(a) of the Act. The Board held that based on the franchise agreement, Saladworks had a contractual obligation to ensure the franchisee had appropriate workers’ compensation in place; because it had not done so, it was potentially liable.

Saladworks appealed, arguing the Board misunderstood the nature of its business and that the relevant statute applied only to contractors and subcontractors and not to franchisor/franchisee agreements. The court agreed, finding the work performed by the franchisee under the franchise agreement was
not a regular or recurrent part of the business, occupation, profession, or trade of Saladworks, as required under the Act. Rather, it agreed that Saladworks’s main business was the sale of franchises to franchisees and that it was not in the restaurant business or the business of selling salads.

NONCOMPETE AGREEMENTS

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

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ORAL AGREEMENTS

Wartburg Enterprises, Inc. was a distributor of baby seats in the United States for South African company Jonibach Management Trust, doing business as Bumbo International Trust, under an oral distribution agreement. A dispute arose when Wartburg failed to make timely payments for products delivered by Bumbo on credit. Wartburg objected to Bumbo hiring another distributor and refused to distribute the baby seats in its possession. Wartburg also asserted that it was the exclusive distributor in the United States of Bumbo baby seats to Wal-Mart, Toys “R” Us, and Babies “R” Us. Bumbo responded by filing suit in the U.S. District Court for the Southern District of Texas for breach of the distributorship agreement and seeking a preliminary injunction requiring Wartburg to distribute its inventory of baby seats. The court granted the preliminary injunction on the condition that Bumbo post a $2,000 bond. Thereafter, Wartburg distributed its remaining inventory, but also filed counterclaims against Bumbo for breach of contract, fraud, and quantum meruit.

Bumbo thereafter dismissed all of its claims because Wartburg had depleted its inventory of child seats and Bumbo had found a replacement distributor. Bumbo also moved to dismiss Wartburg’s counterclaims. The court dismissed all counterclaims with the exception of the breach of contract
claim. The breach of contract claim was divided by the court into three separate claims: (1) the “refusal of sale claim” based on Bumbo refusing to sell product to Wartburg; (2) the “customer relationship claim” based on Bumbo taking over Wartburg’s customers; and (3) the “retailer limitation claim” based on Bumbo demanding that Wartburg sell only to Wal-Mart, Toys “R” Us, and Babies “R” Us.

The court initially granted summary judgment on all breach of contract claims to Bumbo on the grounds that the statute of frauds, as set forth in Texas Business & Commerce Code § 2.201(a), precluded Wartburg from enforcing the oral distributorship agreement. Wartburg appealed to the Fifth Circuit, which upheld the dismissal as to the refusal of sale claim and the customer relationship claim. However, the court reversed and remanded the dismissal of the retailer limitation claim on grounds, among other things, that an exception to the statute of frauds had been met because Bumbo asserted in court filings that a distributorship agreement existed.

On remand to the district court, the court heard an additional motion for summary judgment filed by Bumbo that characterized Wartburg’s retailer limitation claim as a claim that Bumbo wrongfully obtained a preliminary injunction requiring Wartburg to distribute its remaining baby seats. Bumbo argued that Warburg had no damages based on the rule that a party injured by the issuance of an injunction later determined to be erroneous has no claim in the absence of a bond. Wartburg argued that its claim was more broadly related to a breach of the terms of the oral distribution agreement. The court agreed with Wartburg on that point. The court went on to note, however, that Wartburg failed to timely disclose information relating to its damages, as required by Federal Rule of Civil Procedure 26. Bumbo sought exclusion of damage evidence under Rule 37. The court denied Bumbo’s motion on the policy ground favoring disposition of a case on its merits. The court thus determined that Wartburg’s retailer limitation claim survived Bumbo’s motion for summary judgment.

As to Wartburg’s motion for summary judgment in favor of its retailer limitation claim, the court noted that the oral distributorship agreement at issue involved a mix of goods and services, but that goods were a “dominant factor.” Thus, the Texas version of UCC article 2 applied. The court further noted that pursuant to the applicable provisions of UCC article 2, including Section 2.309 where a contract is for an indefinite period, the contract can be terminated by either party upon reasonable notice. In such instance, recovery for damages for breach of the contract is limited to the notice period. Based on those statements of law, the court concluded that it could not grant Wartburg’s motion for summary judgment because the “he said/she said” nature of the allegations raised a number of factual issues relating to the specific terms of the oral agreement.
PETROLEUM MARKETING PRACTICES ACT (PMPA)


The plaintiff, Amphora Oil & Gas Corp., brought an action in the U.S. District Court for the Eastern District of New York against defendants Cumberland Farms, Inc., its subsidiary Gulf Oil Limited Partnership, and 750 Motor Parkway Realty LLC to enforce rights under lease and franchise agreements, seeking relief under the Petroleum Marketing Practices Act (PMPA). Following Cumberland Gulf’s decision not to renew the underlying lease for the service station, it sent a notice of termination to Amphora for both the franchise agreement and sublease. Before the court was a motion, brought by Amphora, for a preliminary injunction preventing the defendants from (1) interfering with Amphora’s operation of the service station, (2) terminating the lease and franchise agreements at issue, and (3) tolling the relevant time periods set forth in those agreements while the litigation is pending. The court denied Amphora’s motion for a preliminary injunction.

The court found that Congress enacted the PMPA due to “the imbalance of power in favor of refiners and franchisors in the making, modifying, renewal and termination of contracts with franchisees” and that the statute prohibits termination or nonrenewal of a franchise relationship by the franchisor, except in certain scenarios. One of those scenarios is the occurrence of an event that is both relevant to the franchise relationship and, as a result of that event, where termination or non-renewal is therefore “reasonable.”

The defendants argued the expiry of Cumberland Gulf’s underlying lease was a scenario in which termination of the lease was permitted by the statute. Section 2802(c)(4) of the PMPA stipulated that the expiry of an underlying ground lease could provide a basis for a franchisor to terminate or not renew a franchise relationship, provided that, among other things, within ninety days of giving notice the franchisor offers to assign to the franchisee any option to extend the underlying lease or purchase the premises. Because Cumberland Gulf offered to assign to Amphora the rights that it had to extend the underlying lease, the court found that the franchisor’s obligation to offer to assign the option to extend the lease to its franchisee was satisfied. The court’s conclusion was not altered by the fact that Cumberland Gulf predicated its offer of assignment on an unconditional release of future liability.

Given that the termination of the franchise agreement was terminated pursuant to the PMPA, the court found that the motion did not present sufficiently serious questions going to the merit to warrant injunctive relief. Accordingly, the plaintiff’s motion was denied.

The defendant franchisor, Chevron USA Inc., appealed a decision of the U.S. District Court for the Northern District of California that found that Chevron violated the Petroleum Marketing Practices Act (PMPA) by failing to provide a bona fide offer to sell a gas station to its franchisee, Transbay Auto Service, Inc. The Ninth Circuit determined that the third party appraisal of the property should have been admitted as an adoptive statement and that the lower court improperly excluded it as evidence. As a result, the Ninth Circuit reversed the district court’s decision to award $495,000 in damages, remanding the matter back for another trial.

The district court had awarded $495,000 in damages against Chevron for failing to make an offer that approached fair market value in the course of making a “bona fide offer” under the PMPA. Transbay had accepted an offer under protest to buy the gas station property at $2.375 million and agreed to have the property appraised in order to obtain financing. The appraisal, which valued the property at $2.52 million and was provided to another bank in order to secure the loan, was not admitted into evidence by the lower court on the basis that Transbay’s owner had not actually looked at it and thus did not “actually hear, understand, and accede to the statement.”

The Ninth Circuit used the “possession plus” test to determine whether the appraisal was an adopted statement and thus could be admitted as evidence under Federal Rule of Evidence 801(d)(2)(B). Previous courts had held that a party who relies on a third-party document by submitting it to another, albeit after reviewing the document, constitutes adoption. The court in this case found that, although this was a novel scenario, it was irrelevant that Transbay did not review the document first. The court held that “a party who is only vaguely aware of the contents of a document manifests an intent to adopt these contents by using the document to accomplish an objective.” In this case, the objective was obtaining a loan to finance the purchase of the gas station property. The jury should have been presented with the appraisal, the verdict was accordingly reversed by the court, and the case was remanded for a new trial.

STATUTE OF LIMITATIONS


TL of Florida, Inc. alleged that it would not have entered into a distributorship agreement with Terex Corporation had Terex not misrepresented four material facts: (1) that there was a market for Terex heavy equipment in Southern Florida (the equipment market representations); (2) that there was a market for Terex parts in Southern Florida; (3) that Terex was in
financial distress and selected distributors on the basis of whether they were financially able to purchase whole goods (the dealership selection representative); and (4) that TL was surrounded by dealers with authorized Terex parts that could sell those parts to customers without having to maintain the inventory of whole goods or infrastructure that TL would have to maintain. Upon becoming aware of the alleged misrepresentations, TL filed suit in the U.S. District Court for the District of Delaware claiming fraudulent non-disclosure, negligent misrepresentation, violation of the Florida Deceptive and Unfair Trade Practices Act, and breach of the implied covenant of good faith and fair dealing.

Terex brought a motion for summary judgment, arguing TL’s claims pertaining to equipment market representations and dealership selection representations were beyond the three-year limitation period and barred because of interrogatory responses. Terex also sought judgment on the pleadings, arguing claims based on dealer representations and omissions were barred because they were expressly contradicted in, or adequately covered by, the dealership agreement between the parties.

The court granted summary judgment motion with respect to the equipment market representations, which it was undisputed were outside the limitation period, but denied summary judgment with respect to the dealership selection representations, holding that although they were related to the equipment market representations, they did not overlap to such an extent that the bar should be extended to the dealership selection representations. The court denied Terex’s motion for summary judgment on TL’s counterclaims except to the extent those counterclaims were based on time-barred representations.

In its motion for judgment on the pleadings, Terex argued claims based on dealer representations and omissions were barred because they were expressly contradicted in, or adequately covered by, the dealership agreement. The court held that a party to a contract could not press fraud claims that were contradicted by or adequately addressed in a subsequent agreement, but that the relevant portions of the dealership agreement neither contradicted nor adequately addressed TL’s claims based on dealer representations and omissions. The court accordingly denied the motion for judgment on the pleadings.


The plaintiffs in this case included Two Brothers Distributing, Inc., which was a gasoline distributor to third-party retailers in the Phoenix area, and ten associated gasoline retailers (the station plaintiffs). Defendant Valero Marketing and Supply Company is a foreign corporation that sells gasoline at the wholesale level and at its own retail stations. In 2013, Valero spun off all of its retail operations to CST Brands, Inc. In February 2007, Two
Brothers entered into a distributor agreement with Valero pursuant to which Valero agreed to sell, and Two Brothers agreed to purchase, a minimum quantity of gasoline at a price fixed by Valero. Around the same time, Valero and Two Brothers entered into brand conversion incentive agreements for each of the stations supplied by Two Brothers. Under those agreements, the stations became Valero-branded stations and were approved to purchase fuel from Two Brothers under the terms of the distributor agreement. Between the consummation of the distributor agreement in February 2007 and August 2009, Two Brothers frequently complained to Valero about its pricing but nonetheless executed two other distributor agreements in July 2011 and July 2014.

In May 2015, the plaintiffs filed a complaint against Valero in Maricopa County Superior Court and the defendant removed to the U.S. District Court for the District of Arizona. In August 2015, the plaintiffs filed an amended complaint asserting claims for breach of contract, fraud, tortious interference, and violation of the Robinson–Patman Act (RPA). Each of the claims related to Valero’s pricing practices under its contracts with Two Brothers, which the plaintiffs alleged were unfair and designed to drive them out of business. Valero moved to dismiss all claims for failure to state a claim. The court granted the motion to dismiss the plaintiffs’ fraud and RPA claims but denied it as to the remaining claims.

First, the court dismissed the plaintiffs’ fraud claim as time-barred. In their complaint, the plaintiffs alleged that Valero made several misrepresentations during the negotiations that culminated in the execution of the distributor agreement and brand conversion incentive agreements in 2007, that the plaintiffs noticed discrepancies between Valero’s representations and its behavior almost immediately, and that the plaintiffs frequently complained to Valero about its pricing between 2007 and August 2009. Based on these allegations, the court found the claim to be time-barred. The court found that the plaintiffs were aware of the facts underlying their fraud claim by August 2009 at the latest, which fell outside the applicable three-year statute of limitations that expired in September 2012.

Second, the court held that the RPA claim failed as a matter of law. Two Brothers contended that Valero violated the RPA by charging Two Brothers a higher price for Valero-branded fuel than it contemporaneously charged its own Valero-owned stations. The court found that the claim was insufficient as a matter of law because the RPA “does not apply to intra-corporate transfers or transfers between a parent and a wholly-owned subsidiary.” Further, the Seventh Circuit has specifically held that the RPA “does not apply to transfers of gasoline from a gasoline supplier to its own retail station.” O’Byrne v. Cheker Oil Co., 727 F.2d 159, 164 (7th Cir. 1984). The plaintiffs insisted that Valero violated the RPA by giving price breaks to stations formerly owned by Valero after those stations were spun off to CST. Because this argument was not fairly set forth on the face of the complaint, the court granted plaintiffs leave to amend it to add this allegation.
Third, the court did not dismiss the plaintiffs’ claim for tortious interference with contract, rejecting Valero’s arguments that the claim was time-barred, insufficiently plead, and that the station plaintiffs lacked standing. The court first considered whether the claim was barred under the applicable two-year statute of limitations. In the complaint, the plaintiffs alleged that Valero engaged in tortious interference by manipulating prices so as to disrupt the relationships between Two Brothers and the station plaintiffs. Although the complaint was mainly concerned with pricing activities from 2008 to 2010, it also alleged that Valero continued to manipulate prices to the present day. Based on these allegations, the court did not dismiss the claim as time-barred, but stated that it would consider only events occurring on or after May 20, 2013 (two years prior to commencement of the lawsuit) in determining whether plaintiff stated a claim. On this point, the court cited Garcia v. Sumrall, 121 P.2d 640, 643 (Ariz. 1942), for the proposition that “damages may be recovered for all of the statutory period prior to the commencement of the action.” Next, the court concluded that the plaintiffs adequately plead a claim for tortious interference under Arizona law. The complaint contained allegations that, during the relevant time period, Two Brothers had exclusive contracts with station plaintiffs to sell fuel to each station, Valero knew about these contracts, Valero engaged in price manipulation in bad faith with the intention of driving the plaintiffs out of business and reducing competition among gasoline retailers, Valero’s conduct made Two Brothers’ performance more expensive, and plaintiffs were economically harmed as a result. These allegations established, the court determined, a prima facie case for tortious interference under Arizona law. The complaint contained allegations that, during the relevant time period, Two Brothers had exclusive contracts with station plaintiffs to sell fuel to each station, Valero knew about these contracts, Valero engaged in price manipulation in bad faith with the intention of driving the plaintiffs out of business and reducing competition among gasoline retailers, Valero’s conduct made Two Brothers’ performance more expensive, and plaintiffs were economically harmed as a result. These allegations established, the court determined, a prima facie case for tortious interference under Arizona law. The court held that sufficient injury to support their claim.

Finally, the court addressed Valero’s arguments that the plaintiffs’ contract claims should be dismissed as time-barred, waived, and foreclosed by the integration clauses in the contracts and the statute of frauds. Addressing the statute of limitations issue first, the court found that the claims were not barred by the four-year statute of limitations applicable to contract claims. The plaintiffs alleged in their complaint that Valero materially breached the 2007, 2010, and 2013 distributor agreements and the various brand conversion incentive agreements by setting prices in bad faith. Although timely claims would have included breaches after May 20, 2011 (four years before the lawsuit was filed), and some of the breaches alleged occurred earlier, the plaintiffs also alleged that the breach was ongoing until at least 2013. Further, at this early stage, the court determined that it did not have “sufficient factual information regarding the alleged breaches to draw fine lines between timely and untimely breach claims.” Therefore, the contract claims were not dismissed as untimely. Next, the court rejected Valero’s argument that Two Brothers waived its claims by entering into contracts with Valero
after learning of the alleged price manipulation. “Because waiver is an affir-
mative defense and a question of fact, it is not properly resolved on a motion
to dismiss unless the plaintiff’s claim to have preserved its rights is totally
implausible.” There was no such implausibility here; thus, the court did
not dismiss the contract claims on waiver grounds. The court, however,
did dismiss the station plaintiffs’ breach of contract claim without leave to
amend based on lack of standing. The station plaintiffs simply had no stand-
ing to assert claims based on the contracts between Two Brothers and Valero
because they were neither parties to those agreements nor third-party benefi-
ciaries. The contracts expressly included “no third-party beneficiary”
clauses and disclaimed any relationship between Valero and “any Dealer(s)
or Distributor” of Two Brothers. With respect to the plaintiffs’ oral contract
claims, the court also dismissed those claims based on the statute of frauds.

STATUTORY CLAIMS

Motor Werks Partners, LP v. General Motors LLC, Bus. Franchise Guide
(CCH) ¶ 15,622, No. 14 CV 119, 2015 WL 6036298 (N.D. Ill. Sept. 29,
2015)
Motor Werks Partners, LP owned and operated a Cadillac dealership in Bar-
rington, Illinois. In 2000, the plaintiff requested and received permission
from General Motors to move the dealership location from a former site
to Barrington. In 2013, the plaintiff requested permission to move the deal-
ership back to its former location to move into a renovated auto mall. The
defendant denied the request on the grounds that operating in the new loca-
tion would violate the franchise agreement requirement that Cadillacs not be
serviced and sold in close proximity of competitor brands. The plaintiff
brought an action in Illinois state court against the defendant, arguing that
the defendant’s refusal to grant permission was a violation of several provi-
sions of the Illinois Motor Vehicle Franchise Act. The defendant removed
the case to the U.S. District Court for the Northern District of Illinois
based on diversity jurisdiction. The plaintiff moved for summary judgment
that the defendant’s refusal was unlawful under the Act.

The court analyzed the matter under Section 4(g) of the Act, which pro-
hibits manufacturers from conditioning their approval of franchise changes
on the dealer’s willingness to enter into an exclusive use agreement. The de-
defendant argued that Section 4(g) did not apply because the plaintiff never ac-
tually entered into any agreement in association with the proposed relocation.
The court disagreed, noting that the Act prohibits manufactures
from indirectly conditioning changes on entering into an exclusive use agree-
ment. The court held that the franchise agreement, which was renewed in
2012, contained the offending provision and that GM’s later refusal to grant
permission was simply an attempt to do something sequentially that it could
not have done all at once. The defendant also argued that Section 4(d)(8) of
the Act, which makes it a violation for a manufacturer to compel a dealer to underutilize its facilities, limits the scope of Section 4(g). The court disagreed with this as well, holding that nothing in the Act suggests such a limitation. Finally, the defendant argued that there could be no violation of the Act because GM never approved anything, conditional or otherwise. The court once again disagreed, holding that the Act applies not only to consummated deals, but also to deals that were not consummated as a result of proscribed conduct. The court ultimately concluded that, although its reading of Section 4(g) favored the plaintiff, the court would not grant summary judgment because of certain remaining factual disputes.


A Texas Kia dealership was allowed to proceed with claims that a competitor in the same market filed a false Franchised Motor Vehicle Dealer’s License Application with the Texas Department of Motor Vehicles.

This case arose out of a dispute between two Kia dealerships in El Paso. Plaintiff Paso del Norte Motors, LP was the sole Kia dealer in the El Paso market until defendant Tri Star Partners, LLC reached an agreement with Kia Motors America, Inc. (KMA) authorizing the defendant to operate a second Kia dealership in the El Paso market. To operate the dealership, the defendant was required to file a Franchised New Motor Vehicle Dealer’s License Application with the Texas Department of Motor Vehicles. To prevent the opening of a second Kia dealership in the same market, the plaintiff filed a protest with the vehicle agency alleging that no good cause existed to issue the license to the defendant. To resolve the protest and clear the way for two Kia dealerships in El Paso, the plaintiff, the defendant, and KMA assented to a written confidential settlement agreement. Under the settlement agreement, the plaintiff received $850,000 from the defendant and KMA and at least 150 new Kia vehicles from KMA. In exchange, the plaintiff agreed to dismiss the protest case against the defendant and not to file any claim or otherwise hinder the opening or operation of the defendants’ Kia dealership.

Sometime thereafter, the plaintiff learned that the defendant’s application purportedly contained false information regarding the defendant’s management and ownership structure and filed suit in Texas state court in January 2015. Although the plaintiff initially obtained an ex parte temporary restraining order (TRO) preventing the defendant from opening its new Kia dealership, the defendant obtained the necessary licenses and began operating its dealership once the TRO expired. After the defendant removed the case to the U.S. District Court for the Western District of Texas, the plaintiff filed another complaint with the vehicle agency in February 2015, alleging that the defendant violated the Texas Transportation Code by submitting a false application regarding its management and ownership structure.
and that the application was untimely. The plaintiff asserted these same claims in the lawsuit. In March 2015, the vehicle agency’s director issued a letter determining that (1) the plaintiff lacked standing to bring a claim under the code; and (2) even if the plaintiff had standing, the defendant was in compliance with the vehicle agency requirements because the defendant properly amended its licensing information to reflect a change in its management. Moreover, the department’s current records were complete and accurate. Based on this letter, the defendant filed a motion for summary judgment alleging that res judicata barred the plaintiff’s claims and that the court should defer to the vehicle agency’s decision to dismiss the complaint.

The court held that res judicata did not attach to the vehicle agency’s decision because Texas law provides a specific framework for the vehicle agency to issue final orders that can be given the force and effect of a final judgment, including separate findings of fact with respect to each issue, which the vehicle agency failed to do here.

On the issue of deference to the agency’s decision, the court noted that Texas law has adopted agency deference regarding its own state agencies. See R.R. Comm’n of Tex. v. Tex. Citizens for a Safe Future & Clean Water, 336 S.W.3d 619, 625 (Tex. 2011). Under this doctrine, a Texas agency’s interpretation of a statute will generally be upheld “so long as the construction is reasonable and does not contradict the plain language of the statute.” Taking each of the vehicle agency’s determinations, the court declined to afford any deference to the determination that the plaintiff lacked standing to bring a claim under the code. The code expressly permits “any interested person” to bring an action and the agency did not even analyze this language of the statute. Moreover, the plaintiff was an interested person, the court concluded. As a Kia dealer, the plaintiff no doubt had an interest in ensuring that the defendant, a fellow competitor Kia dealer, complied with the code. Next, although the agency’s letter supported a finding that defendant did not falsify its application, and the plaintiff presented no evidence to the contrary, the court was troubled by the agency’s determination that the defendant’s amendment to the application was conducted in a “reasonable time” when it took defendant nearly six months to amend. According to the court, only a fact-finder could determine whether six months was a “reasonable time” to amend under the relevant statute, which precluded granting summary judgment. Accordingly, the defendant’s motion for summary judgment was denied.

TERMINATION AND NONRENEWAL


This case is discussed under the topic heading Petroleum Marketing Practices Act (PMPA).
This case is discussed under the topic heading “Injunctive Relief.”

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

Our Hour Air Conditioning Franchising LLC filed suit against Dallas Unique Indoor Comfort Ltd. in the U.S. District Court for the Middle District of Florida for several claims, including breach of contract, unfair competition, trademark infringement, and false designation of origin. The franchise agreement at issue related to an air conditioning repair franchising concept that advertised itself as ensuring a repairman would arrive within an hour or the customer would not pay. The franchisor’s logo that included a round-faced stopwatch and the slogan “Always on Time . . . Or You Don’t Pay a Dime!” The franchise agreement provided that if a franchisee failed to ensure timely arrival, the franchisee would be required to do the repair work for free. The franchise agreement applicable in the case did not have a noncompete agreement.

The franchisee terminated the franchise agreement after operating a franchise in the Dallas/Fort Worth area for a number of years. The franchisee went on to open a non-franchised air conditioning repair business named On Time Experts with a logo that included a round-faced clock and the slogan “When Comfort Can’t Wait.” The franchisor alleged in its suit that the franchisee had breached a post-termination obligation in the franchise agreement to refrain from using any name or mark similar to the franchisor’s slogan and marks. Both parties moved for summary judgment. In addition, the franchisee filed a motion under Daubert v. Merrell Dow Pharmaceuticals, Inc., 509 U.S. 579 (1993), seeking to exclude experts identified by the franchisor on such topics as damage calculation and marketing issues allegedly relevant to whether the marks were “similar.”

The court refused to exclude the experts, principally on the grounds that Daubert is a gate-keeping function; because the matter was a bench trial, the court was its own gate-keeper and would accord the expert testimony its proper weight. The court also denied both parties’ summary judgment motions on the grounds that the case was “rife” with disputed facts, including whether the franchisee’s subsequent business was sufficiently similar to the franchisor’s to constitute a breach of the franchise agreement; whether the breach, if one occurred, was material; and whether there were material damages.
This case is discussed under the topic heading “Antitrust.”

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

This case is discussed under the topic heading “Unfair Competition and Unfair and Deceptive Practices.”

TORTIOUS INTERFERENCE

This case is discussed under the topic heading “Statute of Limitations.”

The U.S. District Court for the Eastern District of Michigan dismissed a truck dealer’s tortious interference with business relationship claim against a truck manufacturer, based on the dealer’s failure to show that the manufacturer’s conduct interfered with any of its business relationships and the claim being a mere restatement of the breach of contract claim, which was insufficient to state a tort claim under Michigan law.

Plaintiff VIP Truck Center, LLC sued defendant Volvo Trucks North America alleging that Volvo breached and wrongfully terminated a dealer sales and service agreement between the parties. VIP asserted five claims, including claims for breach of contract and “Tortious Interference with Present and Future Business.” VIP’s tortious interference claim alleged that Volvo: (1) interfered with VIP’s relationships with employees, customers, suppliers, and others; (2) “refused to objectively evaluate the market area given the available product supplied to Volvo . . . and the limitations of the market and customer demand;” and (3) “adopted an arbitrary, capricious, and inequitable system for measuring sales performance penetration by VIP in a bad faith attempt to pretextually and constructively terminate the franchise and deprive VIP of the value of its franchise.” Volvo moved to dismiss the tortious interference claim for failure to state a claim.
The court agreed that VIP’s tortious interference claim was deficient under Michigan law. In Michigan, the elements of tortious interference with a business relationship are: (1) the existence of a valid business relationship or expectancy, (2) knowledge of the relationship or expectancy on the part of the defendant, (3) an intentional interference by the defendant inducing or causing a breach or termination of the relationship or expectancy, and (4) resultant damage to the plaintiff. Applying these factors, the court found that VIP failed to sufficiently allege that Volvo’s conduct induced or caused termination of any of its business relationships or expectancies. VIP’s complaint contained no allegations that any person or entity declined to do business with VIP and/or terminated a relationship with VIP because of any act or omission by Volvo. The general allegation that Volvo interfered with VIP’s relationships with employees, customers, suppliers, and others was not enough; it alleged no facts and was a mere conclusion. Moreover, the claim was a mere restatement of the breach of contract claim, and under Michigan law, it is “no tort to breach a contract.” VIP based its tortious interference claim entirely on conduct it alleged was in breach of the parties’ agreement. For example, VIP’s breach of contract claim alleged that Volvo wrongfully refused to supply VIP with certain vehicles, assigned VIP an unfairly large area of responsibility, and failed to fairly apply its internal policies to VIP. But if the parties had no contract, then Volvo would have had no obligation to do any of the foregoing. Because Michigan law requires that a tort be independent of a contract, and VIP’s tort claim was entirely dependent upon, not independent of, the parties’ contract, the court granted Volvo’s motion to dismiss VIP’s tortious interference claim.

TRADEMARK INFRINGEMENT

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

A franchisor obtained default judgment against a franchisee that failed to meet its financial obligations. The franchisor also obtained an injunction against the franchisee’s continued use of its trademark following termination of the franchise agreement.

Fruit Flowers, LLC (FFL) owned registered trademarks in connection with its fruit product designs and ran a franchising program. The defendants entered into a franchise agreement that allowed them to use FFL’s trademarks in exchange for royalty payments. Upon failure to pay and thirty days’ written notice, FFL could terminate the agreement. The defendants
defaulted on their payments and the deficiencies were never cured. As a result, FFL terminated the agreement. Despite the termination, the defendants continued to use FFL’s trademarks in their store and online.

The clerk of the U.S. District Court for the District of New Jersey entered default for failure to appear, plead, or otherwise defend the case. FFL then sought default judgment and an injunction enjoining the defendants’ unauthorized use of FFL’s trademarks.

As a preliminary item, the court determined that it had the requisite subject and personal jurisdiction in this matter because the Lanham Act is a federal trademark statute, trademark infringement is a violation of that Act, and the defendants were resident in New Jersey.

The court found that the plaintiff demonstrated that it was the owner of these marks and the marks were validly and legally protectable. Once the franchise agreement was terminated, the defendants’ continued use of the trademark was unauthorized and thus in violation of the Lanham Act. The court did not engage in a detailed analysis of whether the use of the mark created confusion, simply noting that there is a high likelihood of confusion where an infringer uses the exact trademark. The court determined that because the defendants were using the trademark concurrently with FFL, this would create consumer confusion. Thus, the court determined that the defendant violated the Lanham Act and there was a sufficient cause of action for the purposes of the default judgment motion.

The court then considered whether default judgment was appropriate in this case, considering three factors: (1) prejudice to the plaintiff if default is denied; (2) whether the defendant appears to have a litigable defense; and (3) whether the defendants’ delay is due to culpable conduct. Because the defendants failed to plead or otherwise defend, the court concluded that it could not assess whether it had a meritorious defence or whether the delay was due to culpable conduct. Further, the court noted that where the defendants have not answered a complaint or otherwise availed themselves of an opportunity to defend, if default is not entered, no other recourse would be available to the plaintiff. On this basis, the court determined that default judgment was proper.

The court then granted a permanent injunction because an injunction is the “usual and standard remedy” under the Lanham Act. Further, FFL demonstrated that: (1) there was irreparable injury; (2) other remedies would be inadequate; (3) on the balance of hardships, a remedy in equity was warranted; and (4) that the public interest would not be disserved by a permanent injunction.


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

Rib City Franchising LLC is a franchisor of barbecue restaurants around the country. Way Out West Restaurant Group, Inc. (WOW) was a franchisee. In July 2015, Rib City terminated its licensing agreement with WOW following various alleged breaches, including failure to make required payments. The principal of WOW (Jorgensen) alleged she had assigned the franchise agreement to a former Rib City manager (Bowen). Thereafter, Jorgensen changed the name of the restaurant to Pig City BBQ, while keeping the same phone number and website. Rib City also alleged that WOW did not change the décor at the restaurant, offered a substantially similar menu, and kept using trade secret information. Rib City filed suit in the U.S. District Court for the District of Utah against WOW, Jorgensen, and Bowen, making claims for breach of contract, trademark infringement, unfair competition, misappropriation of trade secrets, and civil conspiracy. Rib City sought a preliminary injunction requiring the defendants to cease using Rib City marks; disable all websites and social media pages; disconnect the phone number; cease using the name Pig City BBQ on the grounds that it is confusingly similar to Rib City; remove all Rib City trade dress from the premises; and cease using any confidential, proprietary, or trade secret information.

The court addressed whether Rib City was entitled to a preliminary injunction, focusing on the likelihood that Rib City would prevail on its various claims. As to the trade secret and civil conspiracy claims, the court noted that allegations made regarding WOW’s use of proprietary information and products were insufficient to show that Rib City would prevail. As to the trademark infringement claim, the court analyzed various factors, including the fact that the Pig City BBQ mark differed substantially from the Rib City mark. The court also concluded that Rib City had failed to establish that its mark was conceptually or commercially strong. Furthermore, the court held that Rib City had failed to provide credible evidence of customer confusion. The court stated that evidence that Bowen intended to produce a product similar to Rib City was not sufficient. Rather, Rib City was required to provide evidence that Bowen intended to copy particular marks for the purpose of deceiving customers. The court next addressed Rib City’s trade dress claims. The court held that demonstrating success on the merits of such claim required Rib City to show that: (1) its claimed dress was either inherently distinctive or had acquired secondary meaning, (2) the operation of the
Pig City restaurant created a likelihood of confusion, and (3) Rib City’s claimed trade dress is nonfunctional.

The court concluded that Rib City had failed to provide facts demonstrating the required elements. Nothing in Rib City’s décor, the court found, would intrinsically serve to identify a particular source that signals to customers a particular brand.

TRANSFERS


Franchisees that operated Sunoco branded gas stations and convenience stores in Virginia filed suit against franchisor Sunoco, Inc. (R&M) in the U.S. District Court for the Eastern District of Virginia, alleging that Sunoco violated the Virginia Petroleum Products Franchise Act (VPPFA) in relation to a transfer of the franchise. The VPPFA provides that “refiner” franchisors are prohibited from selling, transferring, or assigning their interest in certain gas station properties unless the franchisor “first either made a bona fide offer to sell, transfer, or assign to the dealer the franchisor’s interest in the premises . . . or, if applicable, offered to the dealer a right of first refusal.” The plaintiffs sought a declaratory judgment that Sunoco violated the VPPFA by transferring certain gas stations at issue to Sunoco, LLC without providing the plaintiffs with a right of first refusal. The plaintiffs also sought damages and an injunction requiring Sunoco to make a bona fide offer to purchase the premises to the plaintiffs.

Sunoco argued that it was not subject to the VPPFA for three reasons: (1) Sunoco is not a “refiner” under the VPPFA because neither it nor any of its affiliates refine crude oil to produce motor fuel; (2) even if Sunoco is subject to the VPPFA, the transfer was to an affiliate and therefore was not a transfer to “another person,” as required by the statute; and (3) the applicable transfer occurred prior to the amendment to the VPPFA that added the right of first refusal requirement.

The court addressed each argument. The court first determined that Sunoco was a refiner because the definition under the VPPFA includes affiliates that refine crude oil into motor fuel. Sunoco had a substantial, although not controlling, interest in refiner Philadelphia Energy Solutions, LLC. The court concluded that the relationship was sufficient to qualify as an affiliate for the purposes of the VPPFA. Next, the court addressed whether the transfer was to “another person” as required under the VPPFA. The court determined that a person can include a company and may even include multiple legal entities. The court also concluded that Sunoco controlled Sunoco, LLC either through its direct ownership of membership interests or through other entities Sunoco controlled. The court therefore concluded that Su-
noco, LLC was not “another person” under the statute. Finally, the court addressed whether the transfer occurred before the applicable amendment to the VPPFA. The court determined that a complete and lawful transfer of the property was concluded approximately one month prior to the enactment of the amendment.

For those reasons, the court concluded that the VPPFA did not apply and that Sunoco was entitled to judgment as a matter of law.

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES


The U.S. District Court for the Northern District of Illinois refused to strike proposed expert witness testimony and declined to strike all but one claim following allegations from an African American franchisee that he had been differentially treated by the franchisor to the detriment of his business.

Michael Wilbern and Wilbern Enterprises, LLC alleged Culver Franchising System, Inc. (CFSI) engaged in a pattern of racial discrimination in violation of 42 U.S.C. § 1982, which prohibits discrimination in making and enforcing contracts. Wilbern had repeatedly requested a Culver’s franchise on the South Side of Chicago, but alleged CFSI steered him away from the predominantly African American neighborhood to a western suburban location in Franklin Park. When the Franklin Park franchise experienced financial difficulties, CFSI allegedly refused to make accommodations given to other franchisees and lulled Wilbern into thinking he would receive support and financial assistance before engaging in a calculated scheme to string him along prior to terminating the franchise agreement upon bankruptcy. CFSI sought to strike proposed testimony from an expert witness and to obtain summary judgment on a number of counts.

CFSI sought to strike proposed testimony from Wilbern’s expert to the effect that CFSI had departed from normal practice with respect to Franklin Park to the detriment of Wilbern; that the decision to deny franchises at sites likely to be more successful had not made sense from a business perspective; and that Wilbern had been treated differentially than other franchisees. On the basis that the expert was a member of the American Association of Franchisees and Dealers and had published numerous relevant articles, the court rejected CFSI’s argument that the expert was not qualified in restaurant franchising. It further ruled that he had not “cherry picked” data in evaluating disparate treatment and that to discount the assumptions underlying his report would usurp the role of the jury.

CFSI sought summary judgment on a number of grounds. In dismissing summary judgment for all but one claim, the court held, among other things, that (1) none of the alleged wrongful acts prior to termination were sufficiently decisive so as to begin the limitation period; (2) there was sufficient
evidence to support a prima facie case of discrimination; and (3) the rights Wilbern was entitled to were not limited to the contents of the franchise agreement, such that he could claim discrimination under § 1981(b), notwithstanding that there was no dispute CFSI had complied with the terms of the agreement.

VICARIOUS LIABILITY


The NLRB brought a series of actions against McDonald’s and various McDonald’s franchisees alleging obstruction of union-related activities and that McDonald’s and the franchisees were joint employers. After the NLRB filed complaints in regional offices, the matters were consolidated in January 2015. In February 2015, the NLRB’s General Counsel served subpoenas duces tecum on McDonald’s and the franchisees seeking documents related to the joint employer issue. The franchisees filed petitions seeking to revoke the petitions, which were denied by an administrative law judge. Thereafter, the parties held a series of discovery conferences but franchisees continued to refuse to produce documents. The NLRB filed an action in the U.S. District Court for the Southern District of New York seeking an order compelling the franchisees to comply with the subpoena.

The court noted that the National Labor Relations Act provides the NLRB with broad subpoena authority and that the court’s role in enforcing an administrative subpoena is very limited. A court will enforce such a subpoena upon the NLRB showing: (1) that the investigation will be conducted pursuant to a legitimate purpose, (2) that the inquiry may be relevant to the purpose, (3) that the information sought is not already within the agency’s possession, and (4) that the administrative steps required have been followed. Once the NLRB shows a prima facie case under these elements, the burden then shifts to the opposing party to show that enforcement is inappropriate because compliance would be unnecessarily burdensome.

The court held that the NLRB made its prima facie case by showing that it was investigating the alleged obstruction of union-related activities and that there was a reasonable connection between that investigation and the joint liability issue. The franchisees then argued that the burden of production would be “astronomical” because they had virtually no staff to handle the voluminous requests. The court held that the franchisees had failed to provide specific evidence of their lack of capacity to comply. Moreover, the court found the franchisees’ arguments unpersuasive relating to burdens associated with alleged duplicate requests made to McDonald’s and the franchisees because the NLRB showed that it made multiple offers to stipulate to
duplicative documents. The court therefore found in favor of the NLRB and ordered compliance with the subpoenas.

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