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## Feature

**Franchising (& Distribution) Currents**

*Jason B. Binford, Earsa R. Jackson, and Marlén Cortez Morris*
Deadline for 2018 Edward Wood Dunham Rising Scholar Award Announced

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

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

Articles must be submitted to Gary R. Batenhorst, the editor-in-chief of the Franchise Law Journal, no later than Monday, July 17, 2017, to be considered in this year's competition. All inquiries should be directed to: gbatenhorst@clinewilliams.com.

We look forward to receiving the submissions!
Welcome to the Summer issue of the *Franchise Law Journal*. I hope many of you are planning to attend the 40th Annual Forum on Franchising in Palm Desert, California, in October. The first Forum I attended was the 2nd Annual Forum in San Francisco in 1979. Much has changed since then—I am sure no one misses the scramble for a pay phone at the breaks—but much remains the same. There will still be the same great programs and the same great networking opportunities.

We are now accepting entries for the 2018 Edward Wood Dunham Rising Scholar Award. The rules have changed, and this writing competition is now open to franchise lawyers from zero to seven years out of law school. This is a wonderful way to start or advance your Forum writing career. The deadline for entries is July 16, 2018, so start early and get ahead of the crowd. Please email me if you are interested in participating.

We lead off this issue with a strong international flavor. Kendal Tyre, Pierce Han, and Nia Newton provide a very interesting article on *International Due Diligence in Cross-Border Franchise Transactions*. Many unique due diligence issues arise with transactions in other countries, and this article provides an excellent survey of these issues.

Next, we are pleased to bring you *Termination and Non-Renewal of Franchise Agreements in the European Union: Italian Law in a Comparative Perspective with Other European Civil Law Systems and England and Wales*. Prof. Aldo Frignani of Torino, Italy, is the principal author of this very helpful comparative law approach to these issues, and we thank him for his contribution. His co-author, well-known London franchise lawyer John Pratt provided Aldo with wise counsel and guidance in preparing this article.

Back in the States, James B. Egle and Jeffrey A. Mandell give us *Sweepstakes and Contests in the Digital Age*. Contests challenge franchise lawyers with a variety of legal issues, and these issues have become more complex as contests...
have migrated to digital platforms. Jim and Jeff provide a very good road map for navigating these issues.

Another challenge in the digital age relates to income tax nexus issues for franchisors. Jay Forester and Mike Drumm give us an excellent update on these issues in *Income Tax Nexus: No Physical Presence Necessary*. The authors have enlivened this article with pertinent quotes from people ranging from Malcolm Forbes to Bruce Lee. I am pleased to report that, for what is likely the first time, the *Franchise Law Journal* has a quote from Alfred E. Neuman. Those of you of a certain age will not doubt recall Mr. Neuman dispensing words of wisdom from the pages of *Mad*. To those who may question Mr. Neuman’s presence in this scholarly journal, my only response is—“What, me worry”?

Back to more serious business, we often hear about disruptions in various industries. This can include disruptions in distribution relationships. Suzie Trigg and Jamee M. Cotton give us a very helpful look at the issues that arise when these relationships are disrupted in *Changing How Products Get from the Manufacturer to the Customer*.

We round out this issue with *An Analysis of Franchise Agreement Terminations and Non-Renewals for Failure to Meet Minimum Performance Standards* by Leon Hirzel. The establishment and enforcement of minimum performance standards is an important issue for franchisors and franchisees. Leon gives us a thoughtful analysis of the many issues that arise in this area.

We could not provide this great variety of articles to you without the hard work of our dedicated editors. I want to single out the efforts of Jason Binford. Not only did Jason devote significant time and effort to working with our European colleagues on the article on terminations in the EU, but he was also lead editor of the Currents section in this issue, working with Earsa Jackson and Marlén Cortez Morris. We are trying something new with the Currents in this issue. We are reporting on fewer cases with more in depth summaries, which we believe will be more helpful for our readers. We are very interested in what you think of this change so please email me with your thoughts.

Finally, with this issue we say good-bye to two of our dedicated editors, Jennifer Dolman of Toronto and Jan Gilbert of Washington, D.C., who have completed their six years of service on our editorial staff. We had a number of articles by Canadian authors during Jennifer’s tenure, and she skillfully edited these articles. Jan also handled a number of diverse and interesting topics for *Journal*. We are grateful for their many years of service. Larry Weinberg of Toronto and Emily Bridges of Greenville, South Carolina, have joined us as new Topic & Article Editors. More about Larry and Emily in our next issue.
SAVE THE DATE

40th Annual Forum on Franchising
October 18 – 20, 2017
JW Marriott Desert Springs
Palm Desert, CA
When a franchise system expands internationally, due diligence that includes a thorough investigation of the business environment of the proposed target market and its legal landscape will provide clues as to the likely success of the expansion. Preliminary investigation will also shape the due diligence that must be conducted on the proposed local master franchisee, area developer, or joint venture partner. Due diligence of the local business requirements, the local legal framework, and the local partner is particularly important in the international context because the stakes are often higher. Compared to a typical domestic franchise transaction in the United States, the amount invested is generally higher, the time to recoup the investment is longer, the pool of viable candidates is smaller, and the available resources to conduct any due diligence are often scarce. Regardless of these challenges, due diligence remains an essential and invaluable component of any cross-border transaction and the key considerations of that exercise are addressed here.

I. Due Diligence of Business Considerations

A franchisor may typically leave some business due diligence to its local partner, relying on the local partner’s knowledge of the market and its industry expertise. If a franchise arrangement covers multiple jurisdictions, the

1. For ease of reference, “local partner” refers to the proposed local master franchisee, area developer, or joint venture partner in the target country.
due diligence conducted should cover each target market and not just the home jurisdiction of the new local partner. No matter who conducts the investigation, the initial business due diligence on any new target market should, at a minimum, include the inquiries detailed below:

• **Composition of product or offering of service.** Does the product sold by the proposed franchise require modification to make it locally compliant or culturally acceptable? For example, some jurisdictions regulate whether a product can be labeled and sold as a particular type of food (i.e., halal or kosher). A franchisor may believe it is desirable, even if not required, to certify food preparation for cultural or religious reasons. If the product does not meet the specific certification requirements, it may have to be re-named or re-designed.

  Such required or desired adaptations may also affect a franchise that offers services as opposed to a product. To comply with religious customs or restrictions, for example, hotels in Israel need to modify some services on the Sabbath, such as the operation of swimming pools and health clubs. Moreover, a franchisor may need to inquire during its business due diligence whether locally prescribed business hours are more restricted than those in the franchisor’s home jurisdiction or whether religious holidays or practices could impact the proposed operations of the franchised business. In some Muslim countries, for example, food and drink cannot be served in the daytime during Ramadan.

• **Suitability of offering.** How suitable is the product or service for the target market? Does the name of the brand translate poorly or is the product culturally insensitive or unpopular? How have competing brands in the marketplace performed? Is there adequate infrastructure to support the franchisor’s business operations? Is there a demand for the product or service in the target market? Will the local customer be a viable client?

• **Import costs.** Will certain supplies or products used or sold in the franchise need to be imported into the target market? Are there tariffs or other local taxes imposed on the import or sale of products that make them too expensive for use by the franchised business in the target market? If so, are there readily accessible alternatives for these imported supplies or products?

• **Local costs.** For those franchises that rely heavily on local supply chains, are affordable suppliers available? Moreover, are there rebates to local or offshore suppliers? Employment of workers, licenses and permits, real estate costs, and/or the cost of goods in the target market may lead to significantly higher cost of sales. A franchisor should refrain from making assumptions as to the affordability and practicality of an international franchise transaction, particularly when its target market consists of multiple countries with a myriad of business and franchise regulations.
• Political risks. The franchisor will need to analyze whether the target market presents significant risks, such as political threats or the threat of civil unrest or terrorism. It is also valuable for a franchisor to consider the reputational harm, political and legal consequences, or social backlash its business may face in the franchisor’s home country, if any, should it decide to enter into business in an unpopular country. The franchisor should assess how supportive the local market’s government will be and what type of political or regulatory red tape it should expect in its effort to establish its business in the local market.

• Payments. Due diligence must address whether local exchange control regulations, tax laws, or both restrict the repatriation of profits to the franchisor’s home jurisdiction or whether payments must be made in local currency of the target market. Franchisors should also familiarize themselves with central banks and/or other financial institutions of the target country.

The foregoing questions (among others) raised during any initial due diligence of a target market’s business environment will almost certainly inform other potential issues or particularities of the target country that a franchisor may want to investigate further. In many instances, a franchisor may have to depend on the market insight and social awareness provided by a proposed local partner. This, of course, makes a franchisor’s independent due diligence and investigation all the more important. Local market research should be based on the efforts of an entire team of advisors that support the franchisor, including accountants; business consultants; investigators; respected industry colleagues; local business contacts; and of course, local legal counsel, who will provide guidance on the due diligence of relevant legal issues.

II. Due Diligence on Legal Matters

Apart from any business due diligence, a franchisor must also conduct legal due diligence on the potential impact that local laws may have on the expansion of the franchise system to the target market. Often these issues are vetted with local counsel, who is familiar with the analysis needed to address the typical matters presented. Advice from local counsel should also be sought on the changes that are necessary for or desirable to the franchisor’s franchise agreement. Changes will inevitably be required because local statutes and public policy will often apply, regardless of the choice of law. Local counsel can provide valuable advice regarding provisions of a franchisor’s agreement that may be difficult to enforce and should be able to suggest alternatives. Initial legal issues that should be investigated by the franchisor include the following:

• Legality. Is it legal to sell the goods or services in the target market? For example, pork products and alcoholic beverages cannot be sold in certain countries in the Middle East. Any attempts to sell items that that
are prohibited could offend local mores and a franchisor could inflict significant damage to its brand domestically and abroad.

- **Trademarks.** The franchisor must inquire whether the system’s principal trademarks are registered or available for registration.

  If the franchise’s principal marks cannot be used in the target market, it may not be worth proceeding with the franchise offering. Permitting local partners in the target market to operate under different brands than those used in the franchisor’s home market may defeat the objective of enhancing the franchisor’s brand internationally.

  Some franchise systems, however, have launched under different brands in foreign markets. For example, in Australia, the U.S.-based brand of “Burger King” is known as “Hungry Jack’s,” and the U.S. brand “Church’s Chicken” is known abroad as “Texas Chicken.” In the United Kingdom, the U.S.-based brand of “Kwik Kopy” is called “Kall Kwik.” Proceeding in this manner can be expensive. Moreover, operating the franchise systems abroad under marks that differ from the franchisor’s principal trademark builds goodwill for a brand in which the franchisor may have no long-term interest.

  Finally, the franchisor must also inquire whether the franchisor’s trademark must be registered before it is licensed to a third party to avoid violating local law in the target market. A franchisor should also investigate the typical duration of trademark registration in the target market, particularly if registration is required prior to the franchisor’s ability to offer or sell the franchise.

- **Disclosure or registration.** A franchisor should know whether any local laws require any disclosures before signing a binding or non-binding letter of intent or before accepting any payment from a prospective local partner. The franchisor should also know whether disclosure is required before the franchise is advertised or before representatives of the franchisor speak to or meet with a prospective local partner candidate.2

  In addition, a franchisor should know whether local franchise laws require a regulatory filing or approval before a franchise agreement can be offered or executed or upon its execution. For example, in Malaysia, Indonesia, Vietnam, and South Korea, franchisors must register their franchise with a regulator before it can be offered. In China, filing is mandated past execution of the franchise agreement. In Mexico, documents, including trademark licenses or a summary of their terms, must be filed with the intellectual property registrar.3
• **Mandatory provisions.** Jurisdictions that have franchise laws often require that certain provisions be included in franchise agreements. Some of these provisions impact the fundamental elements of the franchise offering. Other requirements dictate the form of the franchise agreement. They include a prescribed minimum term of agreement, a mandatory “cooling-off” period, and a requirement that the agreement be written in the local language to be enforceable or mandatory governance by local law.

• **Franchise structure.** The franchisor should analyze whether the structure of the franchise violates any local laws, such as those related to pyramid selling. And if so, how could the structure be modified, if at all, to comply with local law?

• **Local presence.** The franchisor should know whether the target market requires it to establish a local subsidiary or branch in the jurisdiction or whether the franchisor must operate its own units of the franchise being offered for a certain period before it engages in franchising with other local parties. The franchisor should also determine whether foreign investment or ownership laws restrict the franchisor from establishing a presence or investing locally. In certain target markets, local legislation restricts a franchisor’s step-in rights to take over leases and assets to operate franchised units if the local partner is in breach or upon termination of the franchise agreement.

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4. For example, Argentina’s Civil and Commercial Code requires that the minimum term of a franchise agreement be at least four years with certain exceptions. See Mario Eduardo Castro Sammartino, *Franchising in Argentina*, in *INTERNATIONAL FRANCHISING 2016*, supra note 2, at 268.

5. For example, Section 18 of the Franchise Act 1998 of Malaysia requires a cooling-off period of not less than seven working days, during which the franchisee has the option to terminate the agreement. See Wong Sai Fong & Michelle C.Y. Loi, *Franchising in Malaysia*, in *INTERNATIONAL FRANCHISING 2016*, supra note 2, at 442.

6. For example, Indonesia requires that if a franchise agreement is written in a foreign language, the agreement must be translated into the Indonesian language for registration. See Nur-din Adiwibowo, Freddy Karyadi & Gustaaf Reerink, *Franchising in Indonesia*, in *INTERNATIONAL FRANCHISING 2016*, supra note 2, at 418.


8. In China, Article 7 of the Regulation on the Administration of Commercial Franchises, adopted May 1, 2007, requires franchisors to have at least two direct sales stores and to have undertaken the business for more than a year (although this no longer needs to be in China). In Vietnam, Decree No. 35-2006-ND-CP requires a Vietnamese sub-franchisor to operate the franchise for at least one year in Vietnam before sub-franchising. See Paul Jones & Erik Wulf, *Franchise Regulation in China: Law, Regulations, and Guidelines*, 27 *FRANCHISE L.J.* (2007); Mai Thi Minh Hang, *Legal Framework for Franchising in Vietnam*, MONDAX.COM (Mar. 15, 2015), http://www.mondaq.com/x/157420/ Franchising/Legal+framework+for+franchising+in+Vietnam.
• **Industry regulation.** Are there industry-specific regulations that could introduce additional costs or impractical requirements that would impede the expansion of the business model in the target country?

• **Travel restrictions.** A franchisor should know whether visas are required for the local partner’s personnel to visit the franchisor’s home country for training and other required meetings as well as the requirements, if any, for franchisor’s personnel to visit the target market.

• **Compensation and Competition.** A franchisor should conduct legal due diligence to inquire whether any local laws relating to termination or non-renewal of agencies, distributorships, or franchises would require the franchisor to compensate the local partner at the end of the franchise relationship. The franchisor should also investigate whether it will have the right to require its local partner to agree to a non-competition covenant because this type of provision may not always be permitted or may be heavily regulated in some countries.

### III. Due Diligence on the Local Partner—The Background Check

The business as well as the legal due diligence conducted by the franchisor will often benefit from insights provided by the local partner in the target country. Given this and given that the local partner is often the lynchpin to the on-going success of the franchise in the target country, a background check on the individual local partner and/or the principal officers of any proposed franchisee entity is a critical part of the franchisor’s due diligence.

A background “investigation” or “check,” in general terms, delves into an individual’s general reputation and history. It may be as simple as a criminal

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9. The amount of compensation that may be owed to the franchisee under an agency law varies from country to country. However, it is often left to the discretion of local courts, which typically consider the circumstances as a whole, including the franchisee’s actual investment and a reasonable prediction of future profits. A standard award would be the equivalent of one year’s total profits (averaged over four to five years) of the franchisee. Compensation for the goodwill of the business and any unused inventory could also be awarded. The amount of compensation may be higher if the parties have a long-term relationship and the franchisee shows extensive investment in the franchise. Ned Levitt, Kendal Tyre & Penny Ward, *The Impossible Dream: Controlling Your International Franchise System*, ABA 33rd Annual Forum on Franchising, October 13–15, 2010, at 20, http://www.dickinson-wright.com/-/media/documents/documents-linked-to-attorney-bios/levitt-ned/20the-impossible-dream.pdf?la=en.

10. Australian law states that post-term restraints will not be enforceable if: (1) a franchisee requests a new agreement but is declined; (2) the franchisee is not in breach or has not infringed the intellectual property of, or a confidentiality agreement with, the franchisor during the term of the agreement; or (3) the franchisee has claimed compensation for goodwill because the agreement was not extended but the franchisor declined to pay such compensation or only paid a nominal amount (or the franchise agreement did not provide for an entitlement to such compensation). Jon Sier & Philip Colman, *Australia, Getting the Deal Through: Franchise* (Aug. 9, 2016), www.franchise.org/sites/default/files/ek-pdfs/html_page/Australia-laws_1.pdf.
history search. In other cases, it may involve not only a review of criminal records, but also a thorough investigation of civil records, assets and bankruptcy records, credit reports, and driving records. Background checks also usually include the verification of professional licenses held, educational degrees obtained, and information gleaned from personal and professional references. A background check could be based, in part, on a questionnaire prepared by the franchisor or even a drug test or a physical and psychological assessment. Other areas of inquiry include third-party supplier and vendor arrangements of a local partner that could impact the franchisor and its business.

Searches normally involve reviewing a seven-year history of the subject; the scope of the review depends on the particular need of the franchisor, the specific issues of concern in the target market, and the due diligence that has already been completed which results in areas of further inquiry in the background of the local partner.

As a general matter, when conducting an international background check, the franchisor must be guided by a series of laws that frame most investigations to ensure that a potential local partner in a target market does not trigger certain national security and anti-bribery legislation. These are perhaps the most important aspects of a background check in the international context and are highlighted below.

A. United States Office of Foreign Assets Control

The Office of Foreign Assets Control (OFAC) is an agency within the U.S. Department of the Treasury. It administers and enforces economic and trade sanctions based on U.S. foreign policy and national security goals.11

OFAC generally prohibits U.S. persons from engaging in transactions involving property or interests in property belonging to individuals and entities that are listed on OFAC’s Specially Designated Nationals and Blocked Persons (SDN) list.12 Any transaction with an SDN is referred to as a blocked transaction; these include making loans to an SDN, making investments in an SDN, raising money for an SDN, and facilitating any transaction by a non-U.S. person that would be a blocked transaction if conducted by a U.S. person.

Franchisors based in the United States must conduct searches on the current listings of SDNs to ensure that any potential franchise transaction does not involve these individuals and/or entities. To enter into a blocked trans-

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11. OFAC sanctions are applied to targeted foreign countries and regimes; foreign entities and individuals; terrorists; international narcotics traffickers; those engaged in activities related to the proliferation of weapons of mass destruction; and other threats to the United States, its national security, foreign policy, or economy. OFAC violations may result in civil and criminal penalties, including imprisonment.

action, a franchisor must apply for an OFAC license, which OFAC issues on a case-by-case basis, in limited circumstances.

B. Foreign Corrupt Practices Act

The Foreign Corrupt Practices Act of 1977 (FCPA) makes it unlawful for certain classes of persons and entities to make payments to foreign government officials to assist in obtaining or retaining business. The FCPA applies to prohibited conduct anywhere in the world and extends to publicly traded companies and their officers, directors, employees, stockholders, and agents. Agents can include third party agents; consultants; distributors; joint-venture partners; and others, including franchisees.

The anti-bribery provisions of the FCPA prohibit the willful use of interstate commerce (whether through mail or by any other means) corruptly in “furtherance of any offer, payment, promise to pay, or authorization of the payment of money or anything of value to any person, while knowing that all or a portion of such money or thing of value will be offered, given or promised, directly or indirectly, to a foreign official” to:

(i) influence the foreign official in his or her official capacity,
(ii) induce the foreign official to do or omit to do an act in violation of his or her lawful duty, or
(iii) to secure any improper advantage in order to assist in obtaining or retaining business for or with, or directing business to, any person.

Since 1977, the anti-bribery provisions of the FCPA have applied to all U.S. persons. Franchisors should be vigilant when asked to make unusual payment arrangements, either to known or unknown parties, or for services to a bank account not located in either the country where the services were provided or the country where the recipient of the funds is located. In addition, the use of shell entities or aliases by the prospective local partner candidate should raise heightened scrutiny of the transaction to ensure that it is not a vehicle or used to hide corrupt payments. In certain countries, especially those in the developing world, which tend to suffer from more corruption than others, bribes may be customarily paid or demanded. When doing business in a country with a reputation for public corruption, franchisors

13. The U.S. Department of Justice (DOJ) and the U.S. Securities and Exchange Commission (SEC) are jointly responsible for enforcing the FCPA. The SEC’s Enforcement Division has created a specialized unit to further enhance its enforcement of the FCPA.
15. With the enactment of certain amendments to the FCPA, specifically the second amendment, also known as the International Anti-Bribery Act of 1998, which was designed to implement the OECD Anti-Bribery Convention, the anti-bribery provisions of the FCPA also apply to “foreign firms and persons who cause, directly or through agents, an act in furtherance of such a corrupt payment to take place within the territory of the United States.” Foreign Corrupt Practices Act, DEP’T OF JUSTICE, https://www.justice.gov/criminal-fraud/foreign-corrupt-practices-act; see also Lucinda A. Low & Timothy P. Trenkle, U.S. Antibribery Law Goes Global: Standards Tightening Up, BUS. L. TODAY (July/Aug. 1999), https://apps.americanbar.org/buslaw/blt/8-6antibribery.html.
must be particularly suspicious of any activity that may suggest the paying of any bribes. Local counsel in the target country can provide further details regarding the likelihood of officials or agents demanding or soliciting bribes in particular circumstances.

C. U.K. Bribery Act

Franchisors should also be aware of the Bribery Act 2010 (the Act), an act of the Parliament of the United Kingdom. The Act has a near-universal jurisdiction, allowing for the prosecution of an individual or company with links to the United Kingdom, regardless of where the crime occurred.16

The Act introduced a new strict liability offense for companies and partnerships that fail to prevent bribery. This places a burden of proof on corporate entities to show they have adequate procedures in place to prevent bribery. It also provides for strict penalties for active and passive bribery by individuals as well as corporate entities. The Bribery Act creates four primary offenses:

- the offering, promising, or giving of an advantage;
- the requesting, agreeing to receive, or accepting of such an advantage;
- the bribery of a foreign public official; and
- the failure by a company to prevent a bribe being paid to obtain or retain business or a business advantage.

In high risk countries, regions, or areas, and in certain businesses that are at a high risk of bribery, it is paramount that franchisors retain a professional investigator not only to check the background of the potential local partner, but also to conduct background checks on any local agents or consultants hired to represent the franchisor locally, instead of relying on a questionnaire completed by prospective agents.

Because the U.K. Bribery Act creates a strict liability corporate offense for failure to prevent bribery (as opposed to vicarious liability), subject to being able to establish that a company has “adequate procedures,” a franchisor must also ensure compliance by any “associated persons,” which includes anyone who performs services for or on behalf of the commercial organization. As a result, as part of the franchisor’s due diligence, it should investigate whether the proposed local partner has any policies and/or procedures in place that could guard against a violation of the Act or other similar legislation.

A franchisor faces the risk of potential liability if its international partner makes improper payments to local government officials to obtain favorable regulatory treatment or other government approvals, a type of conduct

that can be common in certain parts of the world. A franchisor should periodically review its local partners’ operations and interactions with government officials to ensure that they are not engaging in conduct that might expose the franchisor to possible liability. Such a review will largely consist of interviews of the franchisor’s and local partner’s employees with potential knowledge of the manner in which the local partner interacts with foreign government officials (for example, customs and tax officials and health inspectors) and, where appropriate, targeted document and email review.

Franchisors must recognize that although their anti-bribery policies and procedures (and those of their prospective franchise candidates) may be compliant with the FCPA, this does not automatically ensure that such policies and procedures are compliant under the Act, and vice versa. Steps must be taken to ensure proper due diligence is undertaken to remain compliant with the various laws and regulations aimed at combatting corruption, bribery, and general fraud in international transactions.

D. Third Party

Franchisors conducting business internationally should be aware of the risks posed by third-party relationships of local partner candidates. The federal government is increasingly seeking to impose liability on corporations for the acts of third parties, such as distributors and subsidiaries in the FCPA and other contexts. As a result, it is important that when conducting background checks on potential local partners, the franchisor investigate these third-party arrangements of any candidate.

Under the FCPA, third-party risks are present when a third party (e.g., a distributor or an agent) represents a company in its interactions with foreign government officials. These types of risks do not often arise with vendors and suppliers because they do not act in a representational capacity. For example, a supplier that provides a local partner with vending machine supplies for its employees and that bribes customs officials to transport its products does not act in a representational capacity for a customer-company. The supplier may pay bribes but none of its customers will be subject to FCPA liability for its bribery of customs officials. However, a vendor that ships goods for a specific customer acts as a representative of the customer-company when it bribes customs officials to transport its specialty shipment across country borders. Consequently, FCPA liability could result in that


18. A company may be held liable for the acts of its partners on the theory that the company was willfully blind to the improper payments. Indeed, a majority of the FCPA enforcement actions are based on third-party payments. See Gregory M. Williams & Robert A. Smith, The Federal Government Is Increasingly Seeking to Impose Liability on Corporations for the Acts of Third Parties, such as Distributors, Subsidiaries, and Franchisees, IFA INT’L BLOG (Feb. 8, 2016), http://www.franchise.org/franchisors-and-the-fcpa-balancing-compliance-risk-and-cost-concerns.
circumstance. Given the risks involved, when analyzing a local partner’s arrangements with third parties and vendors/suppliers, a franchisor should screen and investigate these relationships to mitigate any potential risk.

Finally, vendors and suppliers of a local partner can create real and significant reputational risks for franchisors. Franchisors would be prudent to avoid local partners that have relationships with vendors or suppliers that rely on child labor or engage in human trafficking.\textsuperscript{19} In recent years, governments, non-governmental organizations, and the media have increasingly highlighted the role global commerce and the expanding international supply chain have had in proliferating forced and bonded labor across the globe. Real-life examples of modern-day slavery exist in the food we eat, the clothes we wear, and the consumer products we purchase.\textsuperscript{20}

E. Reputational Due Diligence

A franchisor should research the general business reputation of a potential local partner; several sources are available to assist in this effort, including the following:

- **General business reputation.** A search of foreign news sources media associated with the shareholders, principals, and officers of a company under review is generally available on the Internet; to the extent that such sources are not available online, a franchisor should coordinate local searches for news items with local counsel, local investigators, and the local partner.

- **Social media.** To the extent available, searches should be made of the individual local partner or its franchisee entity as well as its principal shareholders and officers on various social media, such as Facebook, Twitter, LinkedIn, etc. If a company account does exist, franchisors should request a list of all such social media accounts, as well as details on who is responsible for such accounts and who has access to them, and any policies and procedures regarding what can be posted to such social media outlets. A franchisor should also discover what social media and press have to say about the potential local partner and assess, if necessary or depending on the service or product the franchisor sells, whether the prospective local partner’s social media presence is sufficient.

- **Criminal records.** Each target country has varying laws about the type of criminal records that are available and who is allowed to access them.

\textsuperscript{19} On March 26, 2015, the United Kingdom’s Modern Slavery Act 2015 became Europe’s first legislation tackling such modern day labor issues as child, forced, and bonded labor. The Act introduced measures compelling United Kingdom companies to disclose their efforts to combat modern day slavery in their supply chains. Similar legislation was enacted in California, but no U.S. federal legislative measures have gained traction. See California Transparency in Supply Chains Act, CAL. CIVIL CODE § 1714.43 (2012).

Each target country also has its own discrimination laws that govern how a third party may use the information within a criminal record. Some countries, for example, will let employers turn down applicants only if their criminal history prohibits them from working with vulnerable populations, such as children. To assist in the aspect of the reputational due diligence, a franchisor should be aware that the U.K. government has compiled a list of target countries and their processes for getting a criminal background check on someone who lives or has lived in the target country.21

- **Civil Lawsuits.** A franchisor should aggressively try in its reputational due diligence to discover, to the extent possible, whether a local partner has been a recurring defendant in civil lawsuits. An individual with an extensive history of being accused of having committed fraud, misrepresentations, or other actions relevant to its trustworthiness is not the type of local partner with whom a franchisor wants to enter into business. A franchisor should make all efforts to solicit the help of local counsel in its examination of its prospective local partner.

- **Reference checks.** Fortunately, checking international references is more straightforward. A franchisor can contact each reference that a franchise applicant has listed and ask questions about the applicant’s background, character, and competency. The franchisor may need to use a translation service if the reference does not speak the same language as the franchisor.

- **Other resources.** Other areas for investigation by the franchisor include the regulatory action history of local partners. Again, the availability of this information may be analyzed by local counsel in the target country or obtained directly from the local partner via a questionnaire or interview.

**F. Financial Due Diligence**

A franchisor should research the available financial information of a potential local partner; several sources are available to assist in this effort, including the following:

- **Credit reports.** As with international criminal records, getting an international credit report on an individual can be tricky.22 Each target country has its own way of reporting credit,23 debt, and responsibility. In addi-

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tion, many target countries have privacy laws about who can review credit reports. Franchisors will have to contact each credit reporting agency to determine whether they can access this information.\textsuperscript{24}

- **Bankruptcies.** A franchisor should try to find records, if any, of a prospective local partner’s former bankruptcies or tax liens. Access to bankruptcy search engines, such as Pacer in the United States or Canada’s Bankruptcy and Insolvency Records Search, can assist a franchisor in such financial due diligence.

- **Other information.** Although it is not always possible to obtain the following, a franchisor should make an effort to review: personal financial statements, business financial records, bank statements, tax records, source of funds, capitalization table, annual budgets, plans and projections, all auditor’s and management letters, accounting policies, receivables, inventory, and equipment.

### IV. Conclusion

Conducting cross-border due diligence on the business environment of the target market as well as the local legal issues remains a vital part of a franchisor’s decision to enter a new jurisdiction. A thorough investigation of the background of the proposed local partner, area developer, or joint venture partner is just as important. International background checks on prospective local partner candidates will likely be more expensive, take longer, and yield less information than the same effort would produce in a domestic context. Given the scarcity of resources in many markets, it is prudent to allow for more time to complete the due diligence process and also be transparent with the prospects with regard to the due diligence process and what is expected of them. To the extent that public sources are limited, a franchisor should be prepared to ask local partner candidates to produce a number of documents related to the due diligence exercise, including copies of passports or national identification cards, address history, and evidence of citizenship, to name a few items. Franchisors should also be prepared to ask the local partner to provide references for additional potential references and create a questionnaire for the prospect. Given the length of the process and the franchisor’s probable need to rely heavily on information provided by the candidate, a franchisor should consider taking the due diligence in phases so as not to overwhelm the prospect with requests. To the extent a franchisor’s inquiries do not reveal a depth of information, the franchisor may have to cover a broad range of topics in a shallow fashion and make the most of the information provided, recognizing that cross-border due diligence is a difficult exercise that may not yield the same results as a domestic investigation.

\textsuperscript{24.} How Do Credit Scores Work in Other Countries, supra note 22.
Termination and Non-Renewal of Franchise Agreements in the European Union: Italian Law in a Comparative Perspective with Other European Civil Law Systems and England and Wales

Aldo Frignani and John H. Pratt

This article is a comparative review of the legal implications of terminating franchise agreements or their non-renewal in a number of jurisdictions in the European Union. Italy is used as the standard\(^1\) for the approach of civil law jurisdictions (which includes almost all European countries with the exclusion of England, Wales, and the Republic of Ireland). This article highlights both the similarities and differences of approach of the two types of jurisdiction.

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1. This explains the number and amplitude given to Italian case precedents in this article in comparison with those in other jurisdictions. Unless otherwise indicated, the authors translated all translations of quoted foreign authorities.

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The authors are profoundly indebted to Karsten Metzlaff for his inestimable help in research and suggestions concerning German law. This article was prepared before the United Kingdom Brexit vote of June 23, 2016, when the United Kingdom was still a full member of the European Union.
I. Termination of Franchise Agreements—Introduction

We begin with a comparative overview of the approach of the Italian civil law with the approach of the English common law. The approaches adopted in a number of other European civil law jurisdictions are also discussed.

A. Italy

The Italian Franchise Law\(^2\) does not contain any specific provisions on the termination of franchise agreements, except that, in the case of a fixed term franchise contract, the franchisor must grant franchisees a minimum term, which cannot be less than three years, required to amortize the franchisee’s investment, but requires that the franchise agreement contains “the conditions of renewal, termination or eventual assignment of the agreement.”\(^3\) As a result, terminations and non-renewals are regulated by the general provisions of the Italian Civil Code, interpreted through the few cases that have dealt with franchise agreements. In this context, Italian law generally provides that franchise agreements may be terminated:

1. in the case of fixed term agreements, when the term of the agreement comes to an end (see Section II);
2. in the case of an indefinite term agreement, when the term of the agreement comes to an end (see Section III);
3. by mutual consent (see Section IV);
4. by unilateral withdrawal under certain circumstances (see Section V);
5. by breach that the innocent party treats as bringing the agreement to an end (see Section VI); or
6. in other circumstances, as permitted by law (Section VII).\(^4\)

B. England and Wales

In England and Wales, there is no legislation regulating franchise agreements or the franchise relationship. Accordingly, franchisors and franchisees have the right to terminate as provided for in the franchise agreement itself or as governed by common law.

The common law envisages that either party to a contract may terminate the contract if the other party commits a “fundamental” or “repudiatory” breach, which is a breach so serious it indicates that the defaulting party no longer wishes to be bound by the agreement. As a result, franchise agree-

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3. Italian Franchise Law art. 3.4(g).
4. See Italian Civil Code arts. 1372, 1373 & 1453.
ments may be terminated for any of the reasons set forth in (1) through (6) above. Additional bases for termination include:

- on the giving of reasonable notice if the fixed term agreement has expired, but the parties have continued to operate under the agreement as if it were still in existence (see Section V); and

- if a franchisor with existing franchisees wishes to withdraw from franchising, the courts may be prepared to imply a term to the effect that the franchisor on the giving of reasonable notice can refuse to renew franchise agreements giving franchisees a right to renew (see Section III).

C. Other Civil Law Jurisdictions

France, Belgium, and Spain have all enacted franchise laws that have an impact on franchise terminations:

1. France

In France, the Loi Doubin of December 31, 1989\(^5\) applies to franchising. It imposes disclosure requirements but does not contain any specific rules on termination. Therefore, as with Italy, the civil code is applied. Further, no termination rules are contained in the Loi Macron of August 6, 2015, which adds two articles to the French Commercial Code\(^6\) referring to franchise agreements.\(^7\) This is with the exception of the mandatory termination on the same day of all connected agreements (for example, a lease contract or a software license) between a franchisor and a franchisee if one of the agreements is terminated. The direct consequence of this “legal indivisibility” is to enable retail business franchisees to join another network if they wish. More recently, Decree number 2016-131 of February 10, 2016,\(^8\) imposes a number of new rules also applying to franchising contracts.

2. Belgium

In Belgium, the law of July 27, 1961, on unilateral termination of distribution contracts (as amended on April 13, 1971, and subsequently on May 31, 2014) (the Belgian Distribution Law) regulates the unilateral termination of distribution contracts (as amended on April 13, 1971, and subsequently on May 31, 2014) (the Belgian Distribution Law) regulates the unilateral termi-

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7. Article L-341-1 of the French Commercial Code provides that

    all contracts (i) concluded between a person making available to an operator of a retail business a trade name, a trademark or a store brand in consideration of an exclusive/quasi-exclusive commitment and (ii) the shared purpose of which is the operation of one or several retail outlets which include clauses which are liable to limit the freedom of the outlet’s operator to carry on his business [shall all have the same expiration date].

8. The decree was entered into force on October 1, 2016, and reformed the French Civil Code concerning contracts and obligations.
nation of exclusive distributorship agreements and applies also to franchise agreements, particularly if a foreign franchisor appoints a franchisee for the Belgian territory.\footnote{See Paul Crahay, *Le contrat de franchise de distribution et la loi relative à la résiliation unilatérale des concessions de vente*, REVUE DE DROIT COMMERCIAL BELGE (1985); Nicole Van Crombrugghe, *Agency and Distribution Agreements in Belgium*, 1 J. INT’L FRANCHISING & DISTRIB. L. 57 (1999).} The Belgian Distribution Law covers (1) the unilateral termination of specific categories of distribution agreement concluded for an indefinite term, and (2) the renewal of those same categories of agreements concluded for a fixed term.

Under the Belgian Distribution Law, a number of agreements that would usually be considered to have been granted for a fixed term will not necessarily come to an end on expiration of their term. Rather, they will sometimes be considered transformed by law into an agreement for an indefinite term if the franchisor fails to serve a notice of termination by registered letter at least three months and at the most six months before the expiration of the term. If this occurs, the agreement is deemed renewed, either for an indefinite period if the agreement does not contain a renewal clause, or for the period stipulated in the renewal clause. Further, the renewal of a franchise agreement for the third time, in accordance with a renewal clause, or otherwise, will transform the agreement into an agreement for an indefinite term.\footnote{See Pascal Hollander, *Possible Legislative Developments: Is Belgium Doomed to Become a Hell for Franchisors?*, 3 J. INT’L FRANCHISING & DISTRIB. L. 46 (2001).} A specific franchise law passed on December 19, 2005, is limited, in the wake of Italian law, to requiring that the disclosure document contain the conditions of termination and renewal.

3. Spain

The Spanish law on franchising (the Spanish Franchise Law)\footnote{Royal Decree 201/2010 of February 26, 2010, at Article 3(g) (regulating the operation of a franchise business). The decree amends the previous law on franchising n.7 of January 15, 1996. See *Nulidad, anulabilidad y resolución por incumplimiento en el contrato de franquicia en Nuevas Formas Contractuales y el Encremento del Endeudamiento Familiar* (Ruiz Peris ed., Valencia 2004); Jaume Mari Miravalls, *Contratos para la internacionalización de franquicia, in* LA LEY-RCD, n.12,2013 at 110.} regulates franchise agreements in requiring that such agreements must include the “duración del contrato” (the contract duration) and the “condiciones de resolución” (conditions of termination).

II. Fixed Term Agreements

A. Italy

Unlike some U.S. jurisdictions where the law requires “good cause” for the non-renewal of a franchise agreement,\footnote{See John Baer & Susan Gruenberg, *United States, in* INTERNATIONAL FRANCHISE SALES LAWS 537 (Andrew Loewinger & Michael Lindsey eds., 2d ed. 2015).} such a rule generally does not exist in Europe. For example, in Italy if the parties have signed a franchise
agreement with a fixed term, the agreement simply ceases to be in force on expiration, without any further intervention. In fact, the basic principle of freedom of contract, which includes freedom not to contract, implies on the one hand that a franchisee has no right to renew the contract when it comes to an end and, on the other, that there is no requirement for the franchisor to provide any reason for the non-renewal. Very often the parties to a franchise agreement stipulate that a fixed term contract may be automatically renewed for a period equal to or shorter than the initial term, unless notice of termination is given by one of the parties in advance (usually three, six, or twelve months).

In the 2003 case Avis Autonoleggio v. Mad, the Tribunal of Taranto decided that if the parties have agreed to a clause giving a party the right to terminate, such termination will not be “unfair” because it reflects the exercise of a contractually granted right.

Although a franchisee has no right to renew a franchise agreement when it comes to an end, reasonable expectations may play an important role in a court’s approach, especially when such expectations have been induced by a franchisor’s representations or behavior. Indeed, the franchisor might breach the principle of good faith if it approves or gives the franchisee permission for new investments on the assumption of the contract’s renewal and then proposes burdensome conditions unacceptable to the franchisee for such renewal.

Because the failure to renew a fixed term agreement is a franchisor’s right, there is no need to give reasons for a failure to renew. However, a decision not to renew must be for a sound business reason or the franchisor risks a finding that it was an “irrational decision.”

B. England and Wales

In the United Kingdom, tacit renewals of franchise agreements would be very unusual. Further, a “tacit” renewal would, for purposes of the vertical restraints block exemption, extend the term of the franchise agreement by the duration of the renewal agreement. This may result in the extension of the five-year period during which Article 5.1(a) allows non-compete obligations to be enforced beyond this five-year period. Generally, franchisors use a renewal to impose new contractual terms on franchisees that cannot, of course, be done with a tacit renewal. In the United Kingdom, renewal

13. See Italian Civil Code art. 1322; see also Spanish Civil Code art. 1255.
14. This issue is discussed in more depth supra.
16. See Italian Civil Code art. 1337.
17. The economic doctrine teaches that profitable business relationships will not be interrupted. But see George A. Akerlof, The Market for “Lemons”: Quality Uncertainty and the Market Mechanism, 84:3 Q.J. ECON. 488 (1970) (reminding that business people, although guided by reason, sometimes allow their decisions to be driven by other criteria).
clauses require franchisees to request a renewal; if they do not, the agreement comes to an end.

In England and Wales, if a fixed term contract expires and is not renewed in accordance with a contractual renewal clause, no further formality is required to terminate. If one of the parties continues as if the contract remained in existence following expiration, the other party, provided action is taken immediately, may notify the party which is treating the contract as continuing that the contract is at an end. If immediate action is not taken, parties may be only entitled to terminate the “holding over” on the giving of reasonable subsequent notice.

C. Other Civil Law Jurisdictions

1. Germany

Other civil law jurisdictions adopt a similar approach to that in Italy. German law, in general, provides that fixed term agreements terminate and are not automatically renewed. A fixed term contract simply expires and no further formality is required to terminate. An automatic renewal requires the consent of both parties and so the franchise agreement must expressly provide for it. These renewal clauses usually provide for automatic renewal if neither party notifies the other prior to the end of the term that the franchise agreement will not be renewed. Automatic renewals can, of course, be subject to certain requirements, such as the proper performance of the franchise agreement or the implementation by the franchisee of updates to the franchise system. Spain and Belgium adopt a similar approach.

Further, in the absence of a renewal clause, a franchisor is not required to provide any reason for non-renewal of a franchise agreement. Both parties are free to decide on renewal or non-renewal. The general rule is that as long as an effective termination notice is received, the reason for termination is not relevant. For example, if the franchisor gives notice of termination because it wishes to withdraw from or take over a geographic or product market or to appoint someone else in that market, such factors would normally not have any bearing on the validity of the termination notice.

Unless a franchise agreement contains a unilateral option to renew in favor of a franchisee, the franchisee is not entitled to a renewal of the agreement. If a renewal is refused, a franchisee may be entitled to bring a damages claim if, for instance, the franchisee incurred high investment costs that were

encouraged or required by the franchisor and such costs were not amortized at expiration of the contract.

2. France

In France, the courts have refused, in the absence of an express renewal clause, to recognize a franchisee’s right to the renewal of a franchise agreement. Therefore, the franchisor is not obliged to give reasons or offer any indemnity for a failure to renew unless the non-renewal constitutes an “abus de droit” (abuse of right). Such an abuse could be found, for example, where a franchisor with dominant market power refuses to continue to sell its goods or services to a franchisee in breach of competition laws.

In civil law jurisdictions, in the case of a fixed term agreement with automatic renewal unless a notice is given, the courts will scrutinize what is “adequate notice” (under Italian law) or “reasonable notice” (under German law). Because there are no statutory provisions on the issue, parties rely on common practice, which is usually a notice between six and twelve months, depending on several factors including, among others, the “mobility” of retail stores in the relevant market, the past duration of the relationship, and the investment involved.

III. Agreements for Indefinite Terms—Reasonable Notice

A. Italy

Although franchise agreements for indefinite terms are very uncommon, they are sometimes contemplated by statute in civil law jurisdictions. The law provides that both parties may withdraw from an indefinite term agreement by giving reasonable notice, provided that the minimum term established by the law has expired. Italian law, for example, mandates a three-year minimum term. By definition, both parties accept the risk that the other may terminate the contract after expiration of the minimum term.

Article 1569 of the Civil Code concerning indefinite term agreements in supply contracts, which is generally considered applicable to franchising, provides: “If the duration of supply obligation is not established, each

24. The wording of Italian Civil Code Article 1569 is “termine congruo.”
26. See Italian Franchise Law art. 3.3, n.129; see also Milan Parivodic, Termination of Franchise Contracts—A Comparative Study, 7 Int’l Franchising L. 7 (2009).
27. Italian Franchise Law art. 3.3.
party may withdraw from the contract, by giving notice within the agreed period or the period established by custom and practice or in default by an adequate period of notice having regard to the nature of the supplies."

B. England and Wales

Franchise agreements granted for an indefinite term are extremely unusual. If an indefinite term agreement is granted, because the agreement contains no provisions expressly dealing with termination, the question is not one of construction in the narrow sense of putting a meaning on language that the parties have used. Rather, the issue is in the wider sense of ascertaining—in the light of all the admissible evidence and what the parties have or have not said in the agreement—what the common intention of the parties was concerning termination when they entered into the agreement. It is likely that a contract that contained no provisions for termination would be held to be terminable by one of the parties on the giving of reasonable notice\(^\text{29}\) because in a commercial context the parties are most unlikely to have contemplated that the relationship would continue forever.

Even when a franchise agreement gives franchisees a right to renew, the view of the English courts is that, notwithstanding the contractual right to renew in favor of a franchisee, a franchisor must be able to withdraw from franchising and decline to renew on the giving of reasonable notice. The Court of Appeal’s decision in \textit{Paperlight Ltd & Ors v Swinton Group Ltd}\(^\text{30}\) provides guidance. In that case, a well-established franchisor with a large number of franchisees offering insurance brokerage services was acquired by an insurance company that did not favor the franchise model. Swinton franchisees were on five-year contracts that could be renewed at the franchisee’s option on the franchisor’s then-current form of contract. Swinton argued that because it was no longer franchising, it no longer had a “current form of contract” and therefore franchisees were not entitled to a renewal contract. The court agreed on the grounds that if the rule were otherwise, once a franchisor started franchising, it would never ever be able to withdraw as long as one franchisee remained. But, the court also indicated that in all cases franchisees had to be given a reasonable period of notice of a franchisor’s withdrawal from franchising and that five years’ notice was reasonable in the circumstances.

The court held:

\begin{quote}
It is, however, common ground, that [franchisees] are entitled to continue in the business of franchising under their existing contracts until the expiry of a reasonable period of notice.

It is thus common ground that what is a reasonable period depends upon all the circumstances of the instant case. . . . I think important to have in mind the purpose of a notice period. . . . Its purpose is not to give the franchisee a new con-
\end{quote}

\begin{footnotes}
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tract . . the implication of reasonable notice is intended to serve only the common purpose of the parties, which is frequently derived from the desire that both parties may have to cushion themselves against sudden change, giving themselves time to make similar arrangements of a sort similar to those which are being terminated. [It is submitted] that in these circumstances the purpose of the notice is to give the franchisees a reasonable opportunity to prepare for their withdrawing from franchising. I accept the submission that that is one of its purposes, perhaps its main purpose, but it is I think right to take all the circumstances into account, including the nature of the contract and the legitimate expectations of the franchisee at the time the notice is given. It is also, of course, important to take account of the position of the franchisor and not to focus only upon that of the franchisee.31

The court also held that the following were all relevant considerations:

- the long-term nature of franchising;
- the expectation that the franchisee would be able to build up an equity for both by earning income and releasing capital;
- the fact that Swinton will be acquiring a valuable asset from the franchisee;
- the restrictions imposed upon the franchisee by the contract on its termination;
- the difficulty facing a franchisee in starting up his own business because the goodwill which it has built up is not its own goodwill but that associated with the Swinton name;
- the difficulty for franchisees in making advantageous arrangements with the leading insurers [the franchisee business related to insurance brokering] without the assistance of Swinton;
- the problem of competing with Swinton; and
- the initial period of the franchise agreement seven or ten years long, which was enough to enable franchisees to recoup their initial outlay and, indeed, to earn a profit.

The court thus concluded:

I have reached the conclusion that I should fix a reasonable period of notice as being five years from the date of the announcement [that the franchisor was withdrawing from franchising]. It follows that the contracts which would have expired before [the expiry of the five-year period] will be extended to their date and that the remaining contracts will expire on their contractual expiry dates.

C. Other Civil Law Jurisdictions

Under all other civil legal systems, either party may end a commercial agency, franchise, or distribution contract of indefinite duration provided that a reasonable notice has been given.32

31. Id.
1. Germany

In Germany, franchise agreements with indefinite terms can be terminated by reasonable notice although franchise agreements usually contain provisions setting out the notice period. If no contractual provision applies, the notice period is calculated in accordance with Section 89 of the German Commercial Code.

In order for notice to be deemed reasonable in accordance with Section 89, the notice period should not be so short that the other party is unable to “adapt” to the termination by reorganizing its business because of the new circumstances, while the terminating party must not be bound by the agreement any longer than is required to protect the other party’s interests. Section 89 provides for a minimum notice period of one month during the first year of the contractual relationship, two months in the second year of the contractual relationship, three months in the third to fifth year of the contractual relationship, and six months thereafter.

2. France

French law provides that a franchise contract for an indefinite term may be terminated at any time. However, for a withdrawal to be valid, a “préavis raisonnable” (a “reasonable notice”) is required. The failure to give such a reasonable notice is tantamount to a “rupture brutale” (a “sudden break”), which gives rise to damages in favor of the party that has been terminated.

3. Spain

In Spain, contracts must be limited in time. An unlimited duration contract, without the possibility to terminate, would be null and void as against public order, according to Article 1255 of the Spanish Civil Code.
sequently, if the franchisor terminates such a contract, the franchisee has no cause of action for damages, unless reasonable notice has not been provided.

4. Belgium

In Belgium, while the law regulating franchising is silent on this specific issue, the Tribunal de commerce of Charleroi on September 22, 1999, held that reasonable notice to terminate a contract with no fixed term should correspond to the duration necessary for the party being terminated to launch other equivalent brands. The following elements are taken into consideration: (1) the percentage of the franchisee’s overall business represented by the agreement to be terminated; (2) the investment made and its amortization; (3) the amount of turnover and profits earned; and (4) the territory, reputation, and nature of the products involved.

IV. Termination by Mutual Consent

In all European civil law countries, a franchise contract can be terminated by mutual consent without any need for a contractual provision to that effect because it operates by effect of the law.

A. Italy

Article 1372, paragraph 1, first part of the Italian Civil Code states that a “contract has force of law between the parties and it cannot be terminated except by mutual consent.” If termination occurs by mutual consent, the termination is effective as of a mutually agreed upon date.

B. France

The French Civil Code New Article 1193 disposes of the issue as follows: “Les contrats ne peuvent être modifiés ou revoqués que du consentement mutual des parties, ou pour les causes que la loi autorise.” (“Agreements may be modified or withdrawn only by mutual consent of the parties, or for the reasons established by the law.”).

C. England and Wales

In England and Wales, parties to any contract also can mutually agree to bring the contract to an end.

40. This is based on the principle of freedom of contract that also entitles parties mutually to agree to change what they had previously agreed.
V. Termination by Unilateral Withdrawal

A. Italy

Italian law addresses this issue in Italian Civil Code Article 1373, which provides:

If the power to withdraw from the contract is given to one of the parties, such power may be exercised until the contract has begun to be performed. In contracts with continuing or periodical obligations, such power may also be exercised subsequently but withdrawal does not have an effect on the performance already undertaken or in the course of being undertaken.

The practical effect of this rule is that obligations that have already been performed, such as the payment of royalties, are unaffected by the termination. The withdrawal will be considered to be in good faith (and, therefore cannot be attacked on that ground) if it is construed as an option and supported by a financial payment (i.e., for money). If a withdrawal is unilateral, its exercise is governed by the principle of good faith. In addition, for the notice period to be adequate, it may have to be longer than the notice period when the withdrawal right is given to both parties because the risk of interruption of ongoing business mostly affects the weaker party.

B. England and Wales

In England and Wales, in the absence of an express contractual term to that effect, one party cannot withdraw from a contract save for the two situations set out below.

If the parties are “holding over” and continuing to operate under an expired franchise agreement or have (unusually) entered into a franchise agreement with no fixed term, either party can give a reasonable period of notice to bring the arrangements to an end. It is not possible to precisely set out what that reasonable period of notice would be. That said, in practice, it is usually not less than three months or more than twelve months, with a six month period likely to be seen as appropriate. The courts would take into account how long the franchise has been operated, the amount of the franchisee’s initial investment, and what will happen on termination.

C. Other Civil Law Jurisdictions

1. Germany

In Germany, a unilateral withdrawal right must be exercised in compliance with the principle of good faith.
2. France

In France, where the new Article 1104, following a long judicial tradition, establishes “Les contrats doivent être négociés, formés et exécutés de bonne foi” (“contracts must be negotiated, executed, and performed in good faith”), the courts may find a “rupture brutale” (“sudden break”), where a franchisor requires the franchisee to undertake an investment that has not yet been amortized when it serves notice of withdrawal because it may be seen as “oppressive of the weaker party.”

VI. Non-Renewal

Non-renewal of a franchise agreement is not treated as a withdrawal from an ongoing contract and thus cannot be considered to be an “abuse of economic power” in most civil law jurisdictions.

Nevertheless, in jurisdictions that have enacted a subcontracting law or a competition law that regulates a dominant power over a contractual partner or dominant power in a market at large, it may be an abuse to interrupt an ongoing business relationship abruptly unless by virtue of the other party’s breach.

A. Italy

According to best practice, parties generally include in their franchise contracts a clause by which the contract is automatically renewed unless either of the parties notifies the other of its decision to discontinue the relationship within a certain time period.

This has given rise to a large number of recent cases where the terminated franchisees have claimed that the termination was a withdrawal and thus ineffective in violation of the law on subcontracting, i.e., June 18, 1998, n.192. Such law provides that the interruption of the business relationship without cause constitutes an abuse of economic power. The Tribunal of Rome in different panels rejected this claim in 2015 in six parallel cases involving Avis Budget Rent a Car as franchisor.

The cases involved a decision by franchisor Avis to re-organize its worldwide network. As a part of the reorganization, Avis communicated to a certain number of its franchisees that it would not renew their franchise agreements. Some of the franchisees complained that such non-renewal was unfair, that Avis abused its power, and that such unfair and/or abusive non-renewal could cause an irreparable and serious injury because they would not be able to recover their investments. In addition, the franchisees argued that the non-renewal constituted a violation of the provisions of the law.

45. This clause is justified by the “transactional costs” doctrine.
46. The relevant part of the law is set out in footnote 48.
47. Italian Law on Subcontracting art. 9, n.192/98.
ticle 9 of Law of June 18, 1998, condemning the “arbitrary interruption” of ongoing business relationship as abuse of economic power.48

The Tribunal noted that the right not to renew the contract was explicitly provided for by a clause in the franchise agreement and that Avis exercised the right in compliance with its provisions. The Tribunal thus held that the non-renewal at issue could not be regarded as an abuse because it was neither “arbitrary” nor “unexpected.”49 Furthermore, the Tribunal pointed out that the non-renewal of the contract was based on a contractual clause, which is typical in long-term relationships. The Tribunal also found that it was lawful in all respects because the clause provided for the automatic renewal of the contract unless one of the parties failed to notify the other of its intention within the period of time specified by the franchise agreement and because it applied equally to the franchisor and the franchisee.

More specifically, the right not to renew the contract (which is consistent with the hostility shown by Italian law makers toward “perpetual” contractual commitments) is obviously intended to allow the parties to adopt, if they deem it appropriate, strategic and operational decisions, including the decision to reorganize the network. Further, the Tribunal found the fact that the same decision was adopted in respect of all franchisees of the network was proof of the absence of any “punitive” or “discriminatory” intent with respect to a specific company.

B. England and Wales

English courts will always uphold a contractual renewal clause. In the recent Apollo Window Blinds Ltd v. McNeil50 decision, which was an injunction application, the court allowed a franchisor to refuse a renewal because the franchisee had failed to serve a request for renewal within the contractual time period, even though the franchisor had never previously required franchisees to comply with these time periods, knew that the franchisee wanted

48. The rule provides:

The abuse by one or more enterprises of its or their situation of economic power vis-à-vis a customer or supplier is prohibited. The expression “economic power” shall mean the situation of an enterprise which is able to determine, in the business relationships with another enterprise, an excessive imbalance of rights and obligations. The economic power shall be evaluated taking into account also the effective possibility for the party who has suffered the abuse to locate satisfactory alternatives on the market. The abuse may also consist of the refusal to sell or the refusal to purchase, in imposing unjustifiably heavy or discriminatory contractual conditions, or in the arbitrary interruption of existing business relationships. The covenant through which the abuse of economic power takes place is void.


to renew, and waited until the last day before expiration to notify the franchisee that it had lost the right to renew.

VII. Termination Due to Breach by the Other Party

A. Italy

In Italy, termination due to breach of the franchise agreement is regulated, in the absence of specific contractual provisions, by Article 1453 of the Italian Civil Code, which provides: “In contracts providing for mutual counter performance, when one of the parties fails to perform his obligations, the other party can choose to demand either performance or dissolution of the contract. . . .”

The Italian legal system envisages no precise equivalent to the common law concept of “fundamental breach.” Rather, the franchisor may terminate the contract whenever a breach of the contract by the franchisee is important to the franchisor.

A failure to pay for a substantial amount of purchased goods has been considered an important breach of the franchise agreement, as confirmed by some summary decisions. Nevertheless, it is doubtful that a single delay in making a payment would be regarded as sufficiently important to justify the termination of the agreement.

The same problem arises in respect of other obligations on the parties. For example, the following have been considered “important breaches”:

1. breach by the franchisor of its obligation to transfer and update the know-how, which represents a key element of a franchise and allows the franchisee to provide services to the client identical to those offered by the franchisor;

2. breach by a distributor of its obligation not to sell competing products because of the damage caused to the commercial image of the supplier that arises from competing products being sold in premises carrying the supplier’s trade signs.

If breaches are committed by both parties, according to the prevailing interpretation of the Italian Supreme Court, it is necessary to determine which

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51. The rules of law in this section apply irrespective of fixed or indefinite term agreements.
52. Long exegesis of the rule in PAOLO GALLO, TRATTATO DEL CONTRATTO 2067–2163 (Torino, UTET 2010).
53. Italian Civil Code Article 1455, headed “Importance of non-performance,” provides: “A contract cannot be terminated if the non-performance of one of the parties has slight importance with respect to the interest of the other.” This implies a certain “subjectivization” of the interest referred to by the legislator.
breach is more significant by comparing the behavior of each party, with reference to their respective interest in, and the objective importance of, the non-performance. On that basis, a court can determine which party may be held liable, bearing in mind that “the breach must be exclusively attributable to the party whose prevailing behavior has impaired the relationship resulting in the justified non-fulfillment of his obligations by the other party.”

A decision of the Tribunal of Palermo, subsequently confirmed by the Court of Appeal, provides a good example. In Winsport v. A.F.M.E., a master franchisee sued its franchisor Athlete’s Foot Marketing Europe (A.F.M.E) before the Tribunal of Palermo for damages and further sought a finding that the master franchise agreement be deemed terminated due to the alleged breach by A.F.M.E. The breaches allegedly consisted of A.F.M.E. failing to (1) arrange agreements with selected suppliers on more favorable terms than those offered to retailers outside the network, (2) supply materials for the training courses to be held before store openings, (3) organize sales promotions and advertising campaigns, and (4) supply the data processing system. A.F.M.E. counterclaimed that the contractual breaches were attributable to the master franchisee because the franchisee failed to: (1) negotiate and sign unit franchise contracts using the standard authorized contract, (2) attend training courses, (3) provide training courses to sub-franchisees, and (4) pay sums due.

The Tribunal found that both parties failed to provide sufficient evidence of the other party’s alleged breaches and that such breaches were not so important as to jeopardize the contractual equilibrium. The Tribunal rejected the claims for damages from both parties, pointing out that “no intentional wrong-doing or negligence can be attributed to either of the parties.”

Article 1455 of the Italian Civil Code also applies when the parties insert a clause in their agreement specifying those obligations that they deem to be of such importance that their breach will give the innocent party the right to terminate the contract immediately simply by notifying the other party. If no such clause exists, the innocent party must provide written notice to the breaching party. Such notice must provide an adequate time to cure the

57. Migliarotti v. Russo; Cass. civ., Sez. II, 3 Jan. 2002, n. 27, in Giur. It (2002). By this decision the Italian Supreme Court seems to have abandoned the old doctrine that gave importance to the first in time breach. The Tribunal Palermo reached the same conclusion on October 4, 2006, in Winsport v. A.F.M.E. (not published).
59. It is worth highlighting the Tribunal’s conclusion that franchisor A.F.M.E. did not fail to perform the obligation to arrange preferential commercial agreements with selected suppliers, mostly because the franchisor succeeded in proving that it had used its best efforts to obtain favorable conditions from suppliers, although the rebates obtained were not as high as the franchisee hoped.
60. Italian Civil Code art. 1456 (headed “express terminative clause”): “The contracting parties can expressly agree that the contract will be terminated if a specific obligation is not performed in the designated manner. In this case the termination take place by operation of law when the interested party declares to the other that he intends to avail himself of the termination clause.”
breach.\textsuperscript{61} Ultimately, the court will determine whether the breach was “important” or not. Such period cannot be shorter than fifteen days unless a shorter term was agreed upon by the parties or is deemed to be adequate according to the nature of the contract or trade custom.\textsuperscript{62} If the breach has not been remedied at the end of this period, the contract is terminated by law.\textsuperscript{63}

Sometimes a franchisee terminates the agreement on the basis of non-performance by the franchisor. Although this occurs very rarely in practice, it is possible for a franchise agreement to explicitly provide for such a remedy. In that case, nothing can preclude the franchisee from terminating the agreement and seeking damages from the franchisor if the latter fails to perform its contractual obligations.

\textbf{B. England and Wales}

In England and Wales, franchise agreements almost invariably contain express contractual provisions setting out breaches of contract that give rise to termination rights in favor of the franchisor. Generally, the courts will not interfere with the termination provisions, and indeed there have been no cases where the courts in the context of a franchise agreement have done so. In practice, it is much less likely that franchisees will also have a contractual right to terminate. Both parties, whatever the contract provides, have a right to terminate at common law for repudiatory or fundamental breach by the other party.

There is, however, a very limited situation where the courts may “interfere” in what has been set out in an agreement although currently there have been no decisions directly relating to termination provisions.

English law requires clauses that are particularly unusual and onerous to be brought specifically to the other party’s attention.\textsuperscript{64} In \textit{PSG Franchising Ltd v Lydia Darby Ltd},\textsuperscript{65} the franchisees argued that the \textit{Interfoto} principle—under which particularly unusual or onerous terms are not binding unless something has been done to draw them to the attention of the other party to the contract—applied to non-compete obligations. The judge rejected that argument on the basis that the non-compete obligations were, in his view, neither particularly unusual nor onerous. In two subsequent cases, franchisees raised \textit{Interfoto}-based arguments. In \textit{Papa Johns (GB) Ltd v Elsada Doyley},\textsuperscript{66} the court considered an argument that it would not be fair to allow the franchisor to rely on a clause contained in a franchise agreement that restricted the franchisor’s liability for

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\textsuperscript{62} Italian Civil Code art. 1454.
\textsuperscript{63} Italian Civil Code art. 1454.1: “The other party can serve a written notice on the defaulting party to perform within an appropriate time, declaring that, unless performance takes place within such time, the contract shall be deemed terminated.”
\textsuperscript{65} [2012] EWHC 3703 (QB).
\end{flushleft}
misrepresentation, because it was a particularly onerous term that the franchisor did not bring fairly and reasonably to the attention of the franchisee. Even though this clause is at least as standard as post-termination non-compete covenants, which the court in the PSG decision rejected as being particularly onerous, the Papa Johns court accepted that the clause should not be enforced.

In a subsequent decision involving a franchise dispute,67 the court rejected Interfoto arguments in relation to a clause that gave the franchisor the right to take over a franchisee’s business following termination or expiration of the franchise agreement. The judge found that the clause was essential to enable the franchisor to continue to provide care services to the elderly following the termination/expiration of the agreement because the franchisee was prevented from doing so by virtue of the non-compete covenants. In any event, the franchisees were experienced business people who had not taken independent legal advice.

It remains unclear the extent to which English courts will allow franchisees to argue that the Interfoto principle defeats contractual provisions. In practice, a great deal will depend on whether the judge is sympathetic to the franchisor or the franchisee.

English law categorizes the terms of a contract as being a condition, a warranty, or an intermediate term.68 The classification is primarily significant for the effect it has on the remedies available to the innocent party for breach of contract. A condition is a term that, if breached, gives the innocent party the right to either: (1) treat the breach as a repudiation and terminate the contract, or (2) affirm the contract. In either case, the innocent party can also claim damages. Curiously, a breach of any condition entitles the innocent party to terminate, even if the consequences of the breach on the innocent party are minor.69

A warranty is a contract term that gives rise to only a claim for damages and not to bringing the contract to an end. An intermediate term is a term where the remedy for its breach depends on the nature and effect of the breach at the time it happens. Generally, the test applied is whether the innocent party is deprived of “substantially the whole benefit which it was the intention of the parties as expressed in the contract that it should obtain.”70 If the effect of the breach substantially deprives the innocent party of the whole of the benefit of the contract, it will be a serious breach of the intermediate term and the remedy will be as for breach of a condition.

67. Carewatch Care Services Ltd v Focus Caring Services Ltd, Anthony Grace and Elaine Grace [2014] EWHC 2313(Ch).
68. See 1 CHITTY ON CONTRACTS ¶¶ 12-019, 12-020 (31st ed. 2012).
69. See id. ¶ 24-040.
70. Hong Kong Fur Shipping Co Ltd v Kawasaki Kisen Kaisha Ltd [1961] EWCA Civ.7 (Dec. 20, 1961).
In the franchise case of *Peart Stevenson Associates Ltd v Holland*, the court concluded that the failure to pay a relatively minor sum (£129.84, or approximately $160) constituted a breach of a condition that entitled the franchisor to terminate. However, it should be noted that the franchise agreement contained a “time of the essence” clause in relation to payments that has the effect of enabling a franchisor to terminate for any failure to make payment on the due date for payment.

In a recent non-franchise case, a party that terminated a contract for common law repudiatory breach was not obliged to follow contractual termination provisions that included a requirement to serve notice and give the defaulting party a period to remedy the breach.

C. *Other Civil Law Jurisdictions*

1. Germany

Under German law, franchise agreements can be terminated for serious cause if, taking into account all the circumstances of the specific case and assessing the interests of both parties, the continuation of the contractual relationship is “unacceptable” for the party giving notice. In *Burger King*, a German court held for the first time that multiple minor breaches of a franchise agreement can be a cause for “extraordinary termination” although the individual infringements would not have been sufficient cause to terminate the franchise agreement.

Section 314.2 of the German Civil Code (BGB) further regulates termination for serious cause by requiring the franchisor to send the franchisee a warning letter providing a reasonable time to cure the breach of the agreement. Usually, a cure period of around two weeks is granted. However, the cure period depends on the time necessary to cure the particular breach.

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73. German Civil Code § 314 [BGB].
75. German Civil Code § 314.2 provides:

(1) Each party may terminate a contract for the performance of a continuing obligation for a compelling reason without a notice period. There is a compelling reason if the terminating party, taking into account all the circumstances of the specific case and weighing the interests of both parties, cannot reasonably be expected to continue the contractual relationship until the agreed end or until the expiry of a notice period.

(2) If the compelling reason consists in the breach of a duty under the contract, the contract may be terminated only after the expiry without result of a period specified for relief or after a warning notice without result. Section 323(2) numbers 1 and 2 applies, with the necessary modifications, as regards the dispensability of specifying a period for such relief and as regards the dispensability of a warning notice. Specifying a period for relief and issuing a warning notice can also be dispensed with if special circumstances are given which, when the interests of both parties are weighed, justify immediate termination.
A letter providing a cure period can be dispensed with if:

(1) the other party seriously and definitively refuses performance;

(2) the other party does not perform on a contractual fixed date or within a contractual period for performance, and the party giving the notice had made it clear prior to the conclusion of the contract that the performance as per the date specified or within the period specified was of essential importance; or

(3) special circumstances exist that justify immediate termination without determining a remedial period.\(^{76}\)

2. Spain

In Spain, early termination takes place when one or more of the obligations under the contract are breached. The most usual causes include: (1) lack of payment by the franchisee; (2) violation of the prohibition on competition, the transfer of know-how, or breach of the exclusivity or confidentiality obligations; (3) lack of quality in the performance of obligations; or (4) non-fulfilment of the franchisor’s instructions concerning updating the franchise system. The *Foster’s Hollywood* case, decided by the Court of Appeals of Avila on June 7, 2015, provides a recent example.\(^{77}\) The case involved a dispute where the franchisee was operating at a loss and decided to terminate the franchise agreement, leaving some royalties unpaid. The franchisor filed a suit against the franchisee seeking a declaration that the franchise agreement had terminated for franchisee’s breach of contract. Ultimately, the court dismissed the plaintiff’s complaint, affirming that the franchisor’s providing wrong information about the potential clients of the restaurant was a breach of contract that was not so material as to entitle the franchisee to terminate the agreement.

As can be seen, there are no uniform rules, even among civil law jurisdictions. On the one hand, time to cure must be given (with some exceptions), while on the other hand a warning letter setting out a time to cure is not mandatory. Nevertheless, throughout Europe, there is a trend toward encouraging the grant of a cure period, instead of an automatic termination, to offer greater protection to franchisees.

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\(^{76}\) German Civil Code § 314.

\(^{77}\) This case is unpublished but has been mentioned in *Euro Franchise Lawyers Newsletter* (May 2016) at 8.
VIII. Termination for Other Causes Provided by Law

A. Italy

Under Italian law, a “contract has force of law between the parties and cannot be terminated except for reasons allowed by the law.”\(^{78}\) In addition, according to Article 1467 of the Italian Civil Code, “[i]n contracts for continuous or periodic performance or for deferred performance, if extraordinary and unforeseeable events make the performance by one of the parties excessively onerous, such party can demand termination of the contract, with the effects set forth in Art. 1458.”\(^{79}\)

Termination cannot be demanded if the supervening onerous event is part of the normal risks inherent in the contract. Termination can be avoided by offering to modify equitably the terms of the contract. Italian case law, however, does not admit a “hardship” clause in the meaning and with the effects commonly known in international trade and referred to in the UNIDROIT Principles of International Commercial Contracts,\(^{80}\) which gives the judge the power to modify the contract in order to take into considerations the new circumstances.\(^{81}\)

This issue came up in the *Midal v. Toson* arbitration, decided in 1989,\(^{82}\) where the arbitrators declared: “Economic difficulties which have occurred during the performance of a contract are not considered extraordinary and unforeseeable events which justify the discharge of such a contract for being excessively onerous.” The facts were as follows: on June 11, 1979, Midal, the franchisor, and Toson, the franchisee, executed a sub-franchising contract that enabled Toson to use a “discount” sales format that had been

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78. Italian Civil Code art. 1372, para.1, pt. 2.
79. See comment by A. Zaccaria in *COMMENTARIO BREVE AL CODICE CIVILE 1614 (11th ed.)* (Giorgio Cian & Alberto Trabucchi eds. Padua, Cedam 2014).
80. See *Principles of International Commercial Contracts* arts. 6.2.2 and 6.2.3 (2d ed. Rome 2004).
81. Italian art. 6.2.2, “Definition of Hardship,” provides:

There is hardship where the occurrence of events fundamentally alters the equilibrium of the contract either because the cost of a party’s performance has increased or because the value of the performance a party receives has diminished, and (a) the events occur or become known to the disadvantaged party after the conclusion of the contract; (b) the events could not reasonably have been taken into account by the disadvantaged party at the time of the conclusion of the contract; (c) the events are beyond the control of the disadvantaged party; and (d) the risk of the events was not assumed by the disadvantaged party.

Further, Italian Code Article 6.2.3 “Effects of Hardship” provides:

1. In case of hardship the disadvantaged party is entitled to request renegotiations. The request shall be made without undue delay and shall indicate the grounds on which it is based.
2. The request for renegotiation does not in itself entitle the disadvantaged party to withhold performance.
3. Upon failure to reach agreement within a reasonable time either party may resort to the court.
4. If the court finds hardship it may, if reasonable, (a) terminate the contract at a date and on terms to be fixed; or (b) adapt the contract with a view to restoring its equilibrium.

82. This case is unpublished. The award is reported in *ALDO FRIGNANI, FRANCHISING 424* (Turin, UTET 1999).
granted to Midal under a franchise contract within the network of a nationwide business association called Végé. The contract was renewed in 1982.

The duration of the agreement was five years and was extendable for periods of two years if not terminated by written notice sent to the other party at least 360 days in advance. In accordance with this provision, Toson gave notice to terminate the contract. Prior to the expiration of the notice period, Toson served legal proceedings before the Tribunal of Latina, claiming the rescission of the contract and alleging that Midal was in breach of contract, while at the same time claiming that the agreement had become excessively onerous.

Subsequently, Midal declared the contract terminated and required Toson to stop using the distinctive signs under the license. On October 20, 1988, Midal served a notice initiating arbitral proceedings, requesting:

1. a declaration of rescission of the contract due to the franchisee’s default,
2. damages according to a clause of the contract that provided for a penalty equal to three percent of the franchisee’s turnover of the preceding year, and
3. assessment and prohibition of the illegitimate use of the franchisor’s distinctive signs and damages.

Midal argued that Toson was in breach of the contract because he did not manage his business according to principles of good management and failed to follow instructions provided by Midal. Toson, for his part, requested a declaration that his withdrawal from the franchise agreement was justified due to excessive hardship.

The arbitrators ascertained that Toson had not operated his business completely in accordance with the franchise agreement’s provisions. Nevertheless, the arbitrators applied Article 1467 of the Italian Civil Code and held that the breaches were not material enough to justify the termination of the contract, either in law or in equity.

The award further rejected the defendant’s claim that the contract was null and void due to certain clauses giving excessive control to Midal because these clauses were common to any contract seeking to regulate business relationships in a uniform and coordinated manner. Their findings conform to the opinion of legal commentators and case law that point out that the parties to a franchise agreement are necessarily independent undertakings, implying that franchisees assume the risk of managing their own businesses. If the risk were to be borne by the franchisor, the franchisor effectively would be offering a guarantee of profitability. In these circumstances, the franchisee could be equated to an employee rather than a franchisee. Although the parties’ independence is an essential factor in franchising, the limitation of the franchisee’s autonomy, in so far as it does not lead to its exclusion, is a normal situation. The arbitrators regarded such control as the expression of the

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83. Italian Franchise Law art. 1, n.129.
need for uniformity and coordination of behavior of all franchisees, which is essential for keeping the unity of a franchise network’s image.

In Italy, the newly amended Article 72 of the Italian Insolvency Law provides that insolvency usually results in the termination of the agreement.\(^{84}\) It provides that the liquidator has the option to “step in” to the franchise agreement, but, in practice, it is difficult to imagine how a liquidator who is not an entrepreneur could carry on a franchise business. As such, legal commentators generally assert that a franchise agreement cannot survive insolvency because it is based upon the co-existence of two mutually integrated enterprises.\(^{85}\) If one fails, the relationship as a whole fails as well.

Termination may also occur if the franchise agreement is found by a competent antitrust authority to be in violation of the rules protecting competition, i.e., for abuse of dominant market power.

B. England and Wales

English law provides for termination for mistake, duress and undue influence, illegality, public policy, and frustration. All of these principles apply to all contracts but have never been applied to franchise agreements. They are, in practice, unlikely to apply to franchising and in any event do not raise any issues that are specific to franchising. Accordingly, they are not analyzed in this article.

In addition, the parties may have the right to terminate for “derogation from grant.” Fleet Mobile Tyres Ltd v Stone & Anor\(^{86}\) is notable on this point. The case involved a franchisor’s attempt to change a franchise system under which franchisees operated vans in a territory and found their own customers to a system where customers placed orders with the franchisor through a central website that was then forwarded to franchisees to fulfill. The Court of Appeal held that such a fundamental change constituted a “derogation from grant” that entitled the franchisee to terminate. The concept of derogation from grant prevents a party from taking away from the other party what that party has granted.

The Court of Appeal in the Fleet Mobile Tyres decision referred to an earlier decision that held that the concept of derogation from grant “is no doubt a useful reminder that in the absence of clear words, parties to a contract are unlikely to have intended to make significant derogations through the operation of a subsidiary clause from the primary benefits intended to be conferred under it.”\(^{87}\) In the Fleet Mobile Tyres case, the franchisor granted fran-
chisees the right to operate and promote its business under the Fleet Mobile Tyres trade name and trademark; the court concluded that the franchisor could not change its name to “etyres.” The court also held that the franchisor’s instructions concerning the trade names/trademarks would “have substantially impeded the defendants’ exercise of their rights under the agreement . . .” and, as a result, the franchisor “was thus acting in breach of the agreement in a manner sufficiently fundamental as to amount to a repudiation, which the defendants were entitled to and did accept.”

C. Other Civil Law Jurisdictions

1. France

In France, the ordinance n. 2016-131 of February 10, 201688 modified the French Civil Code with an important development: courts have been granted new powers, which may significantly impact the parties’ autonomy. Under this law, courts have discretion to amend the terms of the agreement through the principle of “hardship” (imprévision) or to remove from a standard form contract (such as a franchise agreement) a clause creating a “significant imbalance.” Thus, courts will not only have a right to void or terminate an agreement, but also to amend or delete contractual provisions.89

In France, as in other civil law jurisdictions, a franchise agreement is terminated whenever force majeure circumstances prevent the franchisee from exercising its business activity (e.g., if the shop is closed by an order of the public authority or in case of physical destruction of the premises). The parties often lay down a non-exhaustive list of such circumstances, providing also for cases where the impossibility of carrying on business is only temporary.

A franchisee’s insolvency is another cause for termination. Although the parties often provide that such an event is a ground for immediate termination, applicable insolvency laws relating to the maintenance of contracts in existence at the date the insolvency may override such provisions.

2. Germany

In Germany, commencement of insolvency proceedings of the supplier or franchisor will result in an automatic termination of the franchise relationship. In contrast, commencement of insolvency proceedings of the distribu-

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88. Effective October 1, 2016.
89. The new Article 1195 of the French Civil Code provides that:

If a change in circumstances, unforeseeable at the time of execution of the agreement, makes performance unduly onerous for a party that had not agreed to bear the related risk, the latter may apply to the other party for renegotiation of the agreement. It shall continue to perform its obligations during the renegotiation.

In the event of refusal or failure of the renegotiation, the parties may agree to terminate the agreement, at such date and on such terms as they shall determine, or apply jointly to the Court for its adaptation. Absent agreement within a reasonable time, the Court may, upon one party’s motion, amend the agreement or terminate it, at such date and on such terms as it shall determine.
tor or franchisee justifies immediate termination for cause only if the franchisor so wishes.90

3. Spain

In Spain, the relatively new bankruptcy law91 has abrogated the rule according to which a contract clause can provide that a franchisee’s bankruptcy was a valid reason for termination.92

IX. Compensation for Termination or Non-Renewal

A. Italy

Under Italian law, a distributor/franchisee has no statutory right to compensation or indemnity on termination of a franchise contract. Such a right exists in Italy only for “commercial agents” (agenti).93 As yet, there are no court decisions applying the indemnification provisions by analogy in favor of the commercial agents to distributors or franchisees.

However, a recent Italian court case provides guidance on the scope of agency law with respect to distributors. The case94 involved a distributorship contract for the distribution of machinery. Such contract was for an indefinite term and contained a clause permitting either party to terminate the contract on giving a specified period of notice. The supplier communicated to the distributor its intention to terminate the contract. The distributor sued the supplier, claiming a goodwill indemnity, based on the application by analogy to the distributorship contract of the rules concerning agency agreement. Such rules grant to commercial agents an indemnity at the end of the contractual relationship for the goodwill/clientele that the commercial agent had built up.

The court rejected the claim, finding a difference between an agent and a distributor. The court held that an agent promotes the conclusion of contracts within a specific geographical area and is similar to an employee. In contrast, a distributor is a true entrepreneur, which concludes contracts in its own name for the sale of the supplier’s products. These differences, in the opinion of the court, did not permit the application of rules relating to the agency contracts to distributorship agreements; as a result, the court rejected the distributor’s claim for a goodwill indemnity.

B. England and Wales

In English law, there have been no cases where franchisees have sought to argue that they are entitled to compensation on termination of the franchise
agreement in the absence of an express provision to that effect. In some civil
law jurisdictions, courts have accepted arguments treating franchise agree-
ments by analogy as similar to commercial agency agreements under
which, pursuant to the Commercial Agents (Council Directive) Regulations 1993, commercial agents are entitled to compensation. To an English
common law lawyer such arguments are very surprising, and the general view
is that the English courts would be extremely unlikely to adopt a similar
approach.

C. Other Civil Law Jurisdictions

1. France

Under French law, there is no right to compensation in favor of a franchi-
see for the clientele or goodwill the franchisee has built up.95

2. Germany

In Germany, a commercial agent has, in principle, a right to compensa-
tion against the principal after the end of the contract.96 This is intended
to provide reasonable consideration for the fact that the commercial agent
during the agreement established and maintained a customer base for the
principal from which the principal continues to profit after termination.
For authorized dealers, the German Federal Supreme Court (BGH) has re-
peatedly stated that a right to compensation by analogous application of Sec-
tion 89b of the Commercial Code arises in comparable situations if:

(1) the authorized dealer is included in the sales organization of the manu-
facturer/supplier to the extent that he has duties which financially, to
a considerable extent, are comparable to those of a commercial agent;
and

(2) the authorized dealer is contractually obliged to transfer its customer
base to the manufacturer or supplier by the end of the agreement.

The German Federal Court (BGH) has not yet expressly clarified whether
Section 89b of the German Commercial Code analogously applies to fran-
chise agreements. In addition, it has left open whether and how the condi-
tions for analogous application so far developed would be applied to fran-
chise agreements. On February 5, 2015, however, the German Federal
Supreme Court did clarify that, for franchising, a mere de facto customer
continuity in the area of anonymous mass business97 (e.g., restaurants, filling
stations, or bakery franchise systems) is not adequate for the right to com-

95. See LAMY-DROIT ÉCONOMIQUE, supra note 24, § 5999; but see DROIT DE LA DISTRIBUTION,
supra note 23, at 297 (expressing some doubts about this conclusion).
96. German Commercial Code § 89b.
97. Where the clients are not identified by the franchisee, which is not in the position to keep
a list of them.
pensation by analogous application of Section 89b of the German Commercial Code.98

3. Spain

In Spain, the Supreme Court99 and lower courts grant franchisees an indemnity for the goodwill they have built up by analogy to the legal rule concerning the commercial agents.

X. Conclusion

Within the civil law jurisdictions of the European Union where a specific law on franchising has been enacted (France, Spain, Italy, and Belgium), such statutes do not specifically address the termination and non-renewal of the franchise agreement and are primarily concerned with ensuring proper disclosure. Therefore, parties must rely on general termination rules, which incorporate general principles of good faith.100 However, case law is more and more inclined to protect the franchisee as the weaker party of the agreement by restricting a franchisor’s right to terminate.101

98. Lithuanian law is also instructive on this point. In Lithuania, the Supreme Court on February 12, 2016, affirmed that in the termination of the service contract for mobile services and phones, the franchisee has the right to compensation in analogy with the right accrued to commercial agents. The Lithuanian Civil Code of September 6, 2000, in Art. 6.774 establishes the franchisee’s right to the renewal of the franchise agreement. Case law in Austria and Portugal has sometimes followed German jurisprudence applicable to franchise agreements, holding that indemnity rules provided for the commercial agents apply to franchises under certain circumstances. See, e.g., Austria Commercial Agent Act arts. 24 and 25; see also Benedikt Spiegelfeld, The Termination of Franchise and Distribution Agreements in Austria, 7 J. INT’L FRANCHISING & DISTRIB. L. 136 (1993); Benedikt Spiegelfeld, Austria—Recent Decisions of the Supreme Court Related to Distribution Relationship, 8:1 INT’L FRANCHISING & DISTRIB. L. 5 (2010).


100. The Belgian courts retain a measure of discretion to review contract terms that could be considered unfair, abusive, or contrary to fundamental principles of good faith.

101. The authors did not consider the national Codes of Conduct for three reasons: (1) they generally do not address our topic; (2) unlike the Australian code of conduct, they are not binding upon the franchisors unless specifically accepted; and (3) many of them are now under revision.
Sweepstakes and Contests in the Digital Age

James B. Egle and Jeffrey A. Mandell

The digital age and the evolution of social media have spawned a renaissance in the use of marketing promotions, including sweepstakes and contests. The traditional rationale for running such promotions—building brand goodwill—has been augmented by other significant benefits, such as acquiring data and user-generated content specific to the brand through Facebook, Twitter, Pinterest, Instagram, and other social media applications. What’s more, such promotions can be run at relatively little cost to the sponsor, with social media platforms enabling formats seemingly limited only by one’s imagination. A marketing bonanza, right?

Not so fast. Leave it to franchise counsel to throw cold water on their franchise marketing brethren. These new formats for sweepstakes and contests have to comply with an existing patchwork of disparate state and federal laws and regulations regarding lotteries, most of which have not been updated to address online platforms and new technologies. And more recently enacted laws and regulations that are specifically aimed at changing technologies will apply directly to such promotions. Finally, because social media platforms set their own rules, a sponsor that fails to comply with those rules runs the risk of losing access to the platform in the middle of the promotion.

This article details how using social media to conduct sweepstakes and contests has altered the legal due diligence that franchise counsel must conduct when counseling clients on promotions. First, we begin by reviewing the history of lotteries and the development of laws regulating contests and sweepstakes, focusing on how change is nothing new in this area of the law. Next, we discuss the ways contests and sweepstakes have continued to evolve in this digital age. We proceed to outline the changing applications of existing state lottery and intellectual property laws, recent laws and regulations aimed at changing technologies, and the terms and conditions of promotion.

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social media platforms. Finally, we conclude with a discussion of concerns unique to franchisors in dealing with contests and sweepstakes that rely on social media.

I. Traditional Legal Issues in Contests and Sweepstakes

To understand how the relevant legal principles apply to social media, we have to consider how those laws themselves evolved. That evolution makes sense only in the context of the historical and social influences that shaped the approaches of legal authorities—legislators, regulators, and courts—to various forms of contests and promotions across time. Thus, this section provides a brief overview of American lottery and sweepstakes history, followed by a brief overview of the governing legal principles that shaped and were shaped by that history.

This short historical survey concludes before use of the Internet became widespread and thus well before social media transformed the landscape for sweepstakes and contests. It serves to provide a foundation for understanding how the law developed, in fits and starts, over more than two centuries, reaching a relative equilibrium, which has subsequently been upended by the changes wrought by the Internet and the popularity of social media.

A. Lotteries, Sweepstakes, and Contests of Chance Have Deep Roots in American Culture

Lotteries, contests of chance, and other gambling activities have been a significant part of American culture since the early colonial days. A lottery initially provided financial support to the settlement at Jamestown.¹ Several colonies used lotteries to finance early educational efforts, both for operating primary schoolhouses and building colleges, including most of the institutions that we now know as the Ivy League.² George Washington was “an indefatigable lottery patron.”³ Other notable framers who favored lotteries include Benjamin Franklin, Alexander Hamilton, and Thomas Jefferson.⁴

The institution that has now grown into JPMorgan Chase Bank, the largest bank in the United States, was initially capitalized through a lottery.⁵ Similarly, much of the construction of Washington, D.C., as the nation’s capital was financed by a series of lotteries.⁶

Throughout the colonial era and the post-Revolutionary years, lotteries had an essential function, largely substituting for taxation as a way for colonies—

². Id. at 7–8; see also John Samuel Ezell, Fortune’s Merry Wheel: The Lottery in America 55–60 (1960) (listing authorized lotteries in colonial America).
³. Ezell, supra note 2, at 26.
⁶. McGowan, supra note 1, at 12.
and then both states and the nascent federal government—to support public goods and charitable causes. The Continental Congress used a lottery to fund the American Revolution. Lotteries not only helped fund the Revolutionary War, they helped bring it to fruition. In 1769, the English crown prohibited private lotteries in the colonies. The lottery regulation was so “unpopular” on this side of the Atlantic that it has been compared to the widely reviled Stamp Act.

As one commentator has noted, from the earliest days of European settlement on these shores, it has been the case that the “Great American Contest . . . ranks next to sex and politics in the national interest.” There was, during the colonial era, little opposition to lotteries and contests because “[e]very colony and almost every citizen had experience with lotteries.” Nor was the prevalence during colonial times of contests based on chance limited to lotteries. Merchandising raffles were the single most common private money-raising venture in colonial America.

But times change. Lotteries waned in—and even vanished from—the United States twice during the nineteenth century. First, both the establishment of a strong central government and the growth of a robust financial system led to a steep decline in lotteries by the 1840s. This decline was hastened by an increase in lottery-related scandals. Between 1840 and 1860, all but two states banned lotteries. Some new states that joined the nation during those years included in their state constitutions express prohibitions on lotteries.

Lotteries rebounded during the Reconstruction Era after the Civil War, especially in southern states that had dire need of funds to rebuild. The largest lottery of the time was run by the Louisiana Lottery Company, a private entity that had a charter from the state legislature. It sold tickets nationwide, and it was so successful—and so famously corrupt—that Congress repeatedly at-

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8. Sweeney, supra note 4, at 15, 27; McGowan, supra note 1, at 10; Eric Bender, Tickets to Fortune: The Story of Sweepstakes, Lotteries and Contests 112 (1938).
10. Id.; see also Ezell, supra note 2, at 50 (describing the 1769 lottery regulation as “another aspect of the new colonial policy enacted after the French and Indian War whereby England tightened her hold on her overseas possessions and attempted to control more closely their economic life, thus ending the so-called period of ‘salutary neglect’”).
11. Bender, supra note 8, at 3.
15. Id. at 12–13.
16. Id. at 13.
17. See, e.g., Wis. Const. art. IV, § 24 (1848); Tex. Const. art. 3, § 47 (1876); Cal. Const. art. IV § 26 (1880).
19. See Clotfelter & Cook, supra note 7, at 38.
tempted to curb its excesses. After several federal statutes failed to rein in lottery abuses, Congress in 1890 made it a federal crime, punishable by imprisonment, to use the mail for any purpose related to a lottery. By the time Congress passed an additional anti-lottery statute in 1895, there was no need. Legal lotteries in the United States ceased in 1894 and did not resurface for seventy years.

The absence of lotteries in America during most of the twentieth century in no way means there were not contests and games of chance. Similar activities persisted through charity raffles and illegal numbers games. “[S]weepstakes and other so-called chance promotions used to bolster sales” also helped fill the cultural space lotteries had once occupied. Sponsors of these contests found legal distinctions to distinguish their activities from the lotteries that were widely prohibited. Indeed, during the years immediately following the Great Depression, “with shrunken sales volumes and with the public showing no inclination to spend its money for anything,” contests proliferated and “became respectable.” According to one commentator, “[i]n 1932, the nation went contest-crazy.”

Many of those 1930s contests took the form of movie theater giveaways on so-called Bank Nights. Participating theaters placed registries in their lobbies. Both ticket buyers and anyone who wished to stop in the lobby could sign the registry once. Then, one night a week, the theater would hold a drawing to determine which registrant had won a cash prize. Once the winner’s name was announced, that person, whether inside the theater or not, had five minutes to appear and claim the prize. If the winner did not make a timely claim, the prize rolled over to increase the amount available the following week. Promotions like this one had been popping up all over the country. But they “spread across the country like wildfire” once Affiliated Enterprises, Inc. asserted a copyright on the design of Bank Night and licensed that copyright—for a fee—to 5,000 theaters around the nation. Some businesses other than theaters also tried similar promotions; thousands of people stood outside Wilson’s Chief Market in Providence, Rhode Island, for a drawing held every Tuesday evening.

21. Id.; Clotfelter & Cook, supra note 7, at 38; McGowan, supra note 1, at 15.
22. Clotfelter & Cook, supra note 7, at 38.
23. Id.
24. Id.
25. Id. at 41.
26. Id.
27. Bender, supra note 8, at 3–4.
28. Id. at 5.
30. Curtin & Bernardo, supra note 29, at 126, 128.
31. Id. at 135.
Bank Night and similar contests faced legal challenges, which often ended with court rulings decreeing that these were illegal lotteries. In states where the courts ruled in favor of Bank Night, the legislature frequently stepped in and adopted new legislation prohibiting the contests. The craze of Bank Night and similar contests “was essentially dead by Pearl Harbor.” It would take another generation—and another shift in the American view of lotteries—until promotional sweepstakes based solely on chance exploded in popularity again.

The third (and current) wave of lotteries in America began in 1964, when New Hampshire launched a state lottery as a revenue source rather than implement either a sales or income tax. “Throughout the 1970s, there was a slow but steady adoption of lotteries, mostly by northeastern states.” The 1980s saw “a virtual explosion in lottery activity.” Today, forty-four states, the District of Columbia, Puerto Rico, and the U.S. Virgin Islands run lotteries. Additionally, there are two massive, multi-state lotteries—Powerball and Mega Millions—that function almost as de facto national lotteries.

This third wave of lotteries also ushered in a new era of sweepstakes. “Almost simultaneously with the birth of the New Hampshire lottery, promotional sales games exploded into the marketplace as if they’d never been there before, particularly in supermarkets and gas stations.” By 1966, there were more than 600 national sweepstakes. In the late 1960s, public outcry led to federal investigation and regulation of promotional sweepstakes. The first part of the 1970s saw a decline in such contests, but soon after “the popularity of sweepstakes continued to grow—past $650 million in 1980, to over $1.35 billion in 1990.”

B. The Legal Framework That Grew Up Around Lotteries, Sweepstakes, and Contests of Chance

For present purposes, the legal doctrines that matter are those that developed in the early twentieth century, while sweepstakes and contests were thriving but lotteries remained illegal. To maintain legality, sweepstakes and contests had to find ways to distinguish themselves from lotteries.

The legal status of sweepstakes and contests of chance “hinged on the common law definition of three necessary ingredients for a lottery: chance, consid-
operation, and prizes.” Contests and sweepstakes must carefully avoid having all three elements so that they can avoid classification as illegal lotteries and protect their sponsors from the accompanying criminal penalties. Games of skill—a.k.a. “contests”—do not have the element of chance because the winner is determined by a measurement of performance. But games of chance—a.k.a. sweepstakes or contests of chance—lack that distinguishing feature from lotteries.

Thus, for most sweepstakes and giveaways, the key legal concept became consideration, because virtually all such promotions offered prizes that were awarded on the basis of chance. As anyone who has studied contract law knows, consideration can be a slippery concept. The Bank Night craze of the 1930s is a good illustration. Some courts approved Bank Nights, finding that the opportunity to register for the drawing without purchasing a movie ticket meant that no consideration was present. New Hampshire’s Supreme Court, for example, held that the option of free entry kept Bank Night from violating the state’s anti-lottery statute: “Violation is shown only when, regardless of the subtlety of the device employed, the state can prove that, as a matter of fact, the scheme in actual operation results in the payment, in the great majority of cases, of something of value for the opportunity to participate.” Iowa, Tennessee, New York, and New Mexico’s courts reached a similar conclusion. But other courts held that the possibility of free entry was insufficient to insulate Bank Night from the use of consideration. The Supreme Judicial Court of Massachusetts dismissed arguments about consideration, but noted that a lottery occurs where a chance at winning is exchanged for a price, which in this context meant “something of value and not the formal or technical consideration which would be sufficient to support a contract.” The court continued that, for Bank Night, “the test is not whether it was possible to win without paying for admission to the theatre,” but rather “whether that group who did pay for admission were paying in part of the chance of a prize.” The court then found that it was not unreasonable for the jury to have concluded “that the unusual crowds which

43. Clottfelter & Cook, supra note 7, at 41.
44. E.g., Wis. Stat. §§ 945.02(3), 945.03(1m)(d) (providing that conducting an illegal lottery can be a Class B misdemeanor or a Class I felony); Wis. Stat. §§ 939.50(3)(i), 939.51(3)(b) (providing that Class B misdemeanors and Class I felonies are punishable by a maximum $1,000 fine and/or imprisonment up to 90 days, or by a maximum $10,000 fine and/or imprisonment up to three years and six months, respectively).
46. Clottfelter & Cook, supra note 7, at 41.
51. Id. at 30.
completely filled the theatre on ‘Bank Night’ paid to come partly because they had, or reasonably believed they had, a better chance to win the prize than if they had stayed outside, that they had paid their money in part for that better chance, and that the scheme in actual operation was a lottery.”52 The Supreme Court of Illinois similarly concluded that under the Bank Night model, “[t]he price for a fair and reasonable chance to win is the cost of a ticket of admission to the theater, which is the object of the plan, and thus a lottery is completed.”53 Other courts followed this logic.54

The Supreme Court of Kansas held that “the indirect benefit derived by the [theater owner] under the ‘bank night’ plan in the way of increased gross receipts from paid admissions . . . is sufficient consideration coming directly or indirectly from those entitled to the chances generally to meet the requirements as to that necessary element in a policy or scheme of drawing in the nature of a lottery.”55 This logic, which looked to the theater’s benefit rather than the patrons’, to determine whether there was consideration, also appealed to several courts.56

52. Id.
53. Iris Amusement Corp. v. Kelly, 8 N.E.2d 648, 653 (Ill. 1937), reb’g denied.
54. See, e.g., City of Wink v. Griffith Amusement Co., 100 S.W.2d 695, 699 (Tex. 1936) (“It is idle to say that the payment made for seeing the picture is not, in part at least, a charge for the drawing and the chance given. The things to be seen and done in the theater and the privileges above enumerated which accompanies them, are all a part of one and the same show, meaning the entire proceedings inside the theater. The fact that part of the things to be enjoyed by those who paid at the door were classed as ‘free’ by the defendant in error does not change the legal effect of the transaction.”); Jorman v. State, 188 S.E. 925, 927 (Ga. 1936) (“It cannot alter the fact that the operator may have given free chances to some without the purchase of tickets; even so, the lottery scheme as to a gift enterprise was present to all the rest, and this fact did not prevent it from being a lottery under the law of Georgia.”); State v. McEwan, 120 S.W.2d 1098, 1100 (Mo. 1938) (“[A]ny person desiring to participate [in Bank Night] must be in attendance at the theater, either inside or outside. One cannot sit by his fireside and take part therein. He must be present and swell the crowd at the theater. . . . The participants in the lottery care little whether the picture is one portraying a masterpiece of Shakespeare or a light modern novel. The so-called free number feature of the scheme is only the goat’s skin upon the hands of Jacob. It is there in an attempt to fool the law.”); State v. La Crosse Theaters Co., 286 N.W. 707, 710 (Wis. 1939) (“Manifestly a lottery is no less a lottery because the management of it gives away numbers entitling participation in the draw to some persons. It is only all the more objectionable because it does not limit the drawees to the persons buying tickets and thus lessens the chance of those who pay for their tickets.”).
56. See, e.g., Cent. States Theatre Corp. v. Patz, 11 F. Supp. 566, 568 (S.D. Iowa 1935) (“[T]he question of fact . . . is whether or not from this admission charge the scheme and plan was to deduct a certain percentage and use this fractional fee to pay or offset the loss which might be occasioned by the $150 prize. If that was the intention, I can see no reason why it would not be a lottery.”); Grimes v. State, 178 So. 73, 74 (Ala. 1937), reb’g denied (1938) (“[T]he success of the plan in swelling the patronage, and consequent income through the scheme of chance are the final proof of a consideration paid and a consideration received. Certainly it cannot be questioned that such is the result intended by the bank night operator. Without it, the bank night would speedily cease to be.”); Dussault v. Fox Missoula Theatre Corp., 101 P.2d 1065, 1066 (Mont. 1940) (finding consideration because “the price paid for the ticket, in part, though disguised, later reappears as the [prize]. It enters the box office as Dr. Jekyll, and steps out as Mr. Hyde”).
The doctrinal disagreements over whether various iterations of Bank Night included consideration receded as Bank Night itself faded. But the issue at the heart of those disagreements—uncertainty about what constitutes consideration sufficient to transform a promotional contest into a lottery—remained unresolved.\(^{57}\) It would come back to the fore when promotional sweepstakes again became popular. Some state legislatures adopted legal changes to permit some sweepstakes and contests to proceed. Wisconsin, for example, amended its state constitution in 1965 for this purpose.\(^ {58}\)

Importantly, states are not the only legal authority over sweepstakes and contests. Recall that in the nineteenth century, Congress had adopted a series of statutes cracking down on interstate lotteries. In the summer of 1963, only two months after New Hampshire had announced plans to create a legal lottery in America for the first time since the 1890s, the U.S. Postal Service issued a pamphlet outlining what kinds of promotional materials could—and could not—be sent through the mail.\(^ {59}\) The pamphlet emphasized that the Postal Service “would not deliver printed material having to do with a promotion basing its outcome partly or wholly on chance.”\(^ {60}\) But the pamphlet included a crucial caveat: the Postal Service would deliver advertisements for contests that allowed entry not only with evidence of purchase, but also through submission without proof of purchase.\(^ {61}\) The Postal Service, then, put the federal government’s imprimatur on the theory that a mechanism for free entry ensured that a contest was not a lottery.

Only a few years later, as sweepstakes again swept the country, and consumer complaints mounted, the Federal Trade Commission agreed to investigate and regulate promotional contests. Interestingly, the initial impetus for FTC involvement was a belief—likely unfounded—that the prevalence of sweepstakes sponsored by grocery stores was driving up food prices.\(^ {62}\) Although this particular complaint was not borne out by the FTC’s investigation, the agency did uncover some abuses, including: oil companies advertising that all of their service stations were participating in a promotion, when only some were; supermarkets rigging contests so that the big prizes would be won by shoppers at larger stores in selected geographical regions; and a pattern of awarding the largest prizes early in a contest but continuing to advertise the contest as if those prizes were still available.\(^ {63}\)

In light of these findings, the FTC decided to regulate, consistent with its underlying statutory mandate prohibiting “unfair methods of competition in or affecting commerce, and unfair or deceptive acts or practices in or affect-

\(^ {57}\) See, e.g., Herald Publ’g Co. v. Bill, 111 A.2d 4, 7–8 (Conn. 1955); see also Lucky Calendar Co. v. Cohen, 117 A.2d 487, 494 (N.J. 1955) (discussing the idea that consideration is not required to be an illegal lottery).

\(^ {58}\) See WIS. CONST. art. 4, § 24 (amended by 1963 J.R. 35; 1965 J.R.2, vote April 1965).

\(^ {59}\) CURTIN & BERNARDO, supra note 29, at 156.

\(^ {60}\) Id. at 157.

\(^ {61}\) Id. at 161.

\(^ {62}\) Id. at 167.

\(^ {63}\) Id. at 168.
ing commerce.” The FTC regulations, promulgated in 1969, “prohibited rigging games in order to ensure that prizes are distributed on any predetermined basis.” The regulations also imposed transparency requirements, mandating disclosure of the exact number and types of prizes to be awarded, as well as the odds of winning each type of prize.

The FTC continued undertaking new investigations and, where it deemed warranted, imposed significant penalties for deceptive sweepstakes promotions. For example, in 1971 the FTC entered into a consent decree with Reader’s Digest, under which the publisher agreed to cease and desist from mailing consumers simulated checks and currency in its sweepstakes promotions. A few years later, the FTC asserted that Reader’s Digest had violated the consent order by mailing promotions to consumers that included simulated “travel checks” and “cash-convertible bonds.” The agency’s concern was that these mailings induced “participation in sweepstakes by means of items that appeared to be valuable but in fact were not.” Reader’s Digest argued (unsuccessfully) that in the absence of proof that there were any “actually misled or confused consumers,” the enforcement action improperly curtailed its First Amendment rights. Based on nearly eighteen million mailings of the challenged items, the FTC sought—and the courts affirmed—a penalty of $1.75 million.

Review of sweepstakes and consents remains an active FTC priority. One reason is that the agency continues to receive a high number of complaints about misleading promotions and contests. In fact, within an annual list that the FTC makes of the complaints it received from consumers in the prior year, the sweepstakes category is a perennial contender, having “been rated in the Top 10 [every year] since the list was created in 1999.” And the FTC continues cracking down on violators. Recently, the FTC obtained a $9.5 million judgment against an individual sweepstakes promoter, and as a term of settlement, permanently banned her from engaging in direct mail marketing.

69. Id. at 1047.
70. Id. at 1046–47.
II. The New World of Promotions in an Era of Social Media

The development of social media (and the Internet in general) proved to be a game-changer for contests and sweepstakes. Previously, either participants had to mail their entry forms to the promoter or “in-pack chance pieces” had to be provided to customers in person. Both formats were expensive and unwieldy; frequently, advertising in other media was required to develop sufficient awareness of—and “buzz” or excitement for—the promotion.

Today, numerous consulting companies stand ready to assist franchisors, franchisees, and almost any business develop and administer targeted sweepstakes and contest campaigns that utilize social media platforms at a fraction of the cost of the old promotions. These new forms of promotions also offer benefits that would have been unimaginable a generation ago. These include:

- Encouraging customers to develop and submit user-generated content, which may then prove useful for the sponsor’s marketing.
- Acquiring data (e.g., e-mail addresses and information regarding consumer preferences) through participant entry forms.
- Leveraging the enthusiasm of customers for the product. Participating consumers essentially volunteer to be unpaid advocates for the promotion sponsor. This leverage can become exponential if a promotion goes “viral,” but in any event posts will be seen by friends, relatives, and acquaintances of the entrant.

User-generated content is ordinarily generated through creative contests, such as photo and video contests, essay competitions, and caption/fill-in-the-blank games. Consumer data is most likely to be acquired in a sweepstakes that requires a visit to a sponsor’s website and the completion of an entry form, a poll, or a quiz. “Like to Win” and similar promotions typically do not reap user-generated content or consumer data, but may promote the sponsor’s product or service among friends, relatives, and acquaintances of the participant. Some promotions also seek to leverage engagement by utilizing online voting either to determine a winner or finalists or to assist in the selection of a winner.

III. Practical Issues Arising with Social Media Promotions
Under Long-Existing Law

A. “Hidden” Consideration

Traditionally, sweepstakes have sought to eliminate the element of “consideration” in sweepstakes and avoid classification as a lottery by utilizing a free

“alternative method of entry” (AMOE).\(^{75}\) Under a typical AMOE, prospective participants may mail a postcard to the contest or sweepstakes sponsor with the contestant’s name and contact information, without any requirement of purchasing the sponsor’s product or service to enter the sweepstakes.\(^{76}\)

At first glance, an AMOE appears to be unnecessary relic for many social media promotions. Often, entry to contests and sweepstakes is not connected to the actual purchase of products and services from the sponsor. Anyone can enter, either by posting a hashtag, hitting “like,” or filling out an entry form on a sponsor’s website. Indeed, given that sweepstakes using hashtags or “likes” are designed for contestants to display a Twitter or Facebook post that promotes the sponsor on the contestants’ accounts, an AMOE would seem to defeat the purpose.

Although the sponsor of a promotion may receive no monetary consideration from entrants to its sweepstakes and contests, and the promotion may be conducted entirely online,\(^{77}\) it is very likely that “hidden” consideration may be bestowed on that sponsor—benefits to the sponsor that are not obvious on their face, but which may meet the definition of consideration under state law. Recall that many states, such as Wisconsin, have historically defined consideration broadly and construed exceptions narrowly. The types of benefits that may accrue to sponsors, and which could well rise to the level of consideration, include:

- Obtaining irrevocable, royalty-free licenses from participants that involve user-generated content, as well as a release of publicity rights.
- Data and information obtained from surveys conducted in conjunction with a sweepstakes or contest.
- Implied endorsements of the product or service received from the participant who has bestowed a like, used a hashtag, or pinned a photo of the product.

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76. Care should be taken to provide notice of the AMOE to in-store customers if entry or notice of the promotion is being provided at the point of purchase. In 2013, the State of New York fined the Great Atlantic & Pacific Tea Co., d/b/a as A&P, $102,000 as the result of an “A&P Frozen Food Month 2013 Sweepstakes.” Although an AMOE was provided and described in the fine print of online official rules, the AMOE language was not posted in stores. See Schneiderman: A&P ran misleading sweepstakes, LOHUD.COM (June 6, 2013, 4:05 PM), http://statepolitics.lohudblogs.com/2013/06/06/schneiderman-ap-ran-misleading-sweepstakes/.

77. At one time, it was conceivable that the need for participants to obtain Internet access, and the attendant cost, could be deemed to be “consideration” for these purposes. At this point, however, it would appear that this issue has been rendered moot by the ubiquitous nature of computers in our lives and free availability of computers at most public libraries. See Tywanda H. Lord & Laura C. Miller, *Playing the Game by the Rules: A Practical Guide to Sweepstakes and Contest Promotion*, 29 Franchise L.J. (2009); see also Gabriel Karp, *Navigating the Law of Interactive Promotions*, 89 Mich. B.J. 25, 26 (2010). Notably, Congress excluded from the definition of “bet or wager,” “participation in any game or contest in which participants do not stake or risk anything of value other than—personal efforts of the participants in . . . obtaining access to the Internet” in the Unlawful Internet Gambling Enforcement Act of 2006. 31 U.S.C. § 5362(1)(E)(viii)(I).
• An implied obligation to purchase a product, if the contest requires that the contestant post a photo of a person with the product.

Using a promotion as a means of compiling customer data—by asking questions of participants that are not necessarily germane to the promotion—has limitations. First, participants are less likely to enter if they face a long survey. And second, consideration is more likely to be found to exist if an individual has to expend greater effort to participate in the promotion.78

Given these potential traps, an AMOE should be provided for all sweepstakes, even if entry is not tied to a purchase. The old AMOE standby—a postcard that asks for only the name and address of the entrant—may be utilized to avoid the consideration element.79 Such entries, however, must be treated with “equal integrity” to other forms of entry. All participants must have an equal chance of winning the prize; there cannot be different prizes for different categories of participants, and no participant can be disadvantaged in claiming the prize by reason of mode of entry.80

B. Is It Truly a “Contest”?

Many promotions denominated as contests will not entirely eliminate the element of consideration. Often, a contest sponsor seeks user-generated content, intending to incorporate the winner’s submissions in branding initiatives and obtains an irrevocable license from contestants (under the promotion’s terms and conditions) to use the submitted materials. The grant of that license likely constitutes consideration. And for these types of contests, using an AMOE to avoid the element of consideration would make no sense; an AMOE entrant would not provide user-generated content and thus could not win the contest.

Sponsors of such promotions frequently rely on eliminating the element of chance to avoid having their contest being treated as a lottery.81 Although organizers of road running events, such as 10-kilometer runs or marathons, may charge an entry fee and provide a cash prize to the winner, such events are not “lotteries” because chance does not determine the winner.


79. If entry forms for a sweepstakes or game of skill are distributed through the U.S. Postal Service, the materials must comply with the Deceptive Mail Prevention and Enforcement Act (DMPE), 39 U.S.C. §§ 3001, et seq. Given the focus of this article is on using social media as the method of distribution for the promotion, we are not addressing the requirements of the DMPE.


81. It should be noted that some states prohibit, restrict, or regulate consideration being paid in online contests. See, e.g., LA. REV. STAT. ANN. § 14:90.3(B); ARIZ. REV. STAT. §§ 13.3301(1)(d)(ii), 13.3311 (registration of contests involving consideration required).
When consideration is present, it is imperative to make sure that the winner of the contest is determined on the basis of well-defined criteria, which identify a skill or talent to be judged. For example, under Wisconsin law, a lottery is defined as “an enterprise wherein for consideration the participants are given an opportunity to win a prize, the award of which is determined by chance, even though accompanied by some skill.”82 To eliminate the element of chance and remove the risk that the contest is deemed a lottery, a contest should (1) identify a “skill” that is the predominant factor in judging entries, (2) identify a skill possessed by average persons, (3) clearly disclose the criteria for judging the contest, and (4) select winners based on the disclosed criteria.83

Some contests seem to skirt the edge when attempting to eliminate the element of chance by minimizing the requirement of skill. For example, where sponsors ask consumers to post photos of themselves enjoying the sponsor’s product in weekly contests for prizes, are the contestants truly being judged on the basis of skill, or is an employee simply picking out a selfie in random, perfunctory fashion to award the weekly prize?

A format that uses online voting to determine a winner may also undermine the sponsor’s attempt to eliminate the element of chance. It is impractical (if not impossible) to document the motivation of online voters—whether they are knowledgeable about the contest criteria, duly impressed with the entry, or just friends of a rather popular contestant. To buoy the argument that the contest winners have been selected based on disclosed criteria, sponsors that incorporate a voting element should strongly consider limiting the extent to which online voting determines a winner—perhaps by (1) having judges select finalists based on the announced criteria, or (2) providing that the public online vote is only one factor in determining a winner and is weighted less than the vote of a knowledgeable judging panel. The promotion could also limit the number of votes that may be cast by any individual.

C. Intellectual Property

The potential of contests on social media to tap into the talents of the general public for the benefit of the sponsor results in the need to address intellectual property issues when a sponsor seeks to reap benefits from contest submissions.

The official rules of most contests involving social media are ordinarily posted online, typically require that the entrant provide a license to use materials submitted to the sponsor, and generally provide that the entrant warrants and represents that the entry (1) is an original work; (2) does not

82. See Wis. Dep’t of Admin., Contests, Sweepstakes and Sales Promotions, www.doa.state.wi.us/documents/DOG/Charitable/ContestsSweepstakesPromotions.pdf. “For example, if the skill required of a participant involves simply guessing which word from a provided list of possibilities is the right answer, the contest would be illegal.”
infringe on the copyrights, trademarks, rights of privacy or rights of publicity of any person or entity; and (3) has not previously been published.

Given the nature of online relationships, however, it is certainly possible that all intellectual property rights necessary to use a submission in advertising and other promotions might not be properly procured by a promotional sponsor. These potential problems include:

1. Is the entrant the owner of copyrights pertaining to the submitted materials? Even if the sponsor obtains warranties and representations from the entrant as to copyright ownership, if the warranties and representations are not true, the entrant may be judgment-proof.

2. Have releases been obtained from all individuals shown in a photo?

3. Does the photo contain elements that include a trademarked logo or other property that might be protected by intellectual property laws (e.g., a building or a painting in the background?)

4. Is the entrant bound by provisions contained in the online official rules as to representations, warranties, indemnifications, and license grants by clicking “I accept” on an online entry form? Or by hashtagging a photo posted on Instagram?

5. When the contest is entered online, who is the owner of the e-mail, Facebook, Twitter, or other account from which the entry was received?

Properly drafted official rules can address some of these issues (such as by establishing rules as to who is considered the owner of an account and requiring further actions by winners to confirm transfer of copyrights), but rules themselves are not bullet proof. A case filed in the U.S. District Court for the Eastern District of North Carolina in early 2017, Kraft v. Anheuser-Busch, highlights potential problems in using materials gleaned from online promotions. In that case, the plaintiff posted a photograph to Facebook of herself drinking the defendant’s Natural Light beer at a bar while wearing a fake mustache. Anheuser-Busch, meanwhile, was conducting an “Every Natty Has Its Story” marketing campaign. It is not clear from the complaint whether the plaintiff had hashtagged her photograph or otherwise taken steps to enter the promotion. When plaintiff later learned that Anheuser-Busch had used the photograph on coasters and posters, which were then distributed in restaurants and bars as part of the “Every Natty Has A Story” campaign, she acquired the copyright to the photo from the friend who had taken it (using

84. A signed writing from the assignor assigning ownership rights to the assignee is required to transfer ownership of a copyright. 17 U.S.C. § 204. The Fourth Circuit has held that clicking an “I accept” button on a website will suffice to meet the requirement of a written signature for purposes of transferring copyright because the Electronic Signatures in Global and National Commerce Act of 2000 (E–Sign Act) mandates that “no signature be denied legal effect simply because it is in electronic form” and that clicking the button meets the definition of electronic signature under the E–Sign Act. Metro. Reg’l Info. Sys., Inc. v. Am. Home Realty Network, Inc., 722 F.3d 591, 600–03 (4th Cir. 2013).

plaintiff’s cell phone) and then sued Anheuser-Busch for copyright infringement and misappropriation of her right of publicity, alleging that the photo was used without her authorization or consent.86

IV. Practical Issues in Social Media Promotions Arising Under Law or Guidance Adopted During the Digital Age

A. FTC and Endorsements

Section Five of the Federal Trade Commission Act87 prohibits unfair or deceptive acts or practices in or affecting commerce. With respect to social media, the FTC requires “clear and conspicuous disclosure” of the terms and conditions of promotions,88 with an emphasis on disclosure of endorsement relationships.89

In 2015, the FTC released a publication entitled “The FTC’s Endorsement Guides: What People Are Asking.”90 These Guides expressly apply to social media: “Truth in advertising is important in all media, whether they have been around for decades (like television and radio) or are relatively new (like blogs and social media).”91

When a celebrity favorably mentions a product in a social media post (such as on Twitter), the endorsement likely carries significant weight with fans. Not surprisingly, FTC regulations require that businesses and endorsers disclose “[w]hen there exists a connection between the endorser and the seller of the advertised product that might materially affect the weight or credibility of the endorsement.”92 Earlier this year, the FTC sent warning letters to celebrities, such as Heidi Klum, Jennifer Lopez, and Kourtney Kardashian, as well as executives of several franchise companies, cautioning them against posting social media endorsements without proper disclosure of any personal financial connection to the displayed product.93

The Guides go further, however, and assert that even non-celebrities who participate in contests and sweepstakes may have similar influence. In the

86. Id.
89. See 16 C.F.R. §§ 255.0–.05 (2017).
91. Id.
92. 16 C.F.R. § 255.5.
FTC’s view, readers are not likely to understand that posts are part of a contest or sweepstakes, unless “#sweepstakes” or “#contest” appears as part of the hashtag entry. Thus, to comply with this FTC mandate, all contests and sweepstakes should require participants to use an appropriate hashtag in contest or sweepstake entries.

The FTC issued the Guides as a clarification of policy shortly after responding to an online contest run by Cole Haan, a retail shoe distributor and retailer, with an investigation. Cole Haan’s contest for a $1,000 shopping spree required participants to create a Pinterest board titled “Wandering Sole.” Contestants were instructed to pin five pictures of shoes from Cole Haan’s Wandering Sole line, as well as five pictures of the contestants in their “favorite places to wander” and use “#WanderingSole” to describe each pin. The FTC held that the #WanderingSole hashtag alone failed to indicate the “material connection” between the contestants and Cole Haan. However, because relatively few people participated in the contest, and the FTC had not publicly indicated that entry into a contest was a form of “material connection,” the FTC did not seek any penalty.

B. Telephone Consumer Protection Act

The ramifications of the Telephone Consumer Protection Act (TCPA) for franchisors have been addressed in detail in a previous article published by the Journal, but given the potential application of the TCPA when text messaging is used in conjunction with sweepstakes or contests, and its potentially significant consequences, the message merits reiteration.

The TCPA, which was enacted to protect consumers from receiving unwanted and unsolicited communications, places restrictions on robocalls and junk faxes from automated dialers and facsimile machines. Consumers may bring a lawsuit under the TCPA and seek damages of $500 per violation or actual monetary loss, whichever is greater, and damages may be trebled for willfulness. What’s more, damages are not capped or limited in class action suits. In 2013, Papa John’s International, Inc., paid $16.5 million (including $11 million in cash payments to members of the class) to resolve a

94. Press Release, supra note 93. To date, the FTC has not decided whether “liking” a post on Facebook as part of a contest or sweepstakes similarly conveys an undisclosed endorsement, stating “we don’t know at this time how much stock social network users put into ‘likes’ . . . so the failure to disclose that the people giving ‘likes’ received an incentive might not be a problem.”


96. Id.

97. Id.

98. Id.


101. Id. at 422.

nationwide class action that alleged that Papa John’s breached the TCPA when it directed a marketing company to send unsolicited text messages advertising the company’s pizzas.\footnote{103} Domino’s Pizza, LLC, settled a similar lawsuit for $9.75 million in 2012, after a multi-unit franchisee allegedly initiated prerecorded phone calls to residential and cellular phone lines over a four-year period.\footnote{104}

In \textit{Thomas v. Taco Bell Corp.},\footnote{105} the plaintiff alleged that Taco Bell franchisees had used a text messaging provider to market a sweepstakes contest through spam text messages and that the franchisor, Taco Bell, should be found vicariously liable. Although the court (and the Ninth Circuit, in affirming the trial court) held that Taco Bell was not liable, the mere possibility of becoming party to a nationwide class action lawsuit is a frightening prospect for franchisors and their counsel.

\section*{C. CAN-SPAM Act}

Sponsors of contests and sweepstakes that collect e-mail addresses for marketing and solicitation purposes need to be cognizant of yet another federal law, the Controlling the Assault of Non-Solicited Pornography and Marketing Act (CAN-SPAM Act).

Congress enacted the CAN-SPAM Act in 2003 with the goal of reducing unwanted and deceptive e-mails.\footnote{106} The CAN-SPAM Act applies to all “electronic mail message[s] [with] the primary purpose of . . . commercial advertisement or promotion of a commercial product or service . . .”\footnote{107} The CAN-SPAM Act prohibits the use of misleading header information, subject lines, and from fields.\footnote{108} Businesses must clearly and conspicuously identify e-mail as an advertisement, provide a means to opt out of future emails, and honor opt out requests within ten days.\footnote{109} Failure to comply with the CAN-SPAM Act can be very costly. Businesses may be fined up to $16,000 for each unlawful e-mail.\footnote{110}

\section*{D. Privacy Policies and COPPA}

If a contest or sweepstakes is aimed at children thirteen years or younger, additional care must be taken to comply with the provisions of the Children Online Privacy Protection Act (COPPA),\footnote{111} which generally places restric-
tions on commercial e-mails and websites that collect and disclose children’s private information online.

Commercial websites and online services are subject to COPPA if the online material is directed at children thirteen years old or younger, or if the owners know they are collecting information from someone that is thirteen years old or younger.112 COPPA requires that such websites and online services post a privacy policy that describes how personal information collected online from children is handled.113 Websites must give notice to parents and obtain their consent before collecting personal information from children.114 Among the numerous restrictions imposed by COPPA is a prohibition against conditioning entry for a sweepstakes prize on a child disclosing “more personal information than is reasonably necessary to participate in such activity.”115 As of 2017, penalties for violation of COPPA can reach up to $40,654 per violation.116

E. Communications Decency Act

The Communications Decency Act (CDA)117 exempts an “interactive computer services provider” from liability from most claims arising from user content, including defamation, that is posted on the service. This exemption can be lost, however, if a sponsor suggests or prompts participants to post defamatory content.

In Doctor’s Associates v. QIP Holder LLC,118 a restaurant had been ordered to cease making unsubstantiated claims that its sandwiches had more meat than those of its competitor, Subway. The restaurant then ran an online contest using its own domain name and posted submitted videos from customers that again alleged that the restaurant’s sandwiches contained more meat than those of Subway. The Subway chain filed suit against the restaurant. The U.S. District Court for the District of Connecticut declined to grant summary judgment to the defendant on the basis of immunity under the CDA, stating that the sponsor’s actions may have been responsible for the posted content.119 Online promotions, it would appear, are not recommended as a vehicle for negative advertising campaigns.

114. 16 C.F.R. § 312.5(a)(1).
119. Id.
V. The Rules of Social Media Platforms

Of course, the law is not the only source of restrictions that the sponsor of a contest must navigate. If a sponsor uses a social media platform to host or facilitate a contest, it is subject to the rules that the social media platform imposes. Those rules are generally set out in the terms of use for each website or application.

Facebook recently relaxed its policies regulating sweepstakes run through its website. Prior to August 2016, businesses were prohibited from conducting sweepstakes directly on Facebook; instead, businesses had to use a third-party application to run the sweepstakes. Facebook announced on August 27, 2016, that it made “it easier for businesses of all sizes to create and administer promotions on Facebook.” Sweepstakes can be offered directly on a business’s own Facebook “timeline.” Facebook is now quite flexible in the way in which participants may enter sweepstakes and contests. Participants may enter by posting, commenting, messaging, and/or through liking.

Facebook has had a longstanding rule against businesses imposing a sweepstakes onto individuals’ personal timelines. For example, a business cannot require entrants to share the sweepstakes on their own timeline—or to post in on a friend’s timeline—as a condition to entry. Nor can participants be required to tag a friend in a post as a condition of entry. Businesses also may not encourage entrants to tag themselves or others in pictures that they do not appear in. Sweepstakes must require a complete release of Facebook by entrants, typically accomplished by including such a release in the sweepstake’s official rules. Businesses must acknowledge that sweepstakes are not sponsored, endorsed, or associated with Facebook. Facebook disclaims any responsibility for the lawful operation of sweepstakes on its website.

“The Twitter Rules” do not specifically address sweepstakes, but sweepstakes are certainly implicated by them. The rules are what one would expect of a social media website. For example, they include a blanket prohibi-

121. It’s now easier to administer promotions on Facebook, supra note 120.
122. Id.
123. Id.
124. Id.
126. Id.
127. Id.
128. Id.
129. Id.
130. Id.
tion on “abusive behavior” and spam. More helpfully, Twitter has issued “Guidelines for Promotions on Twitter.” Twitter advises businesses to discourage users from creating multiple Twitter accounts by implementing a rule that makes doing so a grounds for disqualification from claiming any contest or sweepstakes prize. Twitter warns businesses and participants that they may violate Twitter’s spam rules if they determine prizewinners by identifying the consumers who retweet company promotions most frequently. Violating the spam rules runs the risk of Twitter removing the sweepstakes from appearing in a Twitter search and could result in Twitter either temporarily or permanently suspending accounts.

Compared to Facebook and Twitter, Pinterest has less restrictive policies regarding promotions. Pinterest urges businesses to “encourage authentic behavior, keep Pinterest spam-free and . . . comply with all relevant laws and regulations.” More specifically, Pinterest tells businesses not to require entrants to pin any specific image. Pinterest wants its users to have discretion in choosing what to pin based on their own “tastes and preferences.” Pinterest requires businesses to allow only one entry per participant. Rather than requiring businesses to explicitly state the social media website does not sponsor the promotion as Facebook does, Pinterest more simply requires that businesses do not “suggest that Pinterest sponsors or endorses” the promotion.

Instagram prohibits inaccurately tagging content or encouraging users to inaccurately tag content. Instagram requires a complete release of Instagram by each entrant, and each sweepstake’s official rules must acknowledge that the promotion is in no way sponsored, endorsed, or administered by, or associated with Instagram.

VI. Concerns Specific to Franchised Businesses

Most franchised businesses—restaurants, hotels, fitness centers, and other personal service industries—sell products and services to consumers. Given that a franchised business’s predominant focus is on individuals, contests and sweepstakes utilizing social media—which are aimed at, and an efficient

132. Id.
134. Id.
135. Id.
136. Id.
138. Id.
139. Id.
140. Id.
way of reaching large numbers of, such customers—are a natural fit for those franchised businesses.

Branding is at the core of the franchise model. Without its trademarks and goodwill, a franchise system is worth little. Thus, the franchisor must vigilantly protect the value of its intellectual property.

Of course, controlling franchisees’ use of trademarks may run counter to the desire of a franchisor to avoid vicarious liability for the actions of its franchisees. On employment issues, for example, a franchisor typically does not retain any ability to control hiring decisions, employee pay, or employee discipline. Many franchisors decline to get involved in any way with franchisee employment matters.

A franchisor, though, must retain enough control over promotional activities—both by the franchisor and by its franchisees—to protect the goodwill reflected in its marks. If too much control is exerted, however, the franchisor may find itself liable for the claims arising out of its franchisees’ actions. For example, in People v. JTH Tax, Inc.,142 the court upheld findings that the franchisor of the Liberty Tax Service franchise was liable, under an agency theory, for misleading advertising conducted by its franchisees in violation of California law. The trial court had focused on Liberty’s operations manual, which it found to provide the franchisor with a right of control “far in excess of what it needed to police its mark.”143 Among other things, the franchisor had required franchisees to offer refund anticipation loans and electronic refund checks from banks identified by the franchisor. The trial court noted that Liberty was “literally providing a detailed, step-by-step guide for every aspect of marketing and advertising.”144 The appeals court upheld findings that such provisions evidenced a principal-agent relationship between the franchisor and its franchisees.145 Further, as demonstrated by the Taco Bell, Domino’s, and Papa John’s cases cited above,146 franchisors may be added as defendants in class action lawsuits involving the marketing activities of their franchisees, based on theories of vicarious liability.

So how does franchisor counsel handle this tension between the need to police franchisees and their use of promotions and exerting too much control? Bright-line rules (e.g., only the franchisor is allowed to conduct online contests and sweepstakes;147 promotions developed by the franchisor are the only ones permitted to be used; promotions are prohibited from utilizing text messaging) might be one answer, especially if the franchisor has the exclusive right to establish rules and guidelines on the use of the Internet, as

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143. Id. at 1223.
144. Id. at 1239.
145. Id.
146. See notes 103–05, supra, and accompanying text.
147. It is recommended that all franchisors maintain a single, central website, which includes an interactive franchisee locator and individual, uniform pages for each franchisee. See Judith A. Powell and Lauren Sullen Ralls, Best Practices for Internet Marketing and Advertising, 29:4 Franchising L.J. 231–32 (2010).
well as unfettered right to control and approve marketing and advertising under the franchise agreement (or to amend provisions of the operating manual that govern marketing and promotions). Such controls would seem consistent with the need of franchisors to police the use of their marks, so that exercising those rights would not establish an agency relationship or other bases for imposing vicarious liability. This option may be limited, though, if an existing franchise agreement authorizes only franchisor review of a franchisee’s promotions, subject to a “reasonable discretion” standard. In any event, it is folly for a franchisor to dismiss the potential for liability arising out of a franchisee’s promotion, simply because the franchisor was not directly involved.

In any event, counsel to franchisors are more likely to have to deal with matters involving sweepstakes and contests on social media than their counterparts in other industries, because franchisor marketers will want to use sweepstakes and contests as effective forms of connecting with individual consumers. With social media continuing to change, so too will these challenges.
Income Tax Nexus: 
No Physical Presence Necessary

Jay Forester and Mike Drumm

[B]ut in this world nothing can be said to be certain, except death and 
taxes.—Benjamin Franklin

Although death and taxes may be certain, to whom you are required to pay 
those taxes is not quite as certain. States have been increasing their reach in an 
attempt to collect taxes from out-of-state entities. As most franchised com-
panies operate in more than one state (and most hope to operate in all states), 
this issue is a primary concern for franchisors and is becoming increasingly 
more troublesome. States are progressively challenging longstanding federal law in an effort to gain more revenue 
from more businesses with minimal connection to a state. What used to be 
primarily a question of physical location of a business, employees, or tangible 
assets now encompasses directing activity or “doing business” in a state under 
the ever-expanding theories of “factor presence” and “economic presence,” 
both with varied applications among states.

I. Overview and History

Taxation with representation ain’t so hot either.—Gerald Barzan

Nexus is the minimum contact a jurisdiction must establish before sub-
jecting a business to its taxing authority. Trial lawyers should be familiar 
with concept as it is analogous to minimum contacts needed to establish per-
sonal jurisdiction. States extend the authority to impose tax on a business as 
far as constitutional foundations allow and, in some cases, further. The pri-

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mary constitutional clauses mapping the boundaries of the states’ taxing authority are the Due Process Clause and the Commerce Clause.

A. Due Process

'It’s a very frightening time when something as basic as due process is seen as somehow radical.—JOHN CUSACK

The Fourteenth Amendment to the U.S. Constitution prohibits states from denying any person “life, liberty, or property, without due process of law.” Because a tax is a deprivation of a property right, states must overcome due process hurdles before subjecting a business to tax. There must be a minimum connection and some rational relationship between a taxpayer and a state. ¹ Historically, the requisite “minimum connection” required was “physical presence” in a taxing jurisdiction. The primary consideration of due process is one of fundamental fairness: does the tax satisfy “traditional notions of fair play and substantial justice”? “That test is whether property was taken without due process of law, or if we must paraphrase, whether the taxing power exerted by the state bears fiscal relation to protection, opportunities, and benefits given by the state. The simple but controlling question is whether the state has given anything for which it can ask return.”²

In 1992, the Supreme Court in Quill Corp. v. North Dakota essentially eliminated the traditional “physical presence” due process requirement, declaring that as long as an out-of-state business purposefully directs solicitation toward residents of a state, the state may subject the business to its taxing authority.³ The chief due process consideration in light of the Quill decision became does a taxpayer “purposefully avail itself of the benefits of an economic market” in the state, irrespective of a physical presence in the taxing state.⁴

B. Commerce Clause

Money, not morality, is the principle commerce of civilized nations.
—THOMAS JEFFERSON

The second constitutional provision limiting the taxing authority of states is the Commerce Clause, which states, “Congress shall have the power to regulate Commerce with foreign Nations, and among the several states, and with the Indian tribes.”⁵ A central authority of the Commerce Clause is its limitation through the Dormant Commerce Clause on the states’ ability to interfere with commerce in areas where Congress has not acted. Under

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². J.C Penney, 311 U.S. at 444.
³. Quill, 504 U.S. at 307.
⁴. Id. at 308.
⁵. U.S. CONST., art. 1, § 8, cl. 3.
the Dormant Commerce Clause principle, taxes that unduly burden inter-
state commerce have been declared unconstitutional. The crux of Com-
merce Clause analysis is not that states are prohibited from imposing a bur-
den on interstate commerce itself; rather, determining if a tax provides a
direct commercial advantage to local businesses or creates multiple taxation
on interstate commerce.

The Supreme Court in National Bellas Hess v. Illinois Department of Revenue
limited the expansive reach of a state tax on a reseller with no physical pres-
ein in a state. National’s only connection with Illinois was the semi-annual
mailing of catalogs to customers residing in the state. The Court stated,

it is difficult to conceive of commercial transactions more exclusively interstate in
character than the mail order transactions here involved. And if the power of Illi-
nois to impose use tax burdens upon National were upheld, the resulting imped-
iments upon the free conduct of its interstate business would be neither imaginary
nor remote. . . . The very purpose of the Commerce Clause [is] to ensure a na-
tional economy free from such unjustifiable local entanglements.

Commerce Clause nexus was further defined by the Supreme Court in
Complete Auto Transit, Inc. v. Brady, which provided a four-prong approach
to determine whether a state tax on interstate commerce is constitutional.
First, the tax must be applied to an activity with substantial nexus with the
taxing state; second, the tax must be fairly apportioned; third, the tax must
not discriminate against foreign commerce; and fourth, the tax must be fairly
related to services provided by the taxing state. The first and fourth prongs
require a substantial nexus and a relationship between the tax and the state
activity as to not burden interstate commerce, while the second and third
prongs require fair apportionment and nondiscrimination to inhibit states
from placing an unfair tax burden on interstate commerce.

In 1992, the Quill Court reaffirmed the physical presence requirement to
satisfy Commerce Clause nexus. The Court concluded that a bright line,
physical presence standard “firmly establishes the boundaries of legitimate
state authority,” “reduces litigation,” “encourages settled expectations,”
and serves the “interest in stability and orderly development of the law
that undergirds the doctrine of stare decisis.” It is important to note the
Quill physical presence requirement was in response to a use tax imposed
on out-of-state mail order sales. The targeted decision recognized a dete-
rioration of a bright line test for nexus and such test’s inability to apply to

6. Brian L. Hazen, Rethinking the Dormant Commerce Clause: The Supreme Court as a Catalyst
9. Id. at 759–60.
11. Id. at 279.
13. Id. at 315–17.
14. Id. at 316.
taxes beyond sales and use tax.15 Perhaps this specificity has created, or at least contributed to, the mélange of state nexus criterion for corporate income, franchise, and other taxes on business activity.16

C. Public Law 86-272

There is no safe haven in today’s markets.—Paul Singer

Congress enacted the most important and salient income tax nexus imperative in 1959. Public Law 86-272 was enacted over concerns of the far-reaching decision in *Northwestern Cement Co. v. Minnesota*, which allowed states to impose nondiscriminatory, fairly apportioned income taxes on interstate businesses with a limited presence in a state.17 The essence of P.L. 86-272 is to provide interstate businesses a safe-haven for certain state activity, and its purpose is to prohibit a state from imposing a tax on net income if a company has minimal presence in a jurisdiction. P.L. 86-272 prohibits taxation if a company’s only activities in a jurisdiction are the solicitation of orders of sales of tangible personal property that are sent outside the state for approval or rejection and, if approved, are shipped or delivered from a point outside the taxing jurisdiction.18 P.L. 86-272 provides protection only from taxes imposed on, or measured by, net income, so taxes measured by gross receipts such as Ohio’s Commercial Activity Tax or Washington’s Business and Occupation Tax are not limited by the law.19 Although P.L. 86-272 does not generally provide significant shelter for the franchise industry, it has shaped current state statutory and judicial nexus criteria.

Prior to the passage of P.L. 86-272, physical presence dictated nexus for state income tax purposes.20 The *Northwest Cement* decision and the subsequent enactment of P.L. 86-272 underscored the concerns of this standard for multistate businesses: the uncertainty of the amount of state activity that gives rise to nexus, how to properly apportion income among all states, and the potential for multiple jurisdictions to tax the same revenue. Congress had no intention of P.L. 86-272 becoming the long-term solution; rather, its enactment was to serve as a “stopgap” while additional options

15. “In sum, although in our cases subsequent to *Bellas Hess* and concerning other types of taxes we have not adopted a similar bright line, physical presence requirement, our reasoning in those cases does not compel that we now reject the rule that *Bellas Hess* established in the area of sales and use taxes.” Id. at 317.

16. The Court in *Quill* noted that Commerce Clause jurisprudence favors a more flexible approach to determining nexus and agreed with the state court’s assessment of the evolution of nexus. The Court also noted that its review of other types of taxes has not sustained the physical presence requirement established by *Bellas Hess*, but the lack of articulation does not imply a repudiation of the standard for other tax types. Id. at 314.


were explored. With no additional federal action, states, like children left unsupervised by their parents, have begun to make their own often irreconcilable nexus rules.

II. Nexus-Creating Activities

A. Intangibles

*The intangible represents the real power of the universe. It is the seed of the tangible.*—BRUCE LEE

In 1993, the South Carolina Supreme Court ruled a taxpayer licensing intangibles, with no physical presence in the state, satisfied the requisite minimum contact for the state to impose tax. Toys “R” Us, Inc. created an intangible holding company named Geoffrey LLC, which held trademarks and trade names for Toys “R” Us subsidiaries in many states, including South Carolina. The subsidiaries paid a royalty to Geoffrey for use of the intangible property in South Carolina. Citing *Quill*, the court stated, “the nexus requirement of the Due Process Clause can be satisfied even where the corporation has no physical presence in the taxing state if the corporation has purposefully directed its activity at the state’s economic forum.” Additionally, the court stated the “minimum connection” required by Due Process is nevertheless satisfied by the presence of Geoffrey’s intangible property in South Carolina. Courts in Louisiana, Massachusetts, and Oklahoma also concluded Geoffrey’s activity in their state was sufficient to create nexus.

*Geoffrey* exemplifies the expansion of the Due Process “minimum connection” nexus requirement. In *Geoffrey*, the court extended the standard, at least in an income tax context, to include the presence of an intangible in a state, thus allowing a state to tax any entity with an intangible in its state, regardless of any traditional physical presence. States were quick to implement the principle of establishing nexus with no physical presence but with “economic presence.”

B. Economic and Factor Presence

*Presence is more than just being there.*—MALCOLM FORBES

Since the *Quill* and *Geoffrey* decisions, states are arbitrarily broadening nexus standards and implementing their own version of economic presence,

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23. *Id.* at 19.
24. *Id.* at 19–20; *see also* Wheeling Steel Corp v. Fox, 298 U.S. 193 (1936) (intangibles may acquire a situs for taxation other than at the domicile of the owner if they have become integral parts of some local business).
maintaining that the physical presence requirement of *Quill* is limited to sales and use tax.\textsuperscript{26} The challenge from a compliance perspective is determining what states operate under what standard, and within a standard, what does a particular state consider substantial economic activity giving rise to nexus. The Multistate Tax Commission (MTC), which is an intergovernmental state tax agency working on behalf of states and taxpayers to equitably administer state tax laws, attempted to resolve the lack of uniformity on what constitutes substantial activity for income tax nexus by adopting a uniform proposal in 2002.\textsuperscript{27} The proposal, “Factor Presence Nexus Standard for Business Activity Taxes,” implements both a physical presence and economic presence standard to determine nexus and provides an out-of-state entity with a bright-line standard to determine income tax nexus with a jurisdiction. Factor presence nexus exists if any of the following thresholds are exceeded in a taxing jurisdiction during a tax period:

- $50,000 of property,
- $50,000 of payroll,
- $500,000 of sales, or
- Twenty-five percent of total property, payroll, or sales.\textsuperscript{28}

The goal of the proposal was to simplify the standard for the imposition of state tax by defining reasonable amounts of economic or physical activity to justify nexus with a state.\textsuperscript{29} The effect has been less than desirable: a limited number of states have implemented the factor presence standard, and the thresholds vary greatly among the states applying the standard.

Ohio was the first state to codify a factor presence standard when it implemented its Commercial Activity Tax (CAT) in 2005.\textsuperscript{30} However, the CAT is imposed on gross receipts rather than net income, which affords the state less concern with the burdens of challenging P.L. 86-272. As of January 1, 2016, Alabama, California, Colorado, Connecticut, Michigan, New York, Tennessee, and Washington utilize a factor presence standard. However, not all states follow the MTC model rule: Alabama, California, Colorado, Tennessee, and Washington mostly follow the MTC model statute,


\textsuperscript{30} Ohio Rev. Code Ann. § 5751.01(H).
while Connecticut, Michigan, and New York vary slightly in their application of factor presence.\footnote{A LA.C ODE § 40-18-31.2(a); C AL.R EV.&T AX.C ODE § 23101(b) (California’s standard amounts are indexed for inflation—for the 2016 tax year the standards are $547,711, $54,771, and $54,771, respectively); COLO.C ODE REGS. § 22-301.1(2)(b); C ONNECTICUT INFORMATION PUB. IP 2010 (29.1) (Connecticut has a bright line $500,000 of sales as the only criteria for factor presence); M ICH.C OMP.L AWS § 206.621(1) (Michigan has a gross receipts threshold of $350,000); N.Y. T AX LAW § 209(1)(b), (1)(d)(i) (New York has two bright line factor based thresholds, receipts of $1 million or more or, for corporate members of a unitary group, if a member has $10,000 or more of gross receipts in New York, and the combined group equals or exceeds $1 million); T ENN.C ODE ANN. § 67-4-2004; W ASH.R EV.C ODE § 82.04.067, as amended by 2015 W ASH. S.B. 6138, effective Sept. 1, 2015 (Washington implements a $267,000 sales threshold).} 

Although the few factor presence states offer helpful and measurable standards for nexus-creating activities, the majority of states implementing a nexus policy under economic presence do not offer clear guidance. As of 2015, thirty-seven states and Washington, D.C., reported the use of an economic presence standard in determining nexus.\footnote{2015 Survey of State Tax Departments, supra note 27. Four states surveyed failed to respond to the question, and four additional states do not impose a corporate income tax.} Unfortunately, state statutory language routinely fails to clearly state what activity sufficiently creates an economic presence, leaving franchisors with little guidance or certainty in determining a filing obligation. States and taxpayers continue to dispute the legislation, and resolution often centers on nuanced factual differences.

In \textit{Lanco, Inc. v. New Jersey Division of Taxation}, the taxpayer licensed intellectual property to a retailer in New Jersey in exchange for royalty payments.\footnote{879 A.2d 1234 (N.J. Super. Ct. App. Div. 2005).} Lanco had no offices, employees, or tangible property in New Jersey, but the court stated the premise “that the physical presence of the taxpayer or its employee(s), agent(s), or tangible property in a jurisdiction has been and remains a necessary element for a finding of substantial nexus under the Commerce Clause of the United States Constitution. We respectfully disagree.”\footnote{Id. at 1241.} The division argued that abandoning the physical presence requirement recognized that a business can engage in a significant level of commercial activity in a state without ever “setting foot” in a state.\footnote{Id. at 1237.} Provided a state can establish that a business derives substantial benefits from an economic activity in a state, there is no principled reason why physical presence should be required to justify taxation.\footnote{Id.} The court explained that Lanco availed itself of numerous benefits provided by New Jersey. The protection of New Jersey courts and police and fire department protection over the physical property utilizing Lanco’s trademarks was sufficient activity to create “substantial nexus.”\footnote{Id. at 1237–38.} The fundamental conclusion of the \textit{Lanco}}
holding was that the Supreme Court in *Quill* simply did not intend to “create a universal physical presence requirement for state taxation under the Commerce Clause.”

A recent ruling specifically involving franchisors is the 2010 case of *KFC Corp. v. Iowa Department of Revenue*. KFC is a Delaware corporation with its principal place of business in Kentucky. KFC licensed the KFC trademark and related system to independent franchisees. All KFC locations in Iowa were owned by franchisees, and KFC had no property or employees located in the state. KFC owned, managed, protected, and licensed all KFC materials. Additionally, KFC received a monthly four percent royalty from the franchises in Iowa; required franchisees to maintain specific KFC standards for menu items, advertising, marketing, and facilities; and mandated the use of KFC approved vendors for procurement of equipment, supplies, and food.

The court concluded that physical presence is not required for a state to impose an income tax. The franchise right to operate in the state bestowed a direct connection to Iowa upon KFC, and taxing KFC’s activity in Iowa did not place an undue burden on commerce, “but rather a payment to government that provided the economic climate for the business to prosper.”

The court noted “[W]hile ‘physical presence’ may have been a significant feature, if not a requirement, in the Supreme Court’s Dormant Commerce Clause analysis in early sales and use tax cases, ‘physical presence’ in the narrow sense does not appear as an important factor in cases involving state income taxation.” The court further suggested that a physical presence standard for income tax would create a huge loophole in tax structure and would provide incentive for “entity isolation” where taxpayers would create affiliates without physical presence to avoid taxation. A fundamental concept of law the court considered is the substance-over-form approach embraced by the Supreme Court in most modern cases involving the Dormant Commerce Clause. The *KFC* decision removes all doubt, at least in the State of Iowa, that physical presence is no longer a requirement under the Commerce Clause for the state to subject an out-of-state taxpayer to tax. The *KFC* court revealed that cases involving income tax do not look to a bright line

39. 792 N.W.2d 308 (Iowa 2010).
40. *Id.* at 310.
41. *Id.* at 311.
42. The court determined that the intellectual property had a substantial nexus with Iowa because it produced significant royalty income for KFC, and therefore, the presence of the intellectual property was the functional equivalent to “physical presence.” *Id.* at 323–24.
43. *Id.* at 311.
44. *Id.* at 314 (citing Nw. States Portland Cement Co. v. Minnesota, 358 U.S. 450, 464 (1940)).
45. *KFC*, 792 N.W.2d at 328.
46. *Id.* at 313.
47. *Id.* at 328.
“physical presence” standard to determine nexus, but rather a flexible approach focusing on economic reality and the nature of the activity giving rise to the income the state seeks to tax.48

A more recent decision furthered the holding in KFC and arguably expanded nexus-creating activities for intangible holding companies. Jack Daniels Properties, Inc. v. Iowa Department of Revenue contains similar facts to KFC; however, Jack Daniels attempted to differentiate itself from KFC in three ways. First, the appellant did not operate any stores in Iowa; second, the activity in Iowa was negligible compared to the overall business of the company; and third, the appellant did not receive the benefit of “orderly society” in Iowa.49 The administrative law judge concluded the differences to be without distinction. While the appellant did not directly operate under agreements with locally owned businesses, the use of a wholly owned subsidiary was not sufficient to shield the entity from tax.50 Additionally, the administrative law judge found merely having sales in Iowa afforded the company the benefits of “orderly society”; the state provided infrastructure, a regulatory scheme, and legal protection, all of which supported the company and its ability to sell and conduct business in the state.51

A more favorable decision for taxpayers occurred in the 2012 case of Scioto Insurance Co. v. Oklahoma Tax Commission.52 Scioto Insurance Company owned the intellectual property of Wendy’s International through its interest in a single member LLC. Vermont-based Scioto licensed the intellectual property to Wendy’s International, which sublicensed the property to restaurants and franchises in Oklahoma. Payments for the use of trademarks, trade names, and operating practices were based on individual restaurant sales and paid by Wendy’s International to Scioto. Scioto licensed directly with Wendy’s International and had no determination in the restaurant locations nor did Scioto have any direct licensing arrangement with individual restaurants. The Oklahoma Supreme Court declared “Oklahoma simply has no connection to or power to regulate the licensing agreement between Scioto and Wendy’s International.”53 The court distinguished Scioto from Geoffrey since Scioto is not a “shell” entity, and the licensing agreement between Scioto and Wendy’s does not merely exist to create a tax deduction in Oklahoma.54 The payments were due to Scioto irrespective of the Oklahoma

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49. Jack Daniels Props., Inc. v. Iowa Dep’t of Revenue, Nos. 09DORFC002:004 (Iowa Dep’t of Inspections and Appeals Mar. 7, 2012).

50. Id.

51. Id. The “orderly society” is a term used by the court in KFC, which the appellant used to distinguish itself from KFC.

52. 279 P.3d 782 (Okla. 2012).

53. Id. at 783.

54. The court noted, “in the case at hand due process is offended by Oklahoma’s attempt to tax an out of state corporation that has no contact with Oklahoma other than receiving payments from on Oklahoma taxpayer. . . .” Id. at 784.
restaurants payments to Wendy’s International, the payments were a part of its income as an insurance company, and none of that business was conducted in Oklahoma.\textsuperscript{55}

Similarly, the West Virginia Supreme Court in \textit{Griffith v. ConAgra Brands, Inc.} affirmed the finding that ConAgra did not have sufficient contacts with the state to satisfy the Due Process or Commerce Clause nexus requirements.\textsuperscript{56} ConAgra owned trademarks for a variety of food and drink products, which were licensed to numerous licensees in West Virginia. ConAgra manufactured all products and performed all business operations entirely outside of the state. Additionally, ConAgra did not maintain any offices, facilities, inventory, employees, or agents in West Virginia.\textsuperscript{57} The Commerce Clause analysis centered on a “significant economic presence” test, which “incorporates due process ‘purposeful direction towards a state while examining the degree to which a company has exploited a local market.’”\textsuperscript{58} Further, “[a] substantial economic presence analysis involves an examination of both the quality and quantity of the company’s economic presence.”\textsuperscript{59} Finally, under this test, “[p]urposeful direction towards a state is analyzed as it is for Due Process Clause purposes,” and the Commerce Clause analysis requires the additional examination of the “frequency, quantity and systematic nature of a taxpayer’s economic contacts with a state.”\textsuperscript{60}

The court held that although physical presence is not a requirement for nexus, a significant economic presence must exist to subject an out-of-state taxpayer to West Virginia tax.\textsuperscript{61} West Virginia previously determined continuous and systematic direct mailing and telephone solicitation satisfies “significant economic presence” criteria, but ConAgra’s activity in West Virginia did not rise to the same level of purposeful direction. ConAgra did not direct or dictate how licensees distributed the products bearing the ConAgra trademarks and trade names or purposefully direct its products to West Virginia.\textsuperscript{62} Additionally, ConAgra did not distribute any of its products in West Virginia or provide any services in the state.\textsuperscript{63} The court concluded ConAgra’s royalties earned from the licensing of food industry trademarks did not satisfy “purposeful direction” under the Due Process Clause or “significant economic presence” under the Commerce Clause.\textsuperscript{64}

\begin{thebibliography}{99}
\bibitem{55} Id.
\bibitem{56} 728 S.E.2d 74 (W. Va. 2012).
\bibitem{57} Id. at 76.
\bibitem{58} Id. at 81 (quoting Christina R. Edson, \textit{Quill’s Constitutional Jurisprudence and Tax Nexus Standards in an Age of Electronic Commerce}, \textit{49 Tax Lawyer} 893, 943 (Summer 1996)).
\bibitem{59} Id. (quoting Quill’s Constitutional Jurisprudence, supra note 58, at 944).
\bibitem{60} Id. (quoting Quill’s Constitutional Jurisprudence, supra note 58, at 945).
\bibitem{61} ConAgra, 728 S.E.2d at 84; see also W. Va. Tax Comm’r v. MBNA Am. Bank, 640 S.E.2d 226, 227 (W. Va. 2006) (the Court indicated that an entity’s physical presence, required to meet the ‘substantial nexus’ prong of \textit{Complete Auto}, applies only to ‘state sales and use taxes’ and not to corporation net income and business franchise taxes”).
\bibitem{62} MBNAD, 640 S.E.2d at 234.
\bibitem{64} Id. at 84.
\end{thebibliography}
Conclusion

Today, it takes more brains and effort to make out the income-tax form than it does to make the income.—ALFRED E. NEUMAN

The expanding case law on economic presence indicates trends in determining nexus for multistate businesses and franchises. “Shell” intangible holding companies issuing licenses, marketing, merchandising skills, and advertising with brick-and-mortar storefronts can constitute purposeful direction and establish the “minimum contacts” and “substantial nexus” requisite for Due Process and Commerce Clause income tax nexus.65 Additionally, the licensing of an intangible and a “related system,” including purchasing requirements to be implemented by franchisors within a state, will likely establish an economic presence.66 However, the licensing of an intangible with no direct policy or regulation of how the license will be used or how sales or distribution will occur fails to create “purposeful direction” or a “significant economic presence” within a jurisdiction.67 Distinguishing the differences is undoubtedly an arduous task and inhibits the ability of franchisors to understand the full scope of state nexus requirements. However, being aware of what state taxing authorities consider when determining nexus provides a franchisor the ability to recognize when out-of-state activity may require professional tax guidance.

Navigating nexus thresholds for franchisors can be an overly burdensome and potentially unreasonable compliance responsibility. The U.S. Supreme Court’s refusal to consider matters of economic nexus coupled with growing constraints on state budgets is likely to foster further expansion of economic and factor presence principles. The landscape of taxability is dramatically shifting to a prospect where physical presence no longer competently determines nexus. Franchisors and practitioners must scrutinize the structure of franchise agreements, state sales volume, and all contact within a state to determine if economic presence exists. Once nexus is determined, a franchisor is faced with either the choice of compliance, which can be unmanageable, or playing the audit lottery, which can entangle a franchise in costly and lengthy litigation.

Most states offer participation in voluntary disclosure programs where taxpayers can anonymously request to remit outstanding taxes. The benefit of these programs is a limited look-back period for liabilities and a waiver of penalties. Lastly, states periodically offer amnesty programs, which allow for the remittance of outstanding tax with less scrutiny and penalty.

66. ConAgra, 728 S.E.2d at 84. See generally KFC Corp. v. Iowa Dep’t of Revenue, 792 N.W.2d 308 (Iowa 2010).
Changing How Products Get from the Manufacturer to the Customer: Common Questions and Risks

Suzie Trigg and Jamee M. Cotton

It starts with the best of intentions: A startup medical device company has just sold to a larger enterprise with an established sales team and customer base and no longer needs distributors. A consumer packaged goods company has just bought a brand and needs to transition to a new team of brokers. A growing company is finally ready to take its supply chain captive, including the distribution of products to customers, and no longer needs small distributors or sales representatives. Then, surprisingly, rather than joining together to celebrate good fortune and new opportunities, the manufacturer or marketer of products finds itself embroiled in a bitter dispute with departing distributors, brokers, or sales representatives, or subject to demands for payment for goodwill that such parties believe that they have built for the manufacturer’s brand. A current example is Kellogg’s new supply-chain model—the transition from direct-store delivery to a retail-warehouse model—which eliminates the need for its independent distributors and streamlines distribution to keep up with e-commerce and rising consumer demands. Kellogg’s transition to its modern supply-chain model is currently receiving significant push back from a handful of its independent distributors that have been terminated as a result. Kellogg’s story will not be the last, and rising consumer expectations on fast, cost-efficient delivery will certainly continue as growing e-commerce platforms set the standard.

1. Manufacturers and marketers of products utilizing distributors, sales representatives, brokers or similar third-party distribution networks are collectively referred to in this article as “manufacturers.”
3. Id.
As with most business matters, advance planning is crucial to avoiding disputes with distributors, sales representatives, brokers, and similar parties when a company changes its distribution strategy. Where possible, a look at what could be in the future might present a company with an opportunity to develop a strategy that works for both the company and its business partners. When that is not possible, knowledge of the common pitfalls of terminating or refusing to renew distribution agreements, broker agreements, and sales representative or referral agreements helps to inform the manufacturer of whether there is risk, and if there is risk, then what the risk actually is, and eventually, a way to a solution that in many cases may help avoid costly and distracting litigation.

Section I of this article discusses, generally, the legal theories that a manufacturer may encounter in a contested nonrenewal or termination of an agreement. Section II takes a closer look at the potential application of franchise relationship laws and discusses what constitutes “good cause” for nonrenewal or termination. Section III of this article discusses the potential application of Article 2 of the Uniform Commercial Code and what constitutes “reasonable notice.” Finally, Section IV provides an overview of the often-overlooked sales representative laws.

I. Overview of the Nonrenewal or Termination of Product Distribution Agreements

Accidental franchises are often alleged to have arisen from distribution relationships. Therefore, manufacturers should consider the potential impact of state and federal franchise disclosure, registration, and relationship laws at both the beginning and end of their distribution relationships. Careful structuring of an underlying agreement at the onset may help a manufacturer avoid triggering franchise registration and disclosure laws. At the end of the relationship, a manufacturer with a well-structured distribution agreement may be relieved to have grounds for termination and notice periods that align with state franchise relationship laws, so that even if such laws are alleged to apply, the application is a distinction without a practical difference in the treatment of the termination of the agreement.

Often, manufacturers attempt to use a single template for domestic distribution agreements and a single template for international distribution agreements. A one-size-fits-all approach may not be the most beneficial; nor is such an approach typically feasible given the broad range of applicable

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4. The focus of this article is agreements where both parties are doing business in the United States. Practitioners and manufacturers should be aware that there are significant laws, including franchise, dealership, agency, and other laws, governing distribution relationships worldwide and that qualified local counsel should review and advise on the formation, nonrenewal, or termination of an international distribution agreement. The International Distribution Institute provides detailed country reports, model contracts, and resources for local counsel in various jurisdictions. The Institute’s general website is https://www.idiproject.com/.
laws and regulations. This section identifies the most relevant laws for manufacturers to consider when structuring a distribution network and when making changes to the distribution network, such as the nonrenewal or termination of existing distribution agreements.

_Beware_: Many available forms of distribution agreement have a provision such as the following: “The Parties to this Agreement are independent contractors and nothing in this Agreement shall be deemed or constructed as creating a joint venture, partnership, agency relationship, franchise, or business opportunity between Seller and Distributor.”\(^5\) Although such a provision might be helpful to establish the parties’ intent, it is not itself determinative of whether the arrangement may be deemed a franchise and does not preclude the application of franchise registration, disclosure, or relationship laws, or business opportunity laws.

**A. Franchise Registration and Disclosure Laws**

Most manufacturers do not think of franchising when structuring distribution arrangements because “business format” franchises, such as restaurants or other service based businesses, typically come to mind when one thinks of franchising. In addition, distribution arrangements usually do not include royalties and other fees, another hallmark of a typical franchise. Therefore, manufacturers may overlook the potential application of franchise registration and disclosure laws. A better approach is for a manufacturer to carefully document the availability of exclusions or exemptions from the application of such laws and to consider whether, or to what extent, the distribution or other agreement should be revised to clearly reflect the parties’ intent. For example, the manufacturer may consider including a provision in a distribution agreement that the distributor is not to pay any fees or amounts to the manufacturer except for the purchase of goods for resale and that the manufacturer does not determine the distributor’s method of doing business. Early consideration of the potential application of franchise registration and disclosure laws (as well as business opportunity laws) also permits the manufacturer to avoid common pitfalls, such as required purchases of inventory.

A distributor will typically wait until the manufacturer threatens (or provides notice of) nonrenewal or termination of the underlying agreement to allege that the arrangement was a franchise for which the manufacturer should have provided a Franchise Disclosure Document (FDD) and, if applicable, registered an FDD. The prudent manufacturer will instead address this potential issue at the outset to ensure that if the manufacturer intends to operate within exemptions or exclusions from the application of franchise

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registration and disclosure laws, the arrangement is structured so that it does not accidentally become a franchise.

A *franchise* occurs when a business (a *franchisor*) licenses its trade name or trademarks and operating methods (i.e., a system of doing business) to a person or entity (the *franchisee*) that agrees to pay certain fees and operate according to the terms of a written agreement for the right to sell the goods or services of the franchisor and benefit from the franchisor’s business methods, trademarks, goodwill, professional training, and operating assistance. A franchise is made up of three elements: (1) use of trademarks, (2) control and/or assistance from the franchisor, and (3) initial and/or ongoing fees. Franchising in the United States is regulated by the Federal Trade Commission (FTC) and state franchise laws.

The problem: Any business relationship that satisfies all three definitional elements—regardless of the “label” or structure of such relationship—may constitute a *franchise* under the broad federal and state franchise laws. Thus, a distributorship is equally susceptible to franchise regulations and rules despite its lack of resemblance to a “franchisor/franchisee” relationship in the traditional sense.

1. The Franchise Rule

The Federal Trade Commission Disclosure Requirements and Prohibitions Concerning Franchising (Franchise Rule) requires franchisors to provide full presale disclosure to prospective franchise purchasers (FDD). The Franchise Rule is applicable in all fifty states plus the U.S. territories (such as Puerto Rico and Guam). In relevant part, the FTC defines a “franchise” as follows:

*Franchise* means any continuing commercial relationship or arrangement, whatever it may be called, in which the terms of the offer or contract specify, or the franchise seller promises or represents, orally or in writing, that:

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

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

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

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6. 16 C.F.R. § 436.1(h).
7. Id.
8. See infra note 13 and accompanying text.
9. 16 C.F.R. § 436.2(a) (“It is an unfair or deceptive act or practice in violation of Section 5 of the [FTC Act] [f]or any franchisor to fail to furnish . . . the franchisor’s most recent disclosure document. . . .”).
10. 16 C.F.R. § 436.1(h).
Fifteen states have separate franchise registration and/or disclosure laws generally applicable to most U.S. franchise programs. The requirements of these laws vary from mere one-page filings to actual registrations involving a comprehensive application and review process by the state. Completion of the registration process is necessary, in most cases, prior to a franchisor initiating any offering activity in a state.

Unfortunately, state franchise laws lack a uniform definition of what constitutes a franchise. However, many state franchise registration and disclosure statutes categorize a relationship as a franchise whenever a franchisee, in return for a franchise fee, is granted the right to sell goods or services under a marketing plan or system prescribed in substantial part by the franchisor if the operation of the franchisee’s business pursuant to that marketing plan or system is substantially associated with the franchisor’s trademark, service mark, or other commercial symbol.

If a transaction satisfies the definition of a franchise under the Franchise Rule, and no exemption or exclusion from the Franchise Rule’s application applies, it is a violation of Section 5 of the FTC Act for a franchisor to fail to furnish an FDD to a prospective franchisee. Although there is no private right of action for a franchisee to enforce the Franchise Rule, the FTC may pursue an enforcement action against a party that violated the Franchise Rule (and therefore, the FTC Act). However, as discussed later, although the coverage of the Franchise Rule is, at least on its surface, quite broad, many distribution networks find that such arrangements fall within an exemption or exclusion from its application. If an exemption or exclusion applies, a franchisor need not provide an FDD under federal law.

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11. These states are California, Hawaii, Illinois, Indiana, Maryland, Michigan, Minnesota, New York, North Dakota, Oregon, Rhode Island, South Dakota, Virginia, Washington, and Wisconsin. See Appendix A for a chart outlining the corresponding state statutes.
12. A minority of state franchise disclosure laws consider a franchise to exist whenever a franchisee, in return for a franchise fee, is granted the right to sell goods or services using the franchisor’s trademark, service mark, or other commercial symbol if the franchisor and franchisee have a “community of interest” in the marketing of such goods or services.
15. In addition, many states have so-called “Little FTC Acts” that afford litigants a private right of action against a party that has engaged in deceptive or unfair treatment, which may include a violation of the Franchise Rule. See generally Altresha Q. Burchett-Williams, Robert M. Einhorn & Paula J. Morency, Claims Under the “Little FTC Acts”: The High Stakes of Risk and Reward, ABA 33rd ANNUAL FORUM ON FRANCHISING (2010). While Little FTC Acts often codify common law concepts, they are often more liberal in permitting causes of action that would fail to satisfy the requirements of a common law claim for fraud or misrepresentation. Id.
16. “The provisions of part 436 shall not apply if the franchisor can establish” the applicability of an exemption. 16 C.F.R. § 436.8(a). An exemption from the Franchise Rule does not constitute an exemption under applicable state franchise registration and disclosure laws, and an analysis of the applicability of state exemptions from disclosure and/or registration must be independently undertaken.
2. A Distributorship Is Not a Franchise

Since most distribution arrangements permit the use of the manufacturer’s trademark to distribute products, the first prong of the definition of a franchise is typically satisfied.17 The lack of an express trademark license does not necessarily negate the trademark element—a certain trap for the unsuspecting manufacturer. In fact, only a minority of states technically require the grant of a trademark license to satisfy this element.18 Even in those “license to use” states, courts have stretched the definition to encompass a de facto trademark license, regardless of explicit contract authority.19 The majority of state franchise laws, on the other hand, apply the “substantial association” test.20 For example, Michigan law defines this element as follows:

A franchisee is granted the right to engage in the business of offering, selling, or distributing goods or services substantially associated with the franchisor’s trademark, service mark, trade name, logotype, advertising, or other commercial symbol designating the franchisor or its affiliate (emphasis added).21

Although states do not uniformly apply “substantial association,” many courts have found the trademark element is met when branded products account for a significant percentage of the independent distributor’s overall sales.22 Other states define the element so broadly it would almost always include distributorships or similar business relationships.23 As a practical matter, the use of typical promotional materials and the promotion of products on websites and otherwise may go a long way to satisfying this element.

As to whether a “significant degree of control” over method of operation or “significant assistance” is present (the second element), the FTC has instructed that significant types of control include, among others, “site ap-

18. See, e.g., N.J. STAT. § 56:10-3; MO. REV. STAT. § 407.400.
19. See, e.g., McPeak v. S-L Distrib. Co., No. 12-348 (RBK/KMW), 2014 U.S. Dist. LEXIS 10794, at *12–18 (D.N.J. Jan. 29, 2014) (acknowledging a trademark license may exist where a manufacturer referred to its distributors as “salespeople” and the distributor used the manufacturer’s trademarks on clothing and vehicles, despite the contract containing specific language prohibiting the distributor from conducting business under the manufacturer’s name, trademarks, or trade names).
20. See, e.g., CAL. BUS. & PROF. CODE § 20001; CONN. GEN. STAT. § 42-133e(b); 815 ILL. COMP. STAT. 705/3; IND. CODE § 23-2-2.5-1; IOWA CODE §§ 523H.1, 537A.1; MICH. COMP. LAWS § 445.1502; VA. CODE § 13.1-559; WASH. REV. CODE § 19.100.010(6).
23. E.g., MINN. STAT. § 80C.1 (trademark element only requires the distribution of goods “using” the franchisor’s trade name or trademark); IOWA CODE §§ 523H.1.3, 537A.1.c(ii) (trademark element satisfied where the agreement merely “allows” the business to be substantially associated with the franchisor’s trademark). For additional commentary on the application of “substantial association” under state law, see Daniel J. Oates et al., Substantial Association with a Trademark: A Trap for the Unwary, 32 FRANCHISE L.J. 130 (Winter 2013).
proval for unestablished businesses, site design or appearance requirements, hours of operation, production techniques, accounting practices, personnel policies and practices, promotional campaigns requiring franchisee participation or financial contribution, restrictions on customers, and location or sales area restrictions.”24 Significant types of assistance include “formal sales, repair or business training programs, establishing accounting systems, furnishing management, marketing or personnel advice, selecting site locations, and furnishing a detailed operating manual.”25 Although control over or assistance provided to distributors is not generally significant enough to meet the threshold of the second prong of the definition of franchise, it is safest to assume that the second prong could be met because definitively disproving this element may time-consuming and expensive. Notably, state laws typically replace the second element—significant control or assistance by the franchisor—with a similar statutory element: marketing plan (e.g., a marketing plan prescribed by the franchisor or advice regarding operations) or community of interest (e.g., continuing financial interest or interdependence among the parties).26 These elements may also be problematic for a manufacturer and, even if the arrangement does not meet the applicable state law’s definition, it may take significant litigation to reach a definitive conclusion.

Finally, the Franchise Rule requires that for an arrangement to be a franchise, the franchisee must make a required payment to the franchisor or its affiliate.27 This is where most distribution relationships fall short of being deemed franchises. Still, because of how a “required payment” is defined, manufacturers should consider whether minimum purchase requirements, sales quotas, or amounts paid for training or the purchase of marketing materials are worth the risk.

The Franchise Rule defines a “required payment” as “all consideration that the franchisee must pay to the franchisor or an affiliate, either by contract or by practical necessity, as a condition of obtaining or commencing operation of the franchise.”28 The FTC has indicated that the definition of payment “is intended to be read broadly, capturing all sources of revenue that a franchisee must pay to a franchisor or its affiliate for the right to associate with the franchisor, market its goods or services, and begin operation of the business.”29 For example, payment may include rent/real estate leases,

24. **COMPLIANCE GUIDE, supra** note 17, at 3.
25. **Id.**
27. 16 C.F.R. § 436.1(h)(3).
28. 16 C.F.R. § 436.1(s).
29. 16 C.F.R. § 436.1(h), **COMPLIANCE GUIDE, supra** note 17, at 5.
advertising assistance, equipment and supplies, training, non-refundable bookkeeping charges, promotional literature, security deposits, or continuing royalties on sales, among other payments, if such amounts are paid to the franchisor or its affiliate. Payments to third parties, however, are not included in the FTC’s definition of payment in the Franchise Rule.

Most distributorship networks do not satisfy the final definitional prong because of the bona fide wholesale price exclusion (i.e., where a new distributor does not pay a distribution fee or make any other required payment to the manufacturer). Specifically, the Franchise Rule states: “A required payment does not include payments for the purchase of reasonable amounts of inventory at bona fide wholesale prices for resale or lease.” In order for the bona fide wholesale price exception to apply, the manufacturer must only require the distributor to purchase inventory in amounts that are reasonable for starting inventory or on-going supply. If a manufacturer requires purchases in excess of that amount, those purchases may be deemed to be a required payment or franchise fee. The bona fide wholesale price exemption is applicable only to the purchase of goods that a distributor is authorized to distribute. It does not apply to the purchase of raw materials required to manufacture the goods that are ultimately sold to the consumer. In addition, if a distribution territory is sold by one distributor that is not affiliated with the manufacturer to a new distributor, and the manufacturer does not receive any payment from the new distributor and is not significantly involved in the transaction, the arrangement will not meet the definition of a franchise. In fact, to sweeten the deal for departing (non-renewed or terminated) distributors, manufacturers often suggest a transfer of the distribution rights to a third party that may be willing to compensate the distributor for such rights.

If an exemption or exclusion applies, a franchisor need not provide an FDD under federal law. As noted earlier, the exclusion of purchases of inventory at bona fide wholesale prices is often utilized for distribution networks. The analysis, however, does not end there. A manufacturer should also separately evaluate the applicability of the state’s franchise law to determine whether it can avail itself of an exemption or exclusion under state law. If there is no distribution fee or other required payment, the evaluation may be very limited, such as confirming that the state’s law provides for a whole-

30. 16 C.F.R. § 436.1(h), COMPLIANCE GUIDE, supra note 17, at 5–6.
31. 16 C.F.R. § 436.1(h), COMPLIANCE GUIDE, supra note 17, at 21.
32. 16 C.F.R. § 436.1(h)
33. Id. at § 436.1(t) (The sale of a franchise “does not include the transfer of a franchise by an existing franchisee where the franchisor has had no significant involvement with the prospective franchisee. A franchisor’s approval or disapproval of a transfer alone is not deemed to be significant involvement.”).
34. “The provisions of part 436 shall not apply if the franchisor can establish” the applicability of an exemption. 16 C.F.R. § 436.8(a). An exemption from the Franchise Rule does not constitute an exemption under applicable state franchise registration and disclosure laws, and an analysis of the applicability of state exemptions from disclosure and/or registration must be independently undertaken.
sale price exclusion. Although state franchise disclosure laws are similar to the Franchise Rule, the definitions utilized, applicable common law, and exclusions and exemptions available under such laws vary.35

B. Franchise Relationship Laws

If distributing products worldwide, many manufacturers are aware of the potential application of agency laws that may provide significant protection for distributors and thwart a manufacturer’s efforts to replace a distributor in certain territories. Often, however, manufacturers do not realize that the potential application of franchise relationship laws in the United States may jeopardize their efforts to replace, refuse to renew, or terminate distribution arrangements.

Some states govern substantive aspects of a franchise business relationship after an agreement is signed.36 These laws are often designed to protect franchisees from termination without “good cause,” termination or nonrenewal of the agreement without advance notice or an opportunity to cure alleged defaults, and discrimination. It is common for a distributor to allege the application of such laws in connection with an effort by its manufacturer to terminate the distributorship or refuse to renew upon expiration of the agreement. Therefore, manufacturers should evaluate the potential application of such laws prior to issuing a notice of default or termination, or undertaking a similar change in a relationship with a distributor. Section II further explores the application of franchise relationship laws in the termination and nonrenewal context.

C. Article 2 of the Uniform Commercial Code

The Uniform Commercial Code (UCC)—a version of which is codified in most states—applies to contracts for the sale of goods and therefore most distribution agreements. If applicable, the UCC affects how parties may terminate a distribution agreement. Importantly, if a distribution agreement does not address the notice required prior to termination, the UCC will supply the missing term, which often imposes a “reasonable notice” requirement on the parties to the distribution agreement. As discussed further in Section III, many state statutes require “reasonable notice,” and the common law provides guidance on such issues.

D. Common Law Attempts at Achieving Equity

Courts continue to examine and define the contours of frequently litigated issues, such as termination or nonrenewal in the context of distribution relationships. Manufacturers must be mindful of potential claims arising under state common law as a result of terminating a distributor or dealer. Of course, a party to an agreement can assert a breach of contract claim, whether based on the express terms of the agreement or covenants or duties

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35. See 16 C.F.R. § 436.1(h), App. A.
36. See Section II for charts identifying state relationship laws and outlining procedural requirements related to termination and nonrenewal.
implied by law, such as good faith and fair dealing. Good faith and fair dealing claims often accompany “without cause” termination provisions and have been applied in various situations to prevent unjust terminations. However, many jurisdictions do not recognize such claims absent a connection with an express term of the agreement.

Depending on the jurisdiction, terminated distributors may also have other claims under state law, including tortious interference, constructive termination, or recoupment.

E. Sales Representative Laws

Manufacturers also may be subject to state legislation governing wholesale representatives and the unlawful termination of their territorial markets. State representative laws generally entitle the representative to reasonable compensation upon termination without good cause or upon expiration of the agreement. In fact, some state laws are drafted such that compensation claims at the end of the relationship are likely unavoidable, making it even more important for suppliers to consider this particular risk. Section IV further explains the scope of these often overlooked laws and details important considerations related to termination or nonrenewal when these statutes may apply.

F. Business Opportunity Laws

In addition to the Franchise Rule and state franchise disclosure, registration and relationship laws, there is a federal business opportunity rule and many states have business opportunity laws. Manufacturers should be aware of and plan for the potential application of these business opportunity laws although the threshold of most distribution arrangements far exceeds their application. Typically, business opportunity laws, like franchise laws, require presale disclosure of enumerated facts about the business opportunity seller.

The federal business opportunity rule contains disclosure requirements that are somewhat similar to, but not the same as the Franchise Rule. Similar to the Franchise Rule, a violation of the business opportunity rule, while not affording a private right of action, is a violation of federal law. A business opportunity is a commercial arrangement which:

1. A seller solicits a prospective purchaser to enter into a new business; and
2. The prospective purchaser makes a required payment; and
3. The seller, expressly or by implication, orally or in writing, represents that the seller or one or more designated persons will:

37. See Appendix B for a chart outlining the corresponding state sales representative statutes.
38. See Appendix C for a chart outlining state business opportunity laws.
39. 16 C.F.R. § 437.
40. Id.
41. “Designated person means any person, other than the seller, whose goods or services the seller suggests, recommends, or requires that the purchaser use in establishing or operating a new business.” 16 C.F.R. § 437.1(d).
(i) Provide locations for the use or operation of equipment, displays, vending machines, or similar devices, owned, leased, controlled, or paid for by the purchaser; or
(ii) Provide outlets, accounts, or customers, including, but not limited to, Internet outlets, accounts, or customers, for the purchaser’s goods or services; or
(iii) Buy back any or all of the goods or services that the purchaser makes, produces, fabricates, grows, breeds, modifies, or provides, including but not limited to providing payment for such services as, for example, stuffing envelopes from the purchaser’s home.42

Similar to the Franchise Rule, there are several exemptions and exclusions available under the business opportunity rule, including if the seller complies with the disclosure requirements of the Franchise Rule.43

State business opportunity laws can be complex and inconsistent. In Texas, the Business Opportunity Act44 is applicable in similar (though not identical) circumstances as the federal business opportunity law. State laws also contain various exemptions and exclusions. For example, under the Texas Business Opportunity Act, a business opportunity does not include a sale of products to a business enterprise that also sells products that are not supplied by the seller.45

For the same reasons discussed above,46 manufacturers should address this possible issue at the creation of its business model instead of waiting until a distributor raises the application of and disclosure obligations under business opportunity laws, which typically occurs when a dispute arises at the end of a business relationship.

II. Franchise Relationship Laws and “Good Cause”

A. Cases Interpreting Whether Franchise Relationship Laws Apply

The wide array of state relationship laws makes it critical for manufacturers to assess whether a distribution arrangement meets the definition of a “franchise” under a particular state law. This is especially important at the end of the business relationship. Although a distribution agreement may not readily appear to comprise a franchise, some state relationship statutes define a “franchise” so broadly that traditional distributorships may also be covered. In fact, some state relationship laws define “franchise” without reference to any required payment or fee.47

42. 16 C.F.R. § 437.1(c).
43. 16 C.F.R. § 437 et seq.
44. TEX. BUS. & COMM. CODE § 51.001 et seq.
45. TEX. BUS. & COMM. CODE § 51.003(b)(5).
46. See supra Section II.A.
47. See, e.g., ARK. CODE ANN. § 4-72-202(1)(A); CONN. GEN. STAT. § 42-133e(b); N.J. STAT. ANN. §§ 56:10-3(a), 4(a); MO. REV. STAT. § 407.400(1).
The following are examples in which courts have applied state franchise laws to distributorships or similar arrangements—sometimes referred to as “accidental” or “hidden” franchises.48

- **Appliance manufacturer** was a franchisor and one of its exclusive regional distributors was a franchisee under the New Jersey Franchise Practices Act where the distributor made substantial franchise-specific investments and those investments created franchise-specific goodwill.49

- **Software distributor**’s $125,000 payment for billing program constituted a franchise fee under the Minnesota Franchise Act.50

- **Furniture dealer**’s relationship with licensed store owner constituted a franchise under Illinois Franchise Disclosure Act because the dealer charged an indirect franchise fee in the form of a two percent advertising contribution.51

- **Forklift distributor**’s required payments for service and parts manuals constituted an indirect franchise fee sufficient to invoke protection under the Illinois Franchise Disclosure Act.52

- **Automobile parts dealer** demonstrated a community of interest sufficient to constitute a franchise through evidence of significant franchise-specific investments in the form of inventory, a computer system, and goodwill, as well as the economic interdependence of the two entities.53

- **Office products manufacturer** held to be a franchisor within the meaning of the California Franchise Investment Law where its distributors were required to, among other things, use best efforts to actively solicit orders, install products, provide ongoing serves to customers, and were subject to prices and terms set by the manufacturer.54

- **Slot machine distributor** in New Jersey protected from termination under the New Jersey Franchise Practices Act where the distributor made franchise-specific investments demonstrated by purchasing service manuals and state...
tionery, leasing additional warehouse space for the product, and advertising as the manufacturer’s exclusive distributor, and where interdependence was shown through evidence of joint activities, such as promotions, events, demonstrations, training, customer focus groups, and product introductions and servicing.\textsuperscript{55}

- \textit{Snack distributorship} constituted a franchise where the distributor paid a fee for training, the supplier and distributor shared fees from a common source, and distributor had the right to use the seller’s trademarks.\textsuperscript{56}

- \textit{Baked goods manufacturer} was a franchisor and its route distributors were franchisees under the Connecticut Franchise Act due to the amount of control exerted over the operations of its distributors, including control over prices, promotions and discounts, product placement, and performance standards and procedures.\textsuperscript{57}

No state applies the definition of a franchise in exactly the same way, and it is not hard to see why even sophisticated manufacturers may be covered by state franchise legislation. Inevitably, whether a distributorship constitutes a franchise affects how the business grows and changes throughout time.

\section*{B. \textit{What Is “Good Cause”?}}

Most state relationship laws require “good cause” for terminating or refusing to renew a franchise. The chart below identifies which U.S. state franchise relationship laws require “good cause” in the context of termination and nonrenewal:

\begin{table}[h]
\centering
\begin{tabular}{|l|l|c|c|}
\hline
\textbf{State} & \textbf{Citation} & \textbf{GOOD CAUSE?} & & \\
 & & \textbf{TERMINATION} & \textbf{NONRENEWAL} & \\
\hline
Arkansas & \textsc{Ark. Code} § 4-72-204 & ✓ & ✓ & \\
\hline
California & \textsc{Cal. Bus. & Prof. Code} §§ 20020, 20025 & ✓ & ✓ & \\
\hline
Connecticut & \textsc{Conn. Gen. Stat.} § 42-133f & ✓ & ✓ & \\
\hline
Delaware & \textsc{Del. Code. Tit. 6} § 2552 & ✓ & ✓ & \\
\hline
Hawaii & \textsc{Haw. Rev. Stat.} § 482E-6 & ✓ & ✓ & \\
\hline
Illinois & \textsc{815 Ill. Comp. Stat.} 705/19 & ✓ & & \\
\hline
Indiana & \textsc{Ind. Code} § 23-2-2.7-1 & ✓ & ✓ & \\
\hline
Iowa & \textsc{Iowa Code} §§ 523H.7, 523H.8 & ✓ & ✓ & \\
\hline
Michigan & \textsc{Mich. Comp. Laws} § 445.1527 & ✓ & & \\
\hline
\end{tabular}
\caption{(Continued)}
\end{table}

\textsuperscript{56} Metro Áll Snax, Inc. v. All Snax, Inc., Bus. Franchise Guide (CCH) ¶ 10,885 (D. Minn. 1996).
\textsuperscript{57} Petereit v. S.B. Thomas, Inc., 63 F.3d 1169 (2d Cir. 1995).
There is no uniform definition of “good cause” although many state relationship statutes attempt to define or limit the parameters of the term. A handful of states define “good cause” as “failure by the franchisee to substantially comply with the material and reasonable requirements imposed by the franchisor....” Others contain unique requirements or examples of good cause. Below is a non-exhaustive list of specific statutory examples of good cause for termination:

- Failure to cure a breach or repeated noncompliance of the agreement
- Voluntary abandonment of the franchise
- Criminal conviction related to the franchise business
- Insolvency or bankruptcy
- Failure to pay sums due
- Loss of either party’s right to occupy the franchise premises
- Material misrepresentation made by franchisee related to the franchise
- Franchisee conduct that materially impairs the goodwill of the franchise business or impairs the franchisor’s trademark or trade name
- Public health and safety issues
- Failure to act in good faith
- Failure to comply with other laws applicable to the operation of the franchise

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58. MINN. STAT. § 80C.14(b); see also, e.g., NEB. REV. STAT. § 87-402(8); N.J. STAT. § 56.10-5; R.I. GEN. LAWS § 6-50-2(4); WIS. STAT. § 135.02(4).

59. This list was adapted from FUNDAMENTALS OF FRANCHISING 389 (Rupert M. Barkoff et al. eds., 4th ed. 2015). The list comprises examples from various state laws and should not substitute a state-specific analysis of the applicable state statute governing the relationship.
Likewise, a subset of state relationship statutes also require good cause for nonrenewal by the franchisor. Of the states that require good cause for nonrenewal, several specifically permit nonrenewal in certain circumstances. Nebraska, for example, permits nonrenewal where the agreement provides that the franchise is not renewable or that the franchise is renewable only if the franchisor or franchisee meets certain reasonable conditions. Illinois, Michigan, and Washington do not require good cause for nonrenewal, but specify the circumstances in which renewal is required or prohibited—e.g., the application of post-term non-competition provisions or fair compensation upon nonrenewal.

Because courts continue to examine the “good cause” requirement, evaluating the individual state’s case law is just as important as examining the applicable statute. Each case is fact intensive; however, courts regularly address good cause in the context of a franchisee’s failure to pay amounts owed or meet performance requirements or a franchisor’s (supplier’s) withdrawal from or reorganization in a particular geographic area.

C. Other Procedural Requirements for Termination and Nonrenewal

State relationship laws—with or without a “good cause” requirement—may also impose procedural requirements on those who are deemed to be franchisors under such laws that are electing not to renew or terminate a franchise. Consequently, a franchisor may need to provide its franchisee with advance written notice or the opportunity to cure a default depending on the applicable state law. The chart below provides a general summary of the procedural requirements for termination and nonrenewal under state franchise relationship laws:

<table>
<thead>
<tr>
<th>State</th>
<th>General Citation</th>
<th>Procedural Requirements</th>
</tr>
</thead>
<tbody>
<tr>
<td>Arkansas</td>
<td>Ark. Code §§ 4-72-201 et seq.</td>
<td>Termination and nonrenewal require 90 days’ written notice setting forth the reasons for such action, and 30-day cure period. 10-day cure period required for repeated deficiencies within a 12-month period. Exceptions for notice and cure under certain circumstances.</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>State</th>
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</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>CA. BUS. &amp; PROF. CODE §§ 20000 et seq.</td>
<td>Termination requires <strong>60 days’ notice</strong> and <strong>60-day cure period.</strong> The cure period shall not exceed 75 days, unless otherwise specified by the franchise agreement. Franchisor must give at least <strong>180 days’ notice of nonrenewal</strong> and meet at least one of the other statutory requirements for nonrenewal. Franchisor may extend the expiration of the current franchise term for a limited period in order to satisfy the time of notice of nonrenewal requirement. Immediate termination and nonrenewal under certain circumstances.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>CONN. GEN. STAT. §§ 42-133e et seq.</td>
<td>Termination and nonrenewal require <strong>60 days’ notice</strong>, which must state the reasons for such action. <strong>Six months’ notice</strong> if nonrenewal based on sale or lease of franchise premises, conversion of property, or expiration of lease. <strong>30 days’ notice</strong> if termination or nonrenewal based on voluntary abandonment by franchisee. Immediate termination or nonrenewal upon notice under certain circumstances. <strong>No cure period required.</strong></td>
</tr>
<tr>
<td>Delaware</td>
<td>DEL. CODE. TIT. 6 §§ 2551 et seq.</td>
<td>Notwithstanding any provision in a franchise agreement which provides otherwise, termination and nonrenewal require at least <strong>90 days’ notice.</strong> <strong>No cure period required.</strong></td>
</tr>
<tr>
<td>Hawaii</td>
<td>HAW. REV. STAT. §§ 482E-1 et seq.</td>
<td>Termination requires <strong>written notice and a reasonable opportunity to cure.</strong> Upon termination or expiration of franchise after the refusal to renew, the franchisor may owe the franchisee fair compensation under certain circumstances.</td>
</tr>
<tr>
<td>Illinois</td>
<td>815 ILL. COMP. STAT. 705/1 et seq.</td>
<td>Termination requires <strong>notice and a reasonable opportunity to cure.</strong> No specified period to cure, but need not be more than 30 days. Nonrenewal requires <strong>6 months’ notice.</strong> Failure to provide adequate notice may require the franchisor to provide fair compensation to the franchisee.</td>
</tr>
<tr>
<td><strong>State</strong></td>
<td><strong>General Citation</strong></td>
<td><strong>Procedural Requirements</strong></td>
</tr>
<tr>
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</tr>
<tr>
<td>Indiana</td>
<td>IND. CODE §§ 23-2-2.7-1 et seq.</td>
<td>Termination and nonrenewal require 90 days’ notice. The statute does not prevent a franchise agreement from providing that the agreement is not renewable upon expiration or that the agreement is only eligible for renewal under certain conditions. No cure period required.</td>
</tr>
<tr>
<td>Iowa</td>
<td>IOWA CODE §§ 523H.1 et seq.</td>
<td>Termination requires written notice setting forth reasons for such action, and a 30-90 day cure period. The cure period need not exceed 30 days for non-payment. Immediate termination upon notice and without opportunity to cure under certain circumstances. Nonrenewal requires 6 months’ notice and meets one of the additional statutory requirements for nonrenewal.</td>
</tr>
<tr>
<td>Michigan</td>
<td>MICH. COMP. LAWS §§ 445.1501 et seq.</td>
<td>Termination requires notice and a reasonable opportunity to cure. No specified period to cure, but need not be more than 30 days. Nonrenewal under certain conditions may require the franchisor to provide 6 months’ notice or provide fair compensation at the time of expiration.</td>
</tr>
<tr>
<td>Minnesota</td>
<td>MINN. STAT. §§ 80C.01 et seq.</td>
<td>Termination requires 90 days’ notice, which sets forth the reasons for such action, and 60-day cure period. Immediate termination upon notice under certain circumstances. Nonrenewal requires 180 days’ notice and 60-day cure period. The franchisor must also give the franchisee an opportunity to operate the franchise for a sufficient period of time to enable the franchisee to recover the fair market value of the franchise as a going concern.</td>
</tr>
<tr>
<td>Mississippi</td>
<td>MISS. CODE §§ 75-24-51 et seq.</td>
<td>Termination and nonrenewal require 90 days’ notice. Immediate termination upon notice under certain circumstances. No cure period required.</td>
</tr>
</tbody>
</table>

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<table>
<thead>
<tr>
<th>State</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Missouri</td>
<td>MO. REV. STAT. §§ 407.400 et seq.</td>
<td>Termination and nonrenewal require 90 days’ notice. Immediate termination upon notice under certain circumstances. No cure period required.</td>
</tr>
<tr>
<td>Nebraska</td>
<td>NEB. REV. STAT. §§ 87-401 et seq.</td>
<td>Termination and nonrenewal require 60 days’ notice. The statute does not prevent a franchisor from providing that the franchise is not renewable or that the franchise is only renewable if the franchisor or franchisee meets certain reasonable conditions. Termination for voluntary abandonment requires 15 days’ notice. Immediate termination upon notice under certain circumstances. No cure period required.</td>
</tr>
<tr>
<td>New Jersey</td>
<td>N.J. STAT. §§ 56.10-1 et seq.</td>
<td>Termination and nonrenewal require 60 days’ notice setting forth the reasons for such action. Termination for voluntary abandonment requires 15 days’ notice. Immediate termination upon notice under certain circumstances. No cure period required.</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>R.I. GEN. LAWS §§ 6-50-1 et seq.</td>
<td>Termination and nonrenewal require 60 days’ notice, which sets forth the reasons for such action, and a 30-day cure period; provided that a dealer has a right to cure 3 times in any 12-month period during the term of the agreement. Immediate termination upon notice under certain circumstances. Termination or nonrenewal for non-payment requires 10-day cure period; provided that a dealer has a right to cure 3 times in any 12-month period during the term of the agreement. If the reason for termination or nonrenewal is for violation of any law, regulation, or standard concerning public health or safety, the dealer is entitled to immediate, written notice, and a 24-hour cure period.</td>
</tr>
</tbody>
</table>
D. Beware: Termination for Convenience Clauses

The “good cause” quandary may not raise a red flag for those who have carefully crafted agreements allowing the franchisor to terminate or not renew the agreement for any reason or without cause—otherwise known as “no-cause” or “termination for convenience” provisions.

Beware. In many states, this type of provision will not protect the franchisor from a state relationship law requiring good cause for termination or nonrenewal.65 Heating & Air Specialists, Inc. v. Jones illustrates such this trap. There, the Eighth Circuit found that a provision in an air conditioner dealer’s contract allowing either party to terminate the agreement without cause was invalid under the Arkansas Franchise Practices Act, which requires good cause for termination.66

<table>
<thead>
<tr>
<th>State</th>
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</tr>
</thead>
<tbody>
<tr>
<td>Virginia</td>
<td>VA. CODE §§ 13.1-557 et seq.</td>
<td>No statutory notice or cure period. Reasonable cause required.</td>
</tr>
<tr>
<td>Washington</td>
<td>WASH. REV. CODE §§ 19.100.180 et seq.</td>
<td>Termination requires notice and a reasonable opportunity to cure. No specified period to cure, but need not be more than 30 days. If the default cannot reasonably be cured in the 30-day cure period, the franchisee must initiate substantial or continuing action to cure within 30 days. Immediate termination without notice or opportunity to cure available under certain circumstances. Nonrenewal requires 1 year’s notice.</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>WIS. STAT. §§ 135.01 et seq.</td>
<td>Termination and nonrenewal require 90 days’ notice, which sets forth all reasons for such action, and a 60-day cure period. No notice is required under certain circumstances. Termination or nonrenewal for non-payment requires a 10-day cure period.</td>
</tr>
</tbody>
</table>

65. See, e.g., Gen. Motors Corp. v. New A.C. Chevrolet, Inc., 263 F.3d 296, 319 (3d Cir. 2001) (“Even if the terms of a private franchise agreement permit termination at will, [New Jersey’s Franchise Practices Act’s] good cause requirement will supersede that arrangement and impose a good cause requirement on the franchisor’s decision.”); To-Am Equip., 953 F. Supp. 987, 991 (N.D. Ill 1997), aff’d, 152 F.3d 658 (7th Cir. 1998) (discussing Mitsubishi forklift distributorship agreement, which provided that either party could terminate without cause on 60 days’ notice, and noting that “[t]ermination of a franchisee under Illinois Franchise Disclosure Act must be supported by good cause, and contracts at odds with statutory scheme are ineffectual”).

66. Heating & Air Specialists, Inc. v. Jones, 180 F.3d 923, 931 (8th Cir. 1999). The court ultimately held, however, that good cause existed to terminate the franchise. Id.
In a few states, such as Nebraska or Indiana, a franchisor may be able to avoid the “good cause” scrutiny in the context of nonrenewal if the agreement provides that it is not renewable upon expiration, but, even in those states, the good cause requirement will prevail if the right to renew is otherwise unaddressed within the agreement.67

III. UCC and Reasonable Notice

A. Determining Whether Article 2 of the UCC Applies

Article 2 of the UCC, a version of which has been adopted in almost every state, governs the performance and termination of contracts for the sale of goods. Because different variations of the UCC exist across state lines and state courts interpret the provisions of the UCC differently, it is important to focus on the applicable state statute and case law.

In most states, the UCC will apply to distribution agreements where the agreement is predominately for the sale of goods.68 The term “goods” is broadly defined as “all things (including specially manufactured goods) which are movable at the time of identification to the contract for sale other than the money in which the price is to be paid, investment securities (Article 8) and things in action.”69 Distribution contracts that contain both a goods and services aspect are subject to the applicable state court’s interpretation of whether such a “hybrid” model is primarily driven by the sale of goods and therefore governed by the statute. Whether Article 2 applies affects the procedural aspects of termination in a distribution relationship.

B. What Is Reasonable Notice?

Section 2-309(3) of the UCC states: “Termination of a contract by one party except on the happening of an agreed event requires that reasonable notification be received by the other party and an agreement dispensing with notification is invalid if its operation would be unconscionable.”70 What constitutes reasonable notification is state-law specific; thus, practitioners must consult the relevant state statute and case law. Although ultimately a fact-specific determination, courts frequently consider what would be a reasonable length of time for the other party to seek a substitute agreement when assessing what constitutes “reasonable notice.”71 Courts have inter-

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67. NEB. REV. STAT. § 87-404(1) (“This subsection shall not prohibit a franchise from providing that the franchise is not renewable. . . .”); IND. CODE § 23-2-2.7-1(8) (same).
69. U.C.C. § 2-105.
70. U.C.C. § 2-309(3).
71. See, e.g., Coburn Supply Co. v. Kohler Co., 342 F.3d 372, 376 (5th Cir. 2003) (analyzing reasonable notice for non-exclusive distributor relationship and holding 105 days’ notice was reasonable); Matheus v. Tombstone Pizza, 303 N.W.2d 855 (Wis. Ct. App. 1981); Serpa Corp. v. McWane Inc., 199 F.3d 6, 8-9 (1st Cir. 1999) (reasonableness of notice is measured in terms of the ability of the party affected by the termination to obtain a substitute arrange-
preted reasonable notice to be anywhere from thirty days to nine months.\textsuperscript{72}

Best practice mandates a close look at local case law dealing with similar circumstances or industries, identifying the average reasonable-notice period and assessing the best strategy in light of the client’s goals and preferences.

\textbf{IV. State Sales Representative Laws}

\textbf{A. What Are Sales Representative Laws?}

A majority of states regulate a manufacturer’s relationship with sales representatives who promote the manufacturer’s products.\textsuperscript{73} The primary focus of these laws is to ensure proper compensation of the sales representatives. A sales representative is generally defined as “a person who engages in the business of soliciting, on behalf of a principal, orders for purchase at wholesale of the product or products of the principal” and who is compensated, in whole or in part, by commission.\textsuperscript{74} A “principal” is defined broadly under state laws and typically applies to any person who engages in manufacturing, producing, importing, or distributing a product or products for sale to customers who purchase the product or products for resale; utilizes sales representatives to solicit orders; and compensates the sales representatives, in whole or in part, by commission.\textsuperscript{75} Some states have exclusions from their statutes, including: (1) sales representatives who place orders for their own account,\textsuperscript{76} (2) employees,\textsuperscript{77} and (3) door-to-door salespeople.\textsuperscript{78}

\textbf{B. How to Address Sales Representative Laws}

If applicable, these laws regulate compensation from the outset (terms of the written contract) to the termination of the business relationship. Of particular importance is the time period during which the manufacturer must pay post-termination commissions to the sales representative; state laws can vary from a few days to forty-five days.\textsuperscript{79} Manufacturers that overlook

\textsuperscript{72. E.g.,} Coburn Supply Co., 342 F.3d at 376 (105 days' notice); Cal. Wine Ass'n v. Wis. Liquor Co., 121 N.W.2d 308, 317-18 (Wis. 1963) (60 days' notice would have been reasonable); Monarch Beverage Co. v. Tyfield Imps., Inc., 823 F.2d 1187, 1190-91 (7th Cir. 1987) (upholding 30 days' notice as reasonable notice); Sierra Wine & Liquor Co. v. Heublein, Inc., 626 F.2d 129, 131 (9th Cir. 1980) (noting six months' notice required under the circumstances).

\textsuperscript{73. See App. B.}

\textsuperscript{74. ALA. CODE § 8-24-1 (defining “Commission,” “Principal,” and “Sales Representative” under Alabama law).}

\textsuperscript{75. See id.}

\textsuperscript{76. 820 ILL. COMP. STAT. ANN. 120/1(4); KY. REV. STAT. § 371.370; OHIO REV. CODE ANN. § 1335.11(A)(3); 43 PA. STAT. ANN. § 1471; S.C. CODE ANN. § 39-65-10(4).}

\textsuperscript{77. 820 ILL. COMP. STAT. ANN. 120/1(4); KAN. STAT. ANN. § 44-341; MD. CODE ANN., LAB. & EMPL. § 3-601; MINN. STAT. ANN. § 181.145; N.Y. LAB. LAW § 191-a(d); OHIO REV. CODE ANN. § 1335.11(A)(3); 43 PA. STAT. ANN. § 1471.}

\textsuperscript{78. KAN. STAT. ANN. § 44-341; MISS. CODE ANN. § 75-87-1(c).}

\textsuperscript{79. See App. B.}
these nuanced state regulations risk liability for treble damages as well as attorney fees and court costs for such violations, thus underscoring the significance of considering whether a state sales representative law applies and determining the applicable procedural requirements upon termination.80

V. Conclusion

The message is clear: changing how products get to a manufacturer’s end customer necessitates careful planning and detailed consideration. Although many arrangements are in fact not franchises, a manufacturer is best served if the manufacturer documents the parties’ specific intentions in the underlying agreement and confirms the application of exemptions or exclusions in advance. In doing so, manufacturers and their counsel must (1) identify applicable federal and state registration, disclosure, and relationship laws; (2) consider whether the UCC affects the logistics of nonrenewal or termination; (3) analyze and protect against risks associated with state common law claims; and (4) address any post-termination obligations related to the manufacturer’s state sales representatives. On a final note, even if such steps are not taken at the outset, creativity and ingenuity may help craft a solution that enables the manufacturer to conduct its business as necessary and dissuades departing distributors from bringing claims that may become a significant distraction from future plans for the distribution network.

80. See App. B.
### APPENDIX A:
General Summary of U.S. State Disclosure and Registration Laws

<table>
<thead>
<tr>
<th>State</th>
<th>State Disclosure/Registration Laws</th>
<th>Citation</th>
<th>Bona Fide Wholesale Exclusion?</th>
</tr>
</thead>
<tbody>
<tr>
<td>California</td>
<td>Franchise Investment Law</td>
<td><strong>CAL. CORP. CODE</strong> § 31000 <em>et seq.</em></td>
<td>Yes [§ 31011]</td>
</tr>
<tr>
<td>Hawaii</td>
<td>Franchise Investment Law</td>
<td><strong>HAW. REV. STAT.</strong> § 482E-1 <em>et seq.</em></td>
<td>Yes [§ 482E-2]</td>
</tr>
<tr>
<td>Illinois</td>
<td>Franchise Disclosure Act</td>
<td><strong>815 ILL. COMP. STAT.</strong> 705/1 <em>et seq.</em></td>
<td>Yes [§ 705/3(14)(c)]</td>
</tr>
<tr>
<td>Indiana</td>
<td>Franchises Law</td>
<td><strong>IND. CODE</strong> § 23-2-2.5-1 <em>et seq.</em></td>
<td>Yes [§ 23-2-2.5-1(i)(3)]</td>
</tr>
<tr>
<td>Maryland</td>
<td>Franchise Registration and Disclosure Law</td>
<td><strong>MD. CODE ANN., BUS. REG.</strong> § 14-201 <em>et seq.</em></td>
<td>Yes [§ 14-201(f)(3)(i)]</td>
</tr>
<tr>
<td>Michigan</td>
<td>Franchise Investment Law</td>
<td><strong>MICH. COMP. LAWS</strong> § 445.1501 <em>et seq.</em></td>
<td>Yes [§ 445.1503(1)(a)]</td>
</tr>
<tr>
<td>Minnesota</td>
<td>Franchises Law</td>
<td><strong>MINN. STAT.</strong> § 80C.01 <em>et seq.</em></td>
<td>Yes [§ 80C.01(9)(a)]</td>
</tr>
<tr>
<td>New York</td>
<td>Franchises Law</td>
<td><strong>N.Y. GEN. BUS. LAW</strong> § 680 <em>et seq.</em></td>
<td>Yes [§ 681(7)(a)]</td>
</tr>
<tr>
<td>North Dakota</td>
<td>Franchise Investment Law</td>
<td><strong>N.D. CENT. CODE</strong> § 51-19-01 <em>et seq.</em></td>
<td>Yes [§ 51-19-02(6)(a)]</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>Franchise Investment Act</td>
<td><strong>R.I. GEN. LAWS</strong> § 19-28-1-1 <em>et seq.</em></td>
<td>Yes [§ 19-28.1-3(b)(3)]</td>
</tr>
<tr>
<td>South Dakota</td>
<td>Franchises for Brand-Name Goods and Services Law</td>
<td><strong>S.D. CODIFIED LAWS</strong> § 37-5B-1 <em>et seq.</em></td>
<td>Yes [§ 37-5B-1(26)]</td>
</tr>
<tr>
<td>Virginia</td>
<td>Retail Franchising Act</td>
<td><strong>VA. CODE ANN.</strong> § 13.1-557 <em>et seq.</em></td>
<td>Yes [§ 13.1-559(A)]</td>
</tr>
<tr>
<td>Washington</td>
<td>Franchise Investment Protection Act</td>
<td><strong>WASH. REV. CODE</strong> § 19.100.010 <em>et seq.</em></td>
<td>Yes [§ 19-100.010(8)(a)]</td>
</tr>
<tr>
<td>Wisconsin</td>
<td>Franchise Investment Law</td>
<td><strong>WIS. STAT.</strong> § 553.01 <em>et seq.</em></td>
<td>Yes [§ 553.03(5m)(a)]</td>
</tr>
</tbody>
</table>
### APPENDIX B: General Summary of U.S. State Sales Representative Laws Termination and Nonrenewal

<table>
<thead>
<tr>
<th>State</th>
<th>Citation</th>
<th>Applies to Wholesale Orders Only?</th>
<th>Applies Only to the Sales of Products, Not Services?</th>
<th>Applies to Any Principal or Only Out-of-State Principals?</th>
<th>Time Required for Last Payment After Termination of Contract?</th>
<th>Damage Remedy?</th>
<th>Recovery of Attorneys’ Fees &amp; Court Costs?</th>
<th>Waiver Allowed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Ala. Code § 8-24-1 through § 8-24-5, ¶ 7010</td>
<td>Yes (8-24-1)</td>
<td>Products only (8-24-1)</td>
<td>Any (8-24-1)</td>
<td>Within 30 days of termination for commissions due at time of termination. For commissions due after termination, within 30 days after date commissions become due. (8-24-2)</td>
<td>3 times the damages sustained (8-24-3)</td>
<td>Yes (8-24-3)</td>
<td>No (8-24-5)</td>
</tr>
<tr>
<td>Alaska</td>
<td>No applicable provision</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by common law</td>
<td>Damages awarded as if the contract had been fully performed. Lost profits may be recovered. Punitive damages not allowed unless tort committed independently. (Common Law)</td>
<td>Yes (Alaska R. Civ. Proc. 82)</td>
<td>Not specified by statute; no applicable case law</td>
</tr>
<tr>
<td>Arizona</td>
<td>Ariz. Rev. Stat. Ann. § 44-1798 through § 44-1798.04 ¶ 7030</td>
<td>Yes (44-1798)</td>
<td>Products and Services (44-1798.04)</td>
<td>Any (44-1798.04)</td>
<td>Not to exceed 30 days for commissions due at time of termination. For commissions due (44-1798.02)</td>
<td>3 times the commissions due (44-1798.02)</td>
<td>Prevailing Party (44-1798.02)</td>
<td>No (44-1798.04)</td>
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<tr>
<td>Arkansas</td>
<td>Ark. Code Ann. § 4-70-301 through § 4-70-306, ¶ 7040</td>
<td>Yes (4-70-301)</td>
<td>Products only (4-70-301)</td>
<td>As specified in written contract, or within 30 working days of termination if contract is not in writing (4-70-303)</td>
<td>3 times the damages sustained (4-70-306)</td>
<td>Yes (4-70-306)</td>
<td>No (4-70-305)</td>
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<thead>
<tr>
<th>State</th>
<th>Citation</th>
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<th>Time Required for Last Payment After Termination of Contract?</th>
<th>Damage Remedy?</th>
<th>Recovery of Attorneys' Fees &amp; Court Costs?</th>
<th>Waiver Allowed?</th>
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</table>
  *Fuhlrodt v. Rela, Inc.*, 71 F. App'x 615, 616 (9th Cir. 2003) | 3 times the damages sustained (12-66-103) | Prevailing Party (12-66-103) | Not specified by statute; no applicable case law |
| Connecticut| Conn. Gen. Stat. § 42-481 through § 42-484     | Yes (42-481)                      | Products and Services (42-481)                 | Any (42-482)                                           | For commissions due *on or before* termination, as specified in contract, or 30 days after termination, whichever occurs later. For commissions due *after* termination, as specified in contract, but not later than 30 days after contractual due date. (42-482) | 2 times the commissions due (42-482) | Prevailing Party (42-482) | No (42-484) |
|------------|-----------------------------------|----------------------------------------------------|----------------------------------------------------------|---------------------------------------------------------------|----------------|----------------------------------------|----------------|
| Delaware   | N/A                               | N/A                                                | N/A                                                      | As specified by agreement and governed by common law          | Actual damages only; no special damages. Damages awarded as if as if the promisor had performed the contract. Punitive damages only available when tort committed independently. (Common Law) | Attorneys' fees available if party brought litigation in bad faith or party acted in bad faith during litigation (Reserves Dev. LLC v. Severn Sav. Bank, FSB, No. 2502-VCP, 2007 Del. Ch. LEXIS 185 (Ch. Dec. 31, 2007)) | N/A |
| Florida    | No Products only                  | Any                                                | As specified in written contract or within 30 days of termination if contract is not in writing | 3 times the commissions due                                   |                 |                                        | Yes            |

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</thead>
<tbody>
<tr>
<td>Georgia</td>
<td>Yes (10-1-700)</td>
<td>No (10-1-700)</td>
<td>All principal or only out-of-state principals (10-1-704)</td>
<td>All payments due within 30 days of termination (10-1-702)</td>
<td>All amounts due, plus exemplary damages up to 2 times the commissions due (10-1-702)</td>
<td>Sales Rep also liable for attorneys’ fees if court determines suit was frivolous.</td>
<td>No (10-1-703)</td>
</tr>
<tr>
<td>Hawaii</td>
<td>No applicable provision</td>
<td>No applicable provision</td>
<td>As specified by agreement and governed by common law</td>
<td>As specified by agreement and governed by common law</td>
<td>Actual damages: just compensation commensurate with loss. Extent of loss must be shown with reasonable certainty; otherwise, plaintiff is only entitled to nominal damages. Punitive damages for “willful, wanton, and reckless” breach causing tortious injury.</td>
<td>Statute permits recovery of reasonable attorneys’ fees only. Sales Rep also liable for attorneys’ fees if court determines suit was frivolous.</td>
<td>No specified by statute; no applicable case law</td>
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<tbody>
<tr>
<td>Idaho</td>
<td>No applicable provision</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by common law</td>
<td>Damages must be reasonable foreseeable. Consequential damages and lost profits only allowed if specifically contemplated by parties. Punitive damages not available absent fraud, malice, or oppression. (Common Law)</td>
<td>Yes (I.C. § 12-120)</td>
<td>Not specified by statute; no applicable case law</td>
<td></td>
</tr>
<tr>
<td>Illinois</td>
<td>820 ILCS 120/0.01 through 120/3, ¶ 7130</td>
<td>Yes (820 ILCS 120/1)</td>
<td>Products only (820 ILCS 120/1)</td>
<td>Within 13 days of termination for commissions due at time of termination. For commissions due after termination, within 13 days of becoming due (820 ILCS 120/1)</td>
<td>Exemplary damages up to 3 times the commissions owed (820 ILCS 120/3)</td>
<td>Yes (820 ILCS 120/3)</td>
<td>No (820 ILCS 120/2)</td>
<td></td>
</tr>
<tr>
<td>Indiana</td>
<td>Ind. Code § 24-4-7-1 through § 24-4-7-8, ¶ 7140</td>
<td>Yes (24-4-7-3)</td>
<td>Products only (24-4-7-3)</td>
<td>Within 14 days after commissions would have been due had the contract not been terminated (24-4-7-5)</td>
<td>Exemplary damages up to 3 times the commissions owed (if bad faith noncompliance) (24-4-7-5)</td>
<td>Principal liable if exemplary damages awarded. Sales Rep liable if court determines suit was frivolous. (24-4-7-5)</td>
<td>No (24-4-7-8)</td>
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<tbody>
<tr>
<td><strong>Iowa</strong></td>
<td>Iowa Code § 91A.1 through § 91A.13, ¶ 7160</td>
<td>Yes (See 91A.2)</td>
<td>Products and Services (91A.2)</td>
<td>Any (91A.2)</td>
<td>By the next regular payday; or if payment owed is difference between credit against the commission and the commission, no later than 30 days after termination (91A.3; 91A.4)</td>
<td>Unpaid wages; but if intentional failure to pay, also liquidated damages—5% of the unpaid commissions per day (91A.2; 91A.8) Also potentially liable to civil penalties of $500/day (91A.8)</td>
<td>Yes (91A.8)</td>
<td>Not specified by statute; no applicable case law</td>
</tr>
<tr>
<td><strong>Kansas</strong></td>
<td>Kansas Stat. Ann. § 44-341 through § 44-347, ¶ 7160</td>
<td>Yes (44-341)</td>
<td>Products only (44-341)</td>
<td>All commissions due no later than 30 days after termination (44-342)</td>
<td>Commissions due, plus the lesser of either: 1% of the unpaid commissions per day, or an amount equal to the unpaid earned commissions (effectively, a maximum of double the commission due) (44-342)</td>
<td>Not specified by statute; no applicable case law</td>
<td>Yes, if fairly and knowingly agreed to. (See LDCircuit, LLC v. Sprint Commc'ns Co., L.P., 364 F. Supp. 2d 1246 (D. Kan. 2005))</td>
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<tr>
<td>Kentucky</td>
<td>Ky. Rev. Stat. Ann. § 371.370 through § 371.385, ¶ 7170 (statute held unconstitutional because statute discriminated against interstate commerce by only imposing requirements on out-of-state principal. Cecil v. Duck Head Apparel Co., 895 Supp. 155 (W.D. Ky. 1995))</td>
<td>Yes</td>
<td>Products only</td>
<td>Out-of-state only</td>
<td>All commissions due no later than 30 days after termination</td>
<td>All amounts due plus exemplary damages up to 2 times the commissions due</td>
<td>Yes</td>
<td>N/A</td>
</tr>
<tr>
<td>Louisiana</td>
<td>La. Rev. Stat. Ann. § 51:441 through § 51:445, ¶ 7180</td>
<td>Yes (51:441)</td>
<td>Products only (51:441)</td>
<td>Any (51:441)</td>
<td>As specified in the agreement, or if not specified, no later than 30 working days after termination (51:443)</td>
<td>3 times the damages (51:444)</td>
<td>Statute permits recovery of reasonable attorney’s fees only and omits court costs. (51:444)</td>
<td>Not specified by statute; no applicable case law</td>
</tr>
<tr>
<td>Maine</td>
<td>Me. Rev. Stat. Ann. 10 § 1341 through § 1344, ¶ 7190</td>
<td>Yes (§ 1341)</td>
<td>Products only (§ 1341)</td>
<td>Out-of-state only (§ 1341)</td>
<td>All commissions accrued due no later than 30 days after termination (§ 1343)</td>
<td>Exemplary damages up to 3 times the commissions due (§ 1344)</td>
<td>Yes. Sales Rep liable for attorneys' fees if court determines suit was frivolous. (§ 1344)</td>
<td>No (§ 1343)</td>
</tr>
</tbody>
</table>

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<th>Recovery of Attorneys’ Fees &amp; Court Costs?</th>
<th>Waiver Allowed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Maryland</td>
<td>Md. Lab. and Empl. Code § 3-601 through § 3-607, ¶ 7200</td>
<td>Yes (3-601)</td>
<td>Products only (3-601)</td>
<td>Any (3-606)</td>
<td>Within 45 days after payment would have been due had the contract not been terminated (3-604)</td>
<td>Up to 3 times the commissions owed (3-605)</td>
<td>Yes (3-605)</td>
<td>No (3-603)</td>
</tr>
<tr>
<td>Mass.</td>
<td>Mass. Gen. 1, ch. 104, § 7 through § 9, ¶ 7210</td>
<td>Yes (§ 7)</td>
<td>Products only (§ 7)</td>
<td>Any (§ 9)</td>
<td>Within 14 days of termination for commissions due at time of termination. For commissions due after termination, within 14 days of date that commissions are due. (§ 8)</td>
<td>Principal amount, plus up to 3 times the commissions owed (§ 9)</td>
<td>Yes (§ 9)</td>
<td>No (§ 9)</td>
</tr>
<tr>
<td>Michigan</td>
<td>Mich. Comp. Laws Ann. § 600.2961, ¶ 7220</td>
<td>Yes (600.2961)</td>
<td>Products only (600.2961)</td>
<td>Any (600.2961)</td>
<td>Within 45 days of termination for commissions due at time of termination. For commissions due after termination, within 45 days after</td>
<td>Actual damages, plus if intentional violation, then the lesser of either: 2 times the commissions due, or $100,000 (effectively, a maximum of double the</td>
<td>Yes (600.2961)</td>
<td>No (600.2961)</td>
</tr>
</tbody>
</table>

<table>
<thead>
<tr>
<th>Notes</th>
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<tr>
<td>Minnesota</td>
<td>Minn. Stat. Ann. § 181.145 and § 325E.37, ¶ 7230 (§ 181.145 establishes when commission payments are due upon contract termination; § 325E.37 protects sales representatives from termination of the agreement absent just cause)</td>
<td>Yes (325E.37)</td>
<td>Products and Services (§ 181.145; 325E.37)</td>
<td>Any (§ 181.145)</td>
<td>Commissions due, plus 1/15 the commissions due for each day the commissions go unpaid—not to exceed 15 days (effectively, a maximum of double the commission due) (§ 181.145)</td>
<td>No</td>
<td>Yes through arbitration (325E.37)</td>
<td>No</td>
</tr>
<tr>
<td>Mississippi</td>
<td>Miss. Code Ann. § 75-87-1 through § 75-87-7, ¶ 7240</td>
<td>Yes (75-87-1)</td>
<td>Products only (75-87-1)</td>
<td>Out-of-state only (75-87-1)</td>
<td>All commissions due within 21 days of termination (75-87-5)</td>
<td>Yes</td>
<td>Not specified by statute; no applicable case law</td>
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<tr>
<td>Missouri</td>
<td>Yes</td>
<td>Any</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
<td>Yes</td>
<td>No</td>
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<tr>
<td>Montana</td>
<td>No</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
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<td>Citation</td>
<td>Applies Only to</td>
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<td>Damage Remedy?</td>
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<tr>
<td>Nebraska</td>
<td>Neb. Rev. Stat. § 48-1228 through § 48-1232, ¶ 7270</td>
<td>No (48-1229)</td>
<td>Products and Services (48-1229)</td>
<td>Payment due on next regular payday following employer’s receipt of payment; claim arises 30 days after regular payday. (48-1230.01; 48-1231)</td>
<td>Unpaid commissions, and if nonpayment was willful, 2 times the commissions due—placed in state’s common school fund, meaning representative may only recover the unpaid wages (48-1231; 48-1232)</td>
<td></td>
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</tr>
<tr>
<td>Nevada</td>
<td>No applicable provision</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by common law</td>
<td>Compensatory damages include lost profits and expectancy damages. Punitive damages not available when based solely on contract. (Common Law)</td>
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</tr>
</tbody>
</table>

Yes. Attorneys’ fees shall not be less than 25 percent of the unpaid wages, unless the employee fails to recover more than he or she would have recovered on their payday. (48-1231) |

No specified by statute; no applicable case law

(Continued)
<table>
<thead>
<tr>
<th>State</th>
<th>Citation</th>
<th>Applies to Wholesale Orders Only?</th>
<th>Applies Only to the Sales of Products, Not Services?</th>
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<th>Time Required for Last Payment After Termination of Contract?</th>
<th>Damage Remedy?</th>
<th>Recovery of Attorneys’ Fees &amp; Court Costs?</th>
<th>Waiver Allowed?</th>
</tr>
</thead>
<tbody>
<tr>
<td>New Mexico</td>
<td>No applicable provision</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by common law</td>
<td>General damages arise naturally as the result of the breach. Consequential damages if harm was foreseeable result of breach. Punitive damages when defendant acted with reckless disregard for victim. (Common Law)</td>
<td>No common law or statutory recovery of attorneys’ fees for breach of contract claims</td>
<td>Not specified by statute; no applicable case law</td>
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<tr>
<td>North Carolina</td>
<td>N.C. Gen. Stat. § 66-190 through § 66-193, ¶ 7330</td>
<td>No (Language limiting statute to wholesalers was repealed in 2003). (66-190)</td>
<td>Products and Services (66-190)</td>
<td>Any (66-190)</td>
<td>Within 30 days of termination for commissions due at time of termination. Within 15 days of the due date for commissions due after termination. (66-191)</td>
<td>Commissions due, plus exemplary damages not to exceed 2 times the amount of commissions due (66-192)</td>
<td>Yes (66-192)</td>
<td>No (66-193)</td>
</tr>
<tr>
<td>North Dakota</td>
<td>No applicable provision</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by common law</td>
<td>Damages must flow directly and naturally from breach. Special damages (including lost profits) recoverable if contemplated by the parties. No punitive damages unless independently tortious conduct involved. (Common Law)</td>
<td>No common law or statutory recovery of attorneys' fees for breach of contract claims</td>
<td>Yes (See Rosenberger v. Son, Inc., 491 N.W.2d 71, 76 (N.D. 1992))</td>
</tr>
<tr>
<td>State</td>
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<tr>
<td>Ohio</td>
<td>Ohio Rev. Code Ann. § 1335.11, ¶ 7350</td>
<td>Yes</td>
<td>Products and Services (1335.11)</td>
<td>Any (1335.11)</td>
<td>Within 30 days of termination for commissions due at time of termination. 13 days of date commissions become due for commissions due after termination. (1335.11)</td>
<td>Exemplary damages not to exceed 3 times the commissions due (1335.11)</td>
<td>Prevailing Party (1335.11)</td>
<td>No (1335.11)</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>Okla. Stat. Tit. 15 § 675 through § 679, ¶ 7360</td>
<td>Yes</td>
<td>Products only (§ 676)</td>
<td>Out-of-state only (§ 676)</td>
<td>Within 14 days for commissions due at time of termination. For commissions due after termination, within 14 days of date commissions become due. (§ 678)</td>
<td>Commissions due (§ 678)</td>
<td>Prevailing Party (§ 678)</td>
<td>No (§ 679)</td>
</tr>
<tr>
<td>Oregon</td>
<td>Or. Rev. Stat. § 646A.097, ¶ 7370</td>
<td>Yes</td>
<td>Products only (646A.097)</td>
<td>Out-of-state only (646A.097)</td>
<td>Within 14 of termination days for all commissions accrued (646A.097)</td>
<td>Commissions due, and 9% interest on amount per annum until paid, plus 3 times the damages if willful failure to comply (646A.097)</td>
<td>Prevailing Party (646A.097)</td>
<td>No (646A.097)</td>
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<tr>
<td>Pennsylvania</td>
<td>Pa. Stat. Ann. § 1471 through § 1478, ¶ 7380</td>
<td>Yes (§ 1471)</td>
<td>Products only (§ 1471)</td>
<td>Any (§ 1471)</td>
<td>Within 14 days of termination for commissions due at time of termination, and within 14 days of contractual due date for commissions becoming due after termination (§ 1473)</td>
<td>Commissions due plus exemplary damages not to exceed 2 times the commission due (§ 1475)</td>
<td>Yes Principal to recover fees if suit was frivolous (§ 1475)</td>
<td>No (§ 1476)</td>
</tr>
<tr>
<td>Rhode Island</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by the common law</td>
<td>Compensatory damages, including lost profits, available. No punitive damages available for breach of contract. (Common Law)</td>
<td>Attorneys' fees awarded when court finds that losing party raised no genuine issue of material fact or law, or if court renders default judgment (R.I. Gen. Laws 1956 § 9-1-45)</td>
<td>N/A Not specified by statute; no applicable case law</td>
<td>No (§ 1476)</td>
</tr>
<tr>
<td>State</td>
<td>Citation</td>
<td>Applies to Wholesale Orders Only?</td>
<td>Applies Only to the Sales of Products, Not Services?</td>
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<td>Time Required for Last Payment After Termination of Contract?</td>
<td>Damage Remedy?</td>
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<td>Waiver Allowed?</td>
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<tr>
<td>South Dakota</td>
<td>N/A N/A N/A N/A As specified by agreement and governed by the common law</td>
<td>South Dakota N/A N/A N/A N/A</td>
<td>South Dakota N/A N/A N/A N/A</td>
<td>South Dakota N/A N/A N/A N/A</td>
<td>South Dakota N/A N/A N/A N/A</td>
<td>Damages must be reasonable certain. Punitive damages only available when independent tort is committed. (Common Law)</td>
<td>No common law or statutory recovery of attorneys' fees for breach of contract claims</td>
<td>Not specified by statute; no applicable case law</td>
</tr>
<tr>
<td>Tennessee</td>
<td>Tenn. Code Ann. § 47-50-114, ¶ 7420</td>
<td>Yes (47-50-114) Products only (47-50-114)</td>
<td>Tennessee Any (47-50-114)</td>
<td>Tennessee Within 14 days of termination for commissions due at time of termination. For commissions becoming due after termination, within 14 days after they become due. If no written contract, all commissions are due within 14 days. (47-50-114)</td>
<td>Tennessee Commissions due. If bad faith, exemplary damages up to 3 times the amount of commissions due (47-50-114)</td>
<td>Yes (47-50-114) Attorneys' fees and court costs are only allowed if the principal's non-payment was in bad faith. Sales Rep liable for attorneys' fees if court determines suit was frivolous. (47-50-114)</td>
<td>No (47-50-114)</td>
<td></td>
</tr>
<tr>
<td>Texas</td>
<td>Tex. Bus. &amp; Com. Code Ann. § 54.001 through § 54.006, ¶ 7430</td>
<td>Yes (54.001) Products only (54.001)</td>
<td>Any (54.005)</td>
<td>As specified in written contract. All commissions due within 30 “working” 3 times the commissions due (54.004)</td>
<td>Yes (54.004)</td>
<td>No (54.006)</td>
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<tr>
<td>Utah</td>
<td>Utah Code Ann. § 34-44-101 through Utah Code Ann. § 34-44-302</td>
<td>Yes (34-44-102)</td>
<td>Products and Services (34-44-102)</td>
<td>Any (34-44-103)</td>
<td>Within 30 days of termination for commissions due at time of termination, and within 14 days of contractual due date for commissions becoming due after termination (34-44-202)</td>
<td>3 times the commission due (34-44-301)</td>
<td>Yes (34-44-301)</td>
<td>No (34-44-104)</td>
</tr>
<tr>
<td>Vermont</td>
<td>No applicable statute</td>
<td>N/A</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by the common law</td>
<td>Direct damages flow naturally from the breach itself. Special/consequential damages must be foreseeable. Punitive damages only available when breach has character of willful tort. (Common Law)</td>
<td>No common law or statutory recovery of attorneys’ fees for breach of contract claims</td>
<td>Not specified by statute; no applicable case law</td>
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<tbody>
<tr>
<td>Virginia</td>
<td>Yes</td>
<td>Any (59.1-455)</td>
<td>Yes (59.1-459)</td>
<td>Earned commission and other earned/payable compensation (59.1-457)</td>
<td>Not specified by statute; no applicable case law</td>
<td>No (59.1-455)</td>
<td>No (59.1-458)</td>
</tr>
<tr>
<td>Washington</td>
<td>Yes</td>
<td>Any</td>
<td>Yes</td>
<td>Within 30 days after receipt of payment by the principal for products/goods sold by sales representative (or earlier, if by contract) (49.48.160)</td>
<td>Not specified by statute; no applicable case law</td>
<td>No (49.48.150)</td>
<td>No (49.48.159)</td>
</tr>
<tr>
<td>Wash. Rev. Code § 49.48.150 through 1590</td>
<td>§ 49.48.150, 1590, 7470</td>
<td>(49.48.150)</td>
<td>(49.48.150)</td>
<td>(49.48.160)</td>
<td>(49.48.160)</td>
<td>(49.48.159)</td>
<td>(49.48.160)</td>
</tr>
<tr>
<td>West Virginia</td>
<td>No applicable statute</td>
<td>N/A</td>
<td>N/A</td>
<td>Compensatory damages recoverable when naturally arising from breach, or when damages were contemplated by parties during agreement. Lost profits are recoverable.</td>
<td>No common law or statutory recovery of attorneys’ fees for breach of contract claims</td>
<td>N/A</td>
<td>N/A</td>
</tr>
</tbody>
</table>

- **Virginia**: Va. Code Ann. § 59.1-455 through 7460
- **Washington**: Wash. Rev. Code § 49.48.150 through 1590
- **West Virginia**: No applicable statute N/A
<table>
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</thead>
<tbody>
<tr>
<td>Wisconsin</td>
<td>Wis. Stats. § 134.93, ¶ 7490</td>
<td>Yes (134.93)</td>
<td>Products only (134.93)</td>
<td>All commissions due at time of termination, cancellation, or nonrenewal of the contract (134.93)</td>
<td>Commissions due plus exemplary damages of not more than 2 times the amount of commissions due (134.93)</td>
<td>Yes (134.93)</td>
<td>Not specified by statute; no applicable case law</td>
<td></td>
</tr>
<tr>
<td>Wyoming</td>
<td>No applicable statute</td>
<td>N/A</td>
<td>N/A</td>
<td>As specified by agreement and governed by the common law</td>
<td>Compensatory damages, as well as incidental damages, are available when foreseeable. Punitive damages are not available for breach of contract. (Common Law)</td>
<td>No common law or statutory recovery of attorneys' fees for breach of contract claims</td>
<td>Not specified by statute; no applicable case law</td>
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<th>Waiver Allowed?</th>
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</thead>
<tbody>
<tr>
<td>Puerto Rico</td>
<td>P.R. Laws Ann. Tit. 10, § 279 through § 279g, ¶ 7520</td>
<td>No (§ 279)</td>
<td>Products and Services (§ 279)</td>
<td>Any (§ 279)</td>
<td>Not specified by statute; no applicable case law</td>
<td>Not specified If terminating without “just cause”, sales representative shall be compensated for either (A) the extent of damages, to be determined by (i) actual value of investments and expenses, (ii) good will attributable to sales rep, (iii) amount of benefit obtained from sales during previous 5 years; or (B) 5% of total sales. (§ 279c)</td>
<td>Not specified by statute; no applicable case law</td>
<td>No (§ 279g)</td>
</tr>
</tbody>
</table>
## APPENDIX C:
General Summary of U.S. State Business Opportunity Laws

<table>
<thead>
<tr>
<th>State</th>
<th>State Business Opportunity Law</th>
<th>Citation</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alaska</td>
<td>Sale of Business Opportunities Law</td>
<td>AK. STAT. § 45.66.010 et seq.</td>
</tr>
<tr>
<td>California</td>
<td>California’s Seller Assisted Marketing Plan Act</td>
<td>CAL. CIV. CODE § 1812.200 et seq.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Business Opportunity Investment Act</td>
<td>CONN. GEN. STAT. § 368-60 et seq.</td>
</tr>
<tr>
<td>Florida</td>
<td>Sale of Business Opportunities Act</td>
<td>Fla. Stat. § 559.80 et seq.</td>
</tr>
<tr>
<td>Georgia</td>
<td>Sale of Business Opportunities Act</td>
<td>O.C.G.A. § 10-1-410 et seq.</td>
</tr>
<tr>
<td>Illinois</td>
<td>Business Opportunity Sales Law</td>
<td>815 ILCS 602/5-1 et seq.</td>
</tr>
<tr>
<td>Indiana</td>
<td>Business Opportunity Transactions</td>
<td>IND. CODE § 24-5-8-1 et seq.</td>
</tr>
<tr>
<td>Iowa</td>
<td>Business Opportunity Promotions</td>
<td>IOWA CODE § 551A.1 et seq.</td>
</tr>
<tr>
<td>Kentucky</td>
<td>Sale of Business Opportunities</td>
<td>KY. REV. STAT. § 367.801 et seq.</td>
</tr>
<tr>
<td>Louisiana</td>
<td>Business Opportunity Sellers and Agents</td>
<td>LA. REV. STAT. § 51:1821 et seq.</td>
</tr>
<tr>
<td>Maine</td>
<td>Regulations of the Sale of Business Opportunities</td>
<td>ME. REV. STAT. tit. 32 § 4691 et seq.</td>
</tr>
<tr>
<td>Maryland</td>
<td>Business Opportunity Sales Act</td>
<td>MD. CODE ANN., BUS. REG. § 14-101 et seq.</td>
</tr>
<tr>
<td>Minnesota</td>
<td>Treated as a “franchise” under the Franchise Law</td>
<td>MINN. STAT. § 80C.01 et seq.</td>
</tr>
<tr>
<td>Nebraska</td>
<td>Seller Assisted-Marketing Plan Act</td>
<td>NEB. REV. STAT. § 59-1701.01 et seq.</td>
</tr>
<tr>
<td>Ohio</td>
<td>Business Opportunity Plans</td>
<td>OHIO REV. CODE § 1334.01 et seq.</td>
</tr>
<tr>
<td>Oklahoma</td>
<td>Business Opportunity Sales Act</td>
<td>OKLA. STAT., tit. 71, § 801 et seq.</td>
</tr>
<tr>
<td>South Dakota</td>
<td>Business Opportunities Act</td>
<td>S.D. CODIFIED LAWS § 37-25A-1 et seq.</td>
</tr>
<tr>
<td>Texas</td>
<td>Business Opportunity Act</td>
<td>TEX. BUS. &amp; COM. CODE § 51.001 et seq.</td>
</tr>
<tr>
<td>Virginia</td>
<td>Business Opportunity Sales Act</td>
<td>VA. CODE ANN. § 59.1-262 et seq.</td>
</tr>
<tr>
<td>Washington</td>
<td>Business Opportunity Fraud Act</td>
<td>WASH. REV. CODE § 19.110.010 et seq.</td>
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An Analysis of Franchise Agreement Terminations and Nonrenewals for Failure to Meet Minimum Performance Standards

Leon F. Hirzel

Many franchisors have implemented minimum performance standards in their franchise systems and included them in franchise agreements. As the name suggests, minimum performance standards are requirements imposed on franchisees to meet or exceed certain performance benchmarks. Unlike sales goals or other aspirational metrics, minimum performance standards are intended to establish a minimally acceptable level of performance. The franchisee’s failure to comply with any applicable minimum performance standard normally constitutes a default under the franchise agreement and, if not cured, can lead to a termination or non-renewal.

Minimum performance standards can vary widely across different franchise systems and can conceivably cover all areas of the franchised business. Nearly all such standards involve some form of quantitative metric, such as minimum sales volumes, minimum purchase volumes, development quotas, or operational compliance audit scores, that must be satisfied by the franchisee. The business rationale behind minimum performance standards is to maximize the potential of the brand by ensuring that each franchised territory and location is being adequately developed and operated according to minimally acceptable levels (rather than desired levels) of performance. Minimum performance standards provide the franchisor with a check against underperforming franchisees.

From the franchisor’s perspective, minimum performance standards establish the minimum acceptable unit economics, in which the franchisor possesses a vested financial interest because the franchisor often gains in proportion to such metrics through ongoing royalty payments. They also further the franchisor’s interest in developing its brand and goodwill by ensuring that an existing franchise territory is not undermined or underutilized.

From the franchisee’s perspective, minimum performance standards can represent both a benefit and a potential risk. The most obvious benefits to

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franchisees result from minimum performance standards that are unambiguously drafted, reasonable in scope, and expressly stated in the franchise agreement. Enforcement of minimum performance standards allows the franchisor to remove chronically underperforming franchisees that can cause substantial harm to the franchise system’s brand and goodwill, which in turn can directly harm the interests of other franchisees.

Notwithstanding these potential benefits, minimum performance standards can be dangerous to franchisees, particularly those that are overly exacting, imprecise, not defined in the franchise agreement, or not uniformly enforced, because they provide a means for termination without regard to the franchisee’s actual efforts to develop its territory. Minimum performance standards may be used to suggest a sense of numerical impartiality to the franchisor’s decision to terminate a franchise agreement, even if such a decision is actually motivated by unrelated considerations. Imprecise or aspirational minimum performance standards are particularly menacing to franchisees, especially when not uniformly enforced, because they can place an otherwise diligent and successful franchisee under the ongoing specter of termination or non-renewal. Subjective standards may also provide the franchisor with an unacceptable level of discretion.

Performance benchmarks are a particularly troublesome type of minimum performance standard. The franchisor may impose performance benchmarks, such as minimum sales or royalties, without taking into account a particular franchisee’s market or efforts. For example, franchisors may choose to set the bar by comparing franchisees to others in the system, which may be problematic if there is not a sufficient sample size or if there are significant local market differences. There will always be some franchisees that are successful in their own market but are not able to match the performance of other franchisees due to external factors beyond their control. In response, the franchisor may either: (1) reduce the minimum performance standards, (2) ignore noncompliance with minimum performance standards, or (3) enforce the minimum performance standards.

In practice, such minimum performance standards function as goal metrics to encourage (or coerce) the franchisee to go above and beyond the franchisor’s actual minimally acceptable requirements.

Minimum performance standards are sometimes less than clearly communicated to the franchisees, through ambiguous terms in the franchise agreement referring to the concept of a minimum performance standard, without specifying the actual benchmarks, i.e., the specific level of sales, audit scores, etc., until after the franchisee has signed the franchise agreement or at such time that the franchisor enforces them. In some instances, the franchisor reserves the right to impose higher minimum performance standards during the initial term or renewal term of the franchise agreement without the input or the consent of the franchisee.

The specific sanctions imposed for failing to adhere to the minimum performance standards are also generally contained within the franchise agree-
ment. Typical sanctions include retraining requirements; loss of territory rights; financial penalties, such as minimum royalties; forfeiture of renewal rights; and termination. Significantly, the franchisee risks losing its entire investment in the franchise by failing to comply with the minimum performance standards.

Legislators and other legal practitioners have long expressed concern about potentially abusive provisions in franchise agreements related to terminations and non-renewals. Judicial decisions and legislative enactments have frequently placed limitations on the franchisor’s ability to enforce “stick-type” terminations for failure to meet minimum performance standards. Conflicting public policies exist regarding the termination or non-renewal of franchise agreements. Specifically, public policy favors freedom of contract, but also seeks to avoid undue forfeitures. Although contractual terms typically favor the franchisor, equitable considerations typically favor the franchisee.

This article sets forth a survey of legal considerations applicable to franchise agreement terminations and non-renewals arising from the failure to satisfy minimum performance standards. This article focuses on the factors that franchisors should evaluate in determining whether to terminate or non-renew a franchisee for failure to meet performance standards and describes a franchisee’s potential defenses and counterclaims to such terminations.

Legal Principles Pertaining to the Termination of Franchise Agreements for Failure to Meet Minimum Performance Standards

Whether the franchisor has the right to terminate the franchise agreement based on the franchisee’s breach of a minimum performance provision in the franchise agreement requires an initial determination of whether the franchise agreement expressly states that a performance standard is material or whether the franchisor’s right to terminate based thereon is explicitly stated in the agreement, thereby implying materiality.

Courts generally uphold the parties’ express agreement concerning contract termination without examining the franchisor’s motives or each respective party’s interest when entering into the agreement.1 The guiding princi-
ple underlying enforcement of express provisions in contracts is the parties’ “freedom to contract,” or the rights of individuals to order their own affairs. This theory is based on a presumption that individuals have an inherent self-interest in protecting themselves and will avoid entering into contracts that contain draconian provisions.

Franchisors are best advised to carefully examine the applicable contractual termination provisions when considering termination. Interpreting a franchisor’s termination rights based on adherence to a strict freedom of contract approach can lead to an unfair result because the written agreement may not reflect the parties’ actual intent. Even though courts seek to refrain from rewriting contracts, legislative enactments and equitable judicial powers rooted in public policy provide courts with the ability to protect franchisees from forfeiture, if and when the circumstances and applicable law permit the franchisee to avoid contractually authorized termination.

As discussed in detail later, many jurisdictions require a showing that the franchisee’s failure to live up to a performance standard is sufficiently material to justify a termination. Further, and as discussed later in this section, contractual and statutory notice and cure requirements also limit a franchisor’s ability to use strict enforcement of termination provisions. After a discussion of various legal principles that impose limitations on a franchisor’s ability to enforce termination provisions for failure to meet performance standards, this article will discuss potential defenses and counterclaims possessed by franchisees.

Materiality and Good Cause Requirements for Franchise Terminations

The rights of a franchisor to terminate may often be governed by more than simply the terms of the contract. The law may impose various additional conditions upon a franchisor’s ability to terminate for failure to meet minimum standards. For example, in Burger King Corp. v. Mason, the Eleventh Circuit rejected the franchisor’s argument that it was entitled to strictly enforce the termination provisions contained in the franchise agreement without regard to the materiality of the alleged defaults, stating:

"Although as a general rule parties to a contract may strictly enforce its terms and the courts will not rewrite an agreement to undo the consequences of a bad bar-o-

2000) (emphasizing that “[i]f party has a legal right to terminate [a] contract[,] . . . its motive for exercising that right is irrelevant”).

2. See Samuel Williston, Freedom of Contract, 6 CORNELL L.Q. 365, 366 (1921); Samuel Williston, Mutual Assent in the Formation of Contracts, 14 ILL. L. REV. 85 (1919); E. Farnsworth, CONTRACTS 21 (1982); see also Morris Cohen, The Basis of Contract, 46 HARV. L. REV. 553, 575 (1933) (“The law of contracts gives expression to and protects the will of the parties, for the will is something inherently worthy of respect.”).

3. See supra note 2.

4. See Nancy S. Kim, Reasonable Expectations in Sociocultural Context, 45 WAKE FOREST L. REV. 641, 642 (2010) (“The goal of contract law is often said to be the enforcement and protection of the reasonable expectations of the parties.” (citing Arthur Linton Corbin, Corbin on Contracts 2 (1952)).
gain, . . . the Florida courts do not blindly sanction unilateral termination of contracts when a default causes no harm to the party seeking to avoid performance. Consistent with this principle, the Florida courts have indicated that the materiality of a breach is relevant when a party seeks to terminate or rescind a contractual relationship.5

Some courts have construed franchise agreements to include an inherent requirement that the contract not be terminated except for “good cause.”6 Similarly, other courts have found that when a franchise agreement does not expressly provide for termination without cause, the contract is interpreted to include a “good cause” termination requirement.7

In addition, at least nineteen states and two U.S. territories have statutes that govern the ending of a franchise relationship. As noted below, many of the states with laws that address franchise agreement terminations require some form of good cause by the franchisor before a right of renewal can be denied.

Statutory Good Cause Requirement

State and federal franchise relationship laws statutorily limit the freedom to contract by imposing limitations on the franchisor’s right to terminate. Franchise relationship laws generally require good (or reasonable) cause for the termination or nonrenewal of a franchise.8 Even in states without generally applicable franchising laws, good cause might be required by special industry laws, such as those governing petroleum marketing,9 motor vehicle,10 farm equipment,11 and alcohol distributors.12 The definition of what constitutes good cause varies, but generally is defined to include the franchisee’s failure or refusal to comply with the material and reasonable obligations under the franchise agreement.

5. 710 F.2d 1480, 1490 (11th Cir. 1983).
Materiality Test

The franchise relationship statutes are generally ambiguous as to what constitutes a material obligation. Under the common law, there is not one single definition of materiality, but all interpretations include the same theme, namely, a material breach of contract “goes to the whole consideration of the contract” or “goes to the root or essence of the contract.” The preceding definitions are intentionally vague because the law employs a “standard of materiality that is necessarily imprecise and flexible,” and determining the materiality of an alleged breach of contract is a highly specific factual inquiry that is typically reserved for the fact finder.

The Restatement (Second) of Contracts posits that materiality depends on all of the facts and circumstances and provides the following five factors to assist in judging whether a breach is material:

(a) the extent to which the injured party will be deprived of the benefit which he reasonably expected;
(b) the extent to which the injured party can be adequately compensated for the part of that benefit of which he will be deprived;
(c) the extent to which the party failing to perform or to offer to perform will suffer forfeiture;
(d) the likelihood that the party failing to perform or to offer to perform will cure his failure, taking account of all the circumstances including any reasonable assurances;
(e) the extent to which the behavior of the party failing to perform or to offer to perform comports with standards of good faith and fair dealing.

The materiality determination must be resolved with reference to the intent of the parties as evidenced by the full circumstances of the transaction. In addition to the Restatement factors, some courts have looked to the extent of partial performance (substantial performance); the relative hardship on the parties; and the willful, negligent or innocent behavior of the party failing to perform. Under the good cause statutes of some jurisdictions, courts also inquire as to the reasonableness of the minimum performance standard.

In view of the circumstantial and fact-specific nature of the inquiry as to what constitutes a material breach, franchisors must tread carefully when deciding to terminate an “underperforming” franchisee for failure to comply

13. 17 AM. JUR. 2D Contracts § 446 (1964) (A material breach of contract “goes to the whole consideration of the contract. . . .”).
14. 6 SAMUEL WILLISTON, WILLISTON ON CONTRACTS § 106, at 368 (rev. ed. 1936).
15. RESTATEMENT (SECOND) OF CONTRACTS § 241 (1981); see also Canada Dry Corp. v. Nehr Beverage Co., 723 F.2d 512, 517 (7th Cir. 1983) (Despite the fact that Canada Dry could cite fourteen breaches of the franchise agreement, the court concluded that “after reviewing the evidence there was sufficient dispute concerning each of the asserted breaches of the franchise agreement that a jury could have reasonably concluded that these alleged breaches were not material and did not justify termination of the franchise agreement.”); Ron Matusalem & Matus of Fla., Inc. v. Ron Matusalem, Inc., 872 F.2d 1547 (11th Cir. 1989); 2 E. ALLAN FARNSWORTH, FARNSWORTH ON CONTRACTS § 8.16, at 443 (1990).
with minimum performance standards using strict enforcement of termination provisions. In order to understand how courts have applied the materiality (or reasonableness) factors to cases involving breaches of minimum performance standards, the following section contains examples from the case law of the types of conduct and circumstances that have been held to constitute, or not to constitute, good cause for terminating the franchise relationship in the context of minimum performance standards.

As demonstrated by these cases, courts tend to carefully examine the totality of the circumstances on a case-by-case basis, inquiring into, among other things, the franchisee’s history of performance; the franchisee’s performance compared to other franchisees; whether the minimum performance standard was imposed unilaterally or negotiated; and whether any external causes, such as franchisor interference or the local market, have caused the franchisee to become noncompliant despite its best efforts.

Cases Interpreting Good Cause for Failure to Meet Minimum Performance Standards

Cases Finding Good Cause for Termination

In *Brown Dog, Inc. v. Quizno’s Franchise Company, LLC*, a Quizno’s master franchisor was terminated for failing to meet a quarterly development quota for opening new restaurants within its territory for six consecutive quarters.18 After a bench trial, the court granted judgment against the area director (AD) on its claim for wrongful termination in violation of the Wisconsin Fair Dealership Law (WFDL). The court held that “good cause” existed to terminate the area director marketing agreement (ADMA) based on its finding that the development quotas were “essential and reasonable requirements” and that the master franchisor failed to “substantially comply” with the quota.

The court emphasized the fact that Brown Dog, rather than Quizno’s, prepared the development schedule.19 A comparison of Brown Dog’s development quota to those of other Quizno’s area directors showed that Brown Dog had a favorable initial ratio of restaurants to population through 2004, although thereafter the ratio gradually dropped closer to the mode for area directors as Brown Dog purchased additional development rights.20

The court also found that Quizno’s viewed the development quota as an actual minimum acceptable amount rather than an aspirational goal.21 The court referenced a “best efforts” provision typically contained in franchise agreements in support of this finding.22 The court also considered local market conditions and found that because Quizno’s established that its products

18. *Bus. Franchise Guide (CCH) ¶ 13,229 (W.D. Wis. 2005).*
19. *Id.*
20. *Id.*
21. *Id.*
22. *Id.*
were “explosively popular” in the market and that the Quizno’s brand was “hot,” that its development quotas as a minimum performance standard were fair and realistic.23

After concluding that the development quota was “essential and reasonable,” the court inquired into whether the area director failed to substantially comply with the development quota. Under Wisconsin law, noncompliance is substantial if it is “of such an extent and nature that there has been no practical fulfillment of the terms of the agreement.” The court recognized that perfection is not the standard in determining substantial compliance; “perforce, we must add a time axis to the equation.”

Brown Dog claimed that it substantially complied with its quotas because it was only one or two restaurants behind and often caught up to the preceding quarter’s quota during the following quarter. The court rejected Brown Dog’s argument, noting that the ninety-day cure provision of the ADMA itself provided that being one restaurant down for one quarter was not a failure to substantially comply with its terms and stated as follows:

Therefore, the ADMA itself provided that being one restaurant down for one quarter was not a failure substantially to comply with its terms. This is reasonable, since anyone could have a bad quarter, and you cannot draw a line with only one point. The ADMA gives an AD a second quarter within which to redouble its “best efforts” and cure the default. But that’s all: the ADMA makes clear that two consecutive quarters below quota will trigger klaxon horns in Denver and ought to trigger equal alarm in the offending AD: now there are two points between which a line may be drawn, and the line is red, representing ongoing noncompliance.24

In Rutman Wine Co. v. E. & J. Gallo Winery, in an unpublished opinion, the Ninth Circuit affirmed the lower court’s finding of “just cause” and “good faith” under the Ohio Alcoholic Beverage Franchise Act (OABFA) to justify termination of Rutman as a franchise distributor for declining and inadequate sales performance based on state and national averages.25

In Mills Datsun, Inc. v. Jaguar Cars, Inc., an authorized Jaguar retail dealership brought a claim against Jaguar for improper termination of its dealer agreement when Jaguar declined to renew Mills’ franchise as part of a nationwide dealer rationalization program in which marginal dealerships were eliminated. The Sixth Circuit, in an unpublished opinion, confirmed the district court’s decision, finding that the franchisor had “good cause” to refuse to renew the franchise agreement under Ohio Revised Code

23. Id.
24. Id.
25. 932 F.2d 973 (9th Cir. 1991) (The OABFA “prohibits acts of coercion and intimidation . . . and authorizes non-offensive and non-threatening acts of reasonable business aggressiveness as acceptable. In other words, the issue of just cause is whether the manufacturer commits acts of actual coercion or intimidation, or, in the alternative, whether such acts were honest and reasonable business decisions of any one of the acts authorized in the applicable sections of the statute.” Although a finding of “just cause” depends on the facts of each case, inadequate sales performance based on state and national averages offers sufficient justification under the OABFA for a manufacturer’s decision to terminate a distributorship agreement.).
§ 4517.55. The Sixth Circuit relied on the district court’s finding that the dealer, by refusing to accept Jaguar automobiles when available in 1980 and 1981, did not even do the amount of business available to it and that other Jaguar dealers in the area had much greater success in promoting and selling Jaguar automobiles. The district court also found that the impact on the public from Mills’ termination as a franchisee would be negligible. The Sixth Circuit reasoned that these two factors are specifically listed in § 4517.55(A) as factors for the court to consider when determining whether good cause has been established for the termination of a franchise. As a result, the applicable statute is non-exclusive, and the district court properly included the “business judgment” of the franchisor among the factors it can consider when determining whether a franchise was terminated for good cause.

In *Aring Equipment, Co., Inc. v. Link-Belt Construction Equipment Co.*, a construction equipment distributor’s failure to meet reasonable and nondiscriminatory sales goals constituted good cause for termination under the Wisconsin Fair Dealership Law. In this case, the distributor failed to meet its sales goals and experienced a decrease in market share from fourteen percent in 1983 to two percent in 1986. The court also reasoned that although the distributor’s sales of one of the supplier’s products was above the company average, the distributor failed to meet the sales objectives with respect to another product. The court found the supplier was justified in requiring the distributor to meet a certain quota with regard to one of several products because it was the supplier’s most important product in the territory.

The second element in the statutory definition of good cause is that the granter’s requirements be reasonable and nondiscriminatory. To achieve the market share and cure other deficiencies, the supplier required the distributor to develop a business plan and provided the distributor with an outline of specific deficiencies and steps to facilitate cure of the deficiencies. These requirements were reasonable. In viewing the distributor’s performance relative to other distributors, the court did not find that the requirements

26. 884 F.2d 579 (6th Cir. 1989) (Under Ohio law, a franchisor may terminate or fail to renew a franchise for “good cause.” In determining whether good cause for termination of a franchise has been established, the court, according to Ohio Rev. Code § 4517.55(A), “shall take into consideration the existing circumstances, including, but not limited to,” seven factors specifically listed in the statute.). *Id.* at 1.

27. Bus. Franchise Guide (CCH) ¶ 8906 (Wis. Cir. Ct. 1987) (The statutory definition of “good cause” for termination has two elements: (1) failure by a dealer to comply substantially with essential and reasonable requirements imposed by the grantor, and (2) requirements that are reasonable and nondiscriminatory.).

28. *Id.*

29. *Id.*

30. *Id.*

31. *Id.*

32. *Id.*

33. *Id.*
to be discriminatory. Accordingly, the court found that the supplier established good cause to terminate the distributorship.

Cases Finding No Good Cause for Termination

In *Newell Puerto Rico Ltd. v. Rubbermaid Inc.*, a Rubbermaid distributor brought a claim against Rubbermaid for improper termination of its exclusive distribution agreement for failure to achieve assigned sales objectives in violation of Puerto Rico Dealer’s Contract Act (Law 75), which prohibits a supplier from terminating or non-renewing a distribution agreement except for “just cause.” The First Circuit affirmed a jury verdict rendered in favor of the distributor finding that Rubbermaid failed to establish “just cause” for terminating the distribution agreement under Law 75.

Newell presented evidence at trial that its assigned sales objectives did not adjust to the realities of the Puerto Rican market and were unreasonable. Law 75 establishes that when a dealer’s violation of a sales quota is because it does not adjust local market conditions, the violation will not be deemed just cause and the burden of proof shifts to the manufacturer “to show the reasonableness of the rule of conduct or of the quota or goal fixed.”

Rubbermaid presented evidence under Law 75 that termination was justified because Newell experienced a decline in sales of Rubbermaid products as the result of engaging in the manufacture and distribution of a competing product line not related to Rubbermaid that created a conflict of interest. Newell submitted evidence to refute Rubbermaid’s contention that the plastic household products it distributed had been in the market since 1968 and competed with Rubbermaid products for the entire span of the distribution agreement. Newell’s evidence indicated that there was no new competition introduced by Newell or any other conflict that would justify termination of the distribution agreement. Newell also presented evidence that its decline in sales was caused, in part, by Rubbermaid’s sale of products within Newell’s territory at the same price it sold to Newell, undercutting the ability of Newell to compete on the Puerto Rican market for sales of Rubbermaid products.

In *Hartford Electric Supply v. Allen-Bradley Co., Inc.*, an Allen-Bradley distributor brought an action against its franchisor under the Connecticut

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34. *Id.*
35. *Id.*
37. *Id.* at 22 (Law 75 defines “just cause” as the “nonperformance of any essential obligations of the dealer’s contract on the part of the dealer, or any action or omission on his part that adversely and substantially affects the interests of the principal or grantor in promoting the marketing or distribution of the merchandise or service.” The law also provides a list of exceptions and presumptions for purposes of determining whether there is “just cause.” 10 P.R. LAWS ANN. tit. 10, § 278a-1.).
38. *Id.*
39. *Id.* at 23.
40. *Id.*
Franchise Act and the Connecticut Unfair Trade Practices Act (CUTPA) seeking damages and injunctive relief in connection with the franchisor’s termination of the distributorship agreement for not meeting sales quota established unilaterally by the franchisor.\(^41\) The trial court entered a temporary injunction and then entered a judgment for damages and permanent injunction in favor of the distributor-franchisee.\(^42\) The trial court found that the franchisor did not have good cause to terminate the distributorship agreement based on the alleged insufficient performance by the franchisee where the economy was depressed, the franchisor had previously praised the franchisee for its performance, the franchisor failed to demonstrate how the franchisee’s performance compared to that of other franchisees, and the franchisee otherwise complied with its requirements under the parties’ distributorship agreement. The Connecticut Supreme Court affirmed.\(^43\)

The distributorship agreement provided that “either party may terminate [it] at any time, with cause or without any cause,” on ninety days’ notice. The franchisor terminated the agreement on the grounds that the franchisee failed to comply with written marketing commitments established in the annual business plan as well as mutually established sales goals established annually.

The Connecticut Franchise Act requires “good cause” for termination of the agreement.\(^44\) To establish “good cause,” the franchisor had to show that the franchisee either failed or refused to comply substantially with a material and reasonable term of the franchise agreement, or that the franchisor had an equivalent business reason of a similar nature.\(^45\) The franchisor has the burden of proving “good cause” to terminate the franchise, even if the franchisee is the plaintiff, as in the present action. An objective standard is applied when determining whether the franchisor had good cause to terminate an agreement.\(^46\)

The evidence demonstrated that the franchisee suffered weakened sales that mirrored the correspondingly infirm Connecticut economy and was placed in a distributor concern program that carried a threat of termination. The franchisor failed to demonstrate how the franchisee’s performance during that period of time compared to similar distributors or to the regional or national growth.\(^47\) Thereafter, the franchisee’s sales increased by 20.6% growth one year and another 22.5% growth the next fiscal year, thereby exceeding the franchisor’s national growth by 3.5%. The franchisor sent the franchisee a letter of commendation because it was one of twenty-one dis-

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\(^41\) 736 A.2d 824 (Conn. 1999) (citing CONN. GEN. STAT. §§ 42-133e to -133h, 42-110a).
\(^42\) Id. at 827.
\(^43\) Id.
\(^44\) CONN. GEN. STAT. § 42-133f(a).
\(^45\) Id.
\(^46\) Hartford Elec. Supply, 736 A.2d 824 (Conn. 1999).
\(^47\) Id. at 829.
tributors to buy more than $10 million worth of the franchisor’s products during the prior fiscal year.\textsuperscript{48}

Thereafter, even though the franchisee’s sales declined 13.5\% during a six-month period, the Hartford Electric court found that this constituted too short of a time period from which the franchisee’s overall sales performance could be reasonably evaluated.\textsuperscript{49} The court also noted that the franchisor failed to show adequately how the franchisee’s performance compared to similar distributors or to the franchisor’s regional or national growth during the same time period.\textsuperscript{50}

The Hartford Electric court also considered the franchisee’s compliance with other requirements in the agreement and found that the franchisee complied with the agreement’s requirement to “vigorously and aggressively promote and develop the market for the sale of [the defendant’s] [p]roducts. . . .”\textsuperscript{51}

In Wadena Implement Co. v. Deere & Company, Inc., the Minnesota Court of Appeals upheld the district court’s summary judgment ruling enjoining the termination of Wadena’s agricultural dealership agreement for failure to comply with a market penetration requirement.\textsuperscript{52} As discussed later, Deere’s termination letter did not comply with the “good cause” notice and opportunity to cure requirement under the Minnesota Agricultural Equipment Dealership Act (MAEDA).\textsuperscript{53} In addition, Deere failed to establish that Wadena “consistently failed” to meet its reasonable market share so as to support termination of the dealer in 1990 under the MAEDA for “consistently failing” to meet the market penetration requirements; “1989 was first year for which specific market share requirement could be inferred, and at least two years of noncompliance was required for consistent failure to be found.”\textsuperscript{54}

In N. I. Petroleum Ventures Corporation v. GLES, Inc., the U.S. District Court for the District of Delaware found that the nonrenewal of a gasoline supply contract for failure to comply with a minimum fuel purchase requirement was unjustified for lack of materiality because the franchisor’s interest in full performance of the quota was satisfied in light of a financial sanction built into the agreement. Specifically, the franchise agreement provided that if the distributor ordered less than 1,000,000 gallons of fuel, the fuel supplier was entitled to receive $0.015 per gallon below the quota. The court found that the financial compensation to the franchisor for sales below the million gallon benchmark satisfied the purpose of the minimum fuel level quota in providing minimum profit for the franchisor and was not a “significant substantive requirement relating to the way the franchisee must run [the] busi-
ness.” The district court also found it relevant that the minimum sales quota was not included among the enumerated material conditions of the franchise relationship, noting that its inclusion as a material condition would not be dispositive, but the failure to do so is informative.

The reasoning in *N. I. Petroleum Ventures* that a franchisor should not be entitled to “have its cake and eat it too” should be considered by franchisors that possess a contractual remedy for noncompliance with a minimum performance representations. Indeed, many franchisors have contractually eliminated the risk of financial loss caused by an underperforming franchisee by imposing minimum royalty fees or other financial sanctions into their franchise agreements. In these situations, a franchisee may successfully argue that its full compliance with a sales or purchase quota does not deprive the franchisor of its benefit of the bargain and thus termination is not appropriate.

*Notice and Cure Requirements Also Limit Terminations for Breach of Minimum Performance Standards*

Franchise agreement terminations must also comply with the notice and cure requirements that may apply under both the franchise agreement and applicable franchise relationship laws, either of which may require that the franchisor provide the franchisee with a realistic opportunity to achieve the performance level required within the time permitted. Failure to comply with the applicable notice and cure requirements may invalidate an otherwise valid termination. However, the practical inability to cure the breach of a minimum performance standard may often limit the ultimate effect of these requirements.

For example, in *Al Bishop Agency, Inc. v. Lithonia-Division of National Service Industries, Inc.*, the court preliminarily enjoined a lithium manufacturer from terminating its dealer where, despite finding that the dealer’s failure to sell a minimum amount of florescent lighting was “good cause” for termination of the dealership agreement under the Wisconsin Fair Dealership Law, the court determined that the manufacturer imposed an unreasonable cure requirement on the dealer. Even though the manufacturer’s termination notice was technically sufficient because it provided ninety days’ notice of termination and granted the dealer the requisite sixty days to cure, the court found that the notice was inadequate in a practical sense because it was impossible for the dealer to comply with the cure requirements. Specifically, the plaintiff-dealer was required to bring its whole year’s sales up to the company average in only sixty days. The court found that this was not

56. *Id.*
58. *Id.*
59. *Id.*
only a difficult task, but in light of the practicalities of the business, this task was impossible for various reasons based on the evidence.  

In *Wadena Implement Co. v. Deere & Co., Inc.*, the Minnesota Court of Appeals reached a similar result. Deere’s termination of an agricultural dealership agreement for failure to comply with a market penetration requirement violated the “good cause” requirement under the Minnesota Agricultural Equipment Dealership Act (MAEDA) because of its “ambiguity and practical impossibility of compliance,” even though the termination letter technically complied with notice requirements under both the MAEDA and the dealer agreement. The court found that for a newly imposed market share requirement measuring a dealer’s performance under the MAEDA to be reasonable, the dealer must have some realistic prospect of achieving the level required within time permitted. Taking the termination letter at face value, the court noted that “Wadena Implement was terminated for failing to increase its market share by 500 percent in one year (1989). For a thirty-year-old dealership, such a requirement is unreasonable on its face.

A reasonable approach for the franchisor to take is to communicate with its non-compliant franchisee while termination is being considered. For example, in *Richland Wholesale Liquors v. Glenmore Distilleries Co.*, the Fourth Circuit upheld the termination and found that not only did the franchisor provide the distributor with written notice that it was considering the termination six months before making its final decision, it also met with the distributor a number of times to discuss its concerns about the sales situation.

**Effect of the Implied Covenant of Good Faith and Fair Dealing**

Under the common law, many jurisdictions imply a duty of good faith, fair dealing, and commercial reasonableness by the franchisor to respect the reasonable expectations of its franchisees, restricting the franchisor

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60. Id.
61. 480 N.W.2d 383, 384–89 (Minn. Ct. App. 1992) (citing MINN. STAT. ANN. § 325E.05 et seq.). The MAEDA defines “good cause” as: “[F]ailure by a farm equipment dealer to substantially comply with essential and reasonable requirements imposed upon the dealer by the dealership agreement, if the requirements are not different from those requirements imposed on other similarly situated dealers by their terms.” MINN. STAT. ANN. § 325E.062, subd. 1 (1990). In addition to this general definition, the MAEDA enumerates eight other situations in which a manufacturer would have the requisite “good cause,” including where: “[T]he farm equipment dealer, after receiving notice from the manufacturer of its requirements for reasonable market penetration based on the manufacturer’s experience in other comparable marketing areas, consistently fails to meet the manufacturer’s market penetration requirements.” MINN. STAT. ANN. § 325E.05 subd. 1(8).
62. Id.
63. Id. at 388.
64. 818 F.2d 312 (4th Cir. 1987); see Aring Equip. Co., Inc., Bus. Franchise Guide (CCH) ¶ 8906 (To achieve market share and cure other deficiencies, in its March 31 letter, Link-Belt outlined specific deficiencies and steps to facilitate cure of deficiencies and required Aring to develop a business plan. These steps were found reasonable by the court’s analysis. The court also found that the requirements for stock, rental, and parts inventory were not so out of line with past custom that Aring was incapable of substantially meeting them.).
from terminating the franchise relationship without good cause. In *Dayan v. McDonald’s Corp.*, the duty of good faith was described as follows: “[A] party vested with contractual discretion must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties.”

Additionally, courts have found implicit in a franchise contract for a term of years the “reasonable expectation,” under “principles of good faith and commercial reasonableness,” that the franchisor will not arbitrarily or summarily terminate the franchise agreement. However, in cases where the franchisee possesses bargaining power and is aware of an explicit no-cause termination provision, some courts have refused to imply the contractual duty of the franchisor not to act arbitrarily in terminating a franchise to override an express contractual right to terminate, finding no breach of the covenant of good faith and fair dealing in a no-cause termination provided for by the explicit terms of the contract.

In *HLT Existing Franchise Holding LLC v. Worcester Hospitality Group LLC*, a terminated Hampton Inn franchisee brought a claim against the franchisor seeking damages and injunctive relief based on the franchisor’s decision to terminate the franchise agreement, primarily as the result of negative results of guest satisfaction surveys. The terminated franchisee argued that Hilton’s performance evaluations were inconsistent, arbitrary, and lacked an objective scoring scale. The terminated franchisee also contended that the guest satisfaction surveys were inadmissible hearsay statements and should not have been considered by the court in assessing whether the franchisor acted properly in terminating the franchise. The Second Circuit held, however, that the surveys were not offered to prove the truth of the matters asserted in the survey reports, but rather “were admitted solely for the purpose of showing their effect on [the franchisor’s] decision to terminate the franchising agreement.” The Second Circuit concluded that the survey data tended to show that the franchisor did not act arbitrarily, irrationally,

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65. See e.g., 7-Eleven, Inc. v. Dar, 757 N.E.2d 515 (Ill. App. Ct. 2001) (“Termination of a franchise must be supported by good cause.”).
67. Id. at 991.
71. Id. at 536.
72. Id. at 535.
73. Id.
or in violation of its implied obligation of good faith and fair dealing, and that it was proper to consider the survey data for that purpose.\textsuperscript{74} The Second Circuit upheld the termination and found that the franchisee was unable to meet its burden that the franchisor had acted inconsistently with the covenant of good faith and fair dealing.\textsuperscript{75}

Some franchise relationship laws also require that the termination of a franchisee be conducted in good faith. In \textit{Milos v. Ford Motor Co.}, a terminated Ford dealer brought suit for violation of the Automobile Dealers Day in Court Act seeking damages for the termination of its franchise agreement.\textsuperscript{76} The dealer admitted that it did not fulfill its contractual sales objectives and failed to increase its facilities as required under the agreement. The dealer contended that the sales and facilities requirements were oppressive and unreasonable, and Ford’s insistence upon them constituted a failure to act in good faith as required by the statute.\textsuperscript{77}

The Third Circuit affirmed the district court’s decision in finding that “the record is devoid of any evidence which would support a jury finding that the termination of plaintiff’s franchise resulted from the failure of Ford to act in ‘good faith’ as that term is defined in the Automobile Dealers Day in Court Act.”\textsuperscript{78} The Third Circuit explained that the critical term is “good faith,” which is defined as “the duty of each party to any franchise, and all officers, employees, or agents thereof to act in a fair and equitable manner toward each other so as to guarantee the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party: Provided, that recommendation, endorsement, exposition, persuasion, urging or argument shall not be deemed to constitute a lack of good faith.”\textsuperscript{79}

The undisputed evidence disclosed that the plaintiff’s sales record was substandard, not merely in terms of the objectives assigned to it, but in comparison with the record of other dealers. The court found that with respect to the sales quotas, the criteria provided in the agreement appeared to be eminently reasonable, objective, and nondiscriminatory, and were based on the market potential of the dealer’s territory, rather than a randomly assigned metric.\textsuperscript{80}

With respect to the adequacy of the dealer’s facilities, the court observed that the dealer acknowledged the deficiency and the first franchise was granted only after it promised to remedy its facilities within two years. The court found that

\begin{itemize}
  \item this is not a case of a manufacturer who, having induced a dealer to accept a franchise and make a substantial investment, then seeks to compel him to expand his
\end{itemize}

\begin{footnotes}
    \item 74. \textit{Id.} at 538.
    \item 75. \textit{Id.} at 540.
    \item 77. \textit{Id.} at 715.
    \item 78. \textit{Id.} at 718–19.
    \item 79. \textit{Id.} at 715 (citing 15 U.S.C. § 1221(e)).
    \item 80. \textit{Id.} at 717.
\end{footnotes}
facilities. Rather, it is a case of one party to a contract freely entered into requiring
the other party to perform. An attempt to enforce an unambiguous contractual ob-
ligation, under these circumstances, can hardly be said to constitute coercion or
intimidation. 81

Accordingly, the Third Circuit affirmed the decision of the district court and
found that Ford acted in good faith. 82

Waiver of Minimum Performance Standards Through Course of Conduct

Under the common law, a party to a contract may voluntarily and inten-
tionally surrender, relinquish, or forego a known right that the party other-
wise may have had against other parties. 83 Parties may generally modify their
contracts by oral agreement or course of dealing after the date of the initial
contract, and a “no oral modifications” clause does not prevent such oral
modification. 84 The equitable doctrines of waiver or estoppel may similarly
prohibit a franchisor from invoking a provision in its written contract where
it has, by its conduct, led its franchisee to believe it would not invoke the
provision to terminate.

In cases where the franchisor generally does not enforce its standards
against a group of noncompliant franchisees, such “routine practices” of
the franchisor are relevant to prove that the franchisor acted in conformity
with its habit or routine practice of waiving compliance with respect to
the franchisee. The franchisor’s “routine practice” of waiving strict perfor-
mance is a classic form of admissible Federal Rule of Civil Procedure
Rule 406 evidence. 85

81. Id. at 717–18.
82. Id. at 719.
(D. Del. 1979) (“The type of ‘waiver’ that is claimed to have occurred in this case is that
which arises when a party to a contract learns of a breach by the other party that gives him
the right to terminate the contract and he does not exercise his right to do so within a reasonable
period of time. Such a decision to continue with the contract is viewed by the Illinois courts as a
waiver of the right to terminate the contract on that ground.”); LaGuardia Assoc. v. Holiday
found the franchisor also waived the right to bring suit for failure to begin operating the franchi-
sees’ other franchise (as ostensibly required by the franchise agreement) within twelve months after
the franchise agreement’s execution. The franchisor had waited over two years to assert its claim
and told the franchisees, after the deadline elapsed, that they need not worry about the deadline’s
expiration.)
84. Potts v. Draper, 864 S.W.2d 896, 899 (Ky.1993) (“Course of actual performance by the
parties must be considered the best indication of what they intended the writing to mean.”); Vi-
naird v. Bodkin’s Adm’n, 72 S.W.2d 707, 711 (Ky. 1934) (“The power to modify or rescind a
preexisting agreement is coextensive with the power to initiate it; either is an incident of con-
tractual capacity. This rule prevails, though the contract recites that no modification shall be
made except in writing.”); Shaull Equip. & Supply Co. v. Ingersoll-Rand, Bus. Franchise
Enter. Fin. Grp., Inc., 148 F.3d 1206, 1218 (10th Cir.1998) (evidence of a pervasive, consistent
pattern of abusive rescissions was clearly relevant to question of how defendant acted in one
Habitual non-enforcement of minimum performance standards may arise in franchise systems where the franchisor does not suffer any financial loss as a result of its franchisees’ underperformance. Indeed, franchisors tend to be much less inclined to terminate a franchisee for not meeting sales quotas if the franchisor does not sustain a financial detriment. Overly aggressive aspirational standards as minimum performance standards can also lead to a substantial number of noncompliant franchisees. In practice, such minimum performance standards function as goal metrics to encourage (or coerce) the franchisee to go above and beyond the franchisor’s actual minimally acceptable requirements. For whatever the reason, the franchisor may be found to have relinquished its right to demand “strict performance” of its minimum performance requirement through its course of performance of non-enforcement.

In Swartz v. Chrysler Motors Corp., all franchised dealers of Dodge automobiles had a minimum sales responsibility (MSR) under their dealership agreements with Chrysler Motors. At any time, there were a substantial number of franchised dealers in technical default of the MSR requirement and “nowhere near that number had been terminated.” Thus, the court concluded, inter alia, that “Chrysler has waived failure to achieve MSR as a default in plaintiff’s dealership agreements by treating it as a performance goal rather than as a condition of those agreements.”

Selective Enforcement of Minimum Performance Standards

Enforcing a minimum performance standard against a franchisee to the exclusion of other similarly situated franchisees may avail a terminated franchisee with a defense or counterclaim under the common law doctrines of waiver, modification, estoppel, and good faith and fair dealing, as well as for violation of anti-discrimination statutes.

Identical treatment of all franchisees is not, however, required to avoid the standard. Indeed, a level of differentiation when evaluating non-performing franchisees is often necessary to enable the franchisor to take into account each franchisee’s particular situation. For example, in Key v. Chrysler Motors Corp., the Supreme Court of New Mexico found that “quotas need to be applied uniformly to all franchisees, taking into account local con-
ditions, because failure to meet quotas may be attributed to economic or market factors beyond the franchisee’s control.” Also relevant is the degree of noncompliance between the terminated franchisee that may have been consistently failing to meet sales goals versus others that are improving their performance and taking steps to rectify.88

The terminated franchisee may also possess a claim for breach of the implied covenant of good faith and fair dealing as a result of the selective enforcement of a minimum performance standard.89 The fact that a franchisor may have declined to exercise its contractual right to terminate a franchise in the past does not transform that right into a discretionary decision governed by the standard of good faith and fair dealing.90 However, the covenant of good faith and fair dealing may prevent termination when the franchise can establish disparate treatment of franchisees and abrupt changes in the parties’ course of dealing.91

In *Kilday v. Econo-Travel Motor Hotel Corp.*, the franchisee brought a claim for discrimination against the franchisor, asserting that the franchisor breached the franchise agreement by requiring the franchisee to comply with standards of quality, maintenance, and cleanliness, as specified in the franchise agreement, but not required of other franchisees.92 The U.S. District Court for the Eastern District of Tennessee, acting in the absence of a franchise relationship law or an anti-discrimination statute, dismissed this claim because the standards imposed upon the franchisee did not “appear to obligate the defendant to require all its franchisees to conform to the standards required of the plaintiffs.”93 The court found that a uniform franchise agreement does not grant a protected, third-party beneficiary status to franchisees as a whole, authorizing such franchisees to insist that the provisions be enforced consistently. Instead, each franchise agreement between the franchisor and the respective franchisee is independent of one another.94

In situations where a minimum performance standard has not been routinely enforced against a group of franchisees, the franchisor should consider issuing a “new day” letter to its franchisees communicating its intention of

89. RESTATEMENT (SECOND) OF CONTRACTS § 205 (1981) (sets forth the basic rule that “every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”).
93. Id. at 163.
94. Id.
strictly enforcing the franchise agreement in the future. For example, in *Brown Dog*, the U.S. District Court for the Western District of Wisconsin stated:

It was untenable for the master franchisor to imply that after jettisoning its tolerance for mediocrity, the franchisor nonetheless was required ever after to provide each underperforming master franchisor with as much cure time as its worst-ever performing master franchisor had received prior to the policy change. It was not the master franchisor’s concern whether the franchisor let some of its other master franchisors “slide” prior to its announced policy change.95

Franchisors must also ensure that termination does not violate the anti-discrimination provisions of certain franchise relationship laws.96 In *L-O Distributors, Inc. v. Speed Queen Co.*, the termination of a dealership due to poor sales performance was found to not be discriminatory under WFDL where six other dealers were also terminated for poor sales performance over a seventeen-month period.97

**Effect of State Unfair and Deceptive Trade Practices Acts**

A franchisor’s ability to terminate may also be impacted by an applicable state unfair and deceptive trade practices statute.

For example, in *Richland Wholesale Liquors*, a liquor distributor obtained a judgment against its franchisor after a jury trial for wrongful termination of its liquor distributorship and for violations of the South Carolina Unfair Trade Practices Act (SCUTPA).98 The termination was based on the distributor’s declining sales that fell short of minimum performance standards. On appeal, the Fourth Circuit considered whether the termination is wrongful if it is conducted in accordance with the parties’ contract and the manner of termination is not contrary to equity and good conscience.99 The Fourth Circuit found that the supplier acted in accordance with its contractual right to terminate the relationship and that it had a reasonable business justification for terminating and transferring the distributorship because the distributor’s sales had declined over a substantial period of time, the distributor agreed with at least some of the proposed performance goals, and the distributor was pushing other supplier’s products more aggressively.100 The court also noted that the successor distributor sold substantially more products in its first year of operation.101 The malicious

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96. See e.g., Wis. Stat. § 135.01–135.07 (2006) (the statutory definition of “good cause” for termination has two elements: (1) failure by a dealer to comply substantially with essential and reasonable requirements imposed by the grantor, and (2) requirements that are reasonable and nondiscriminatory); Aring Equip. Co., Inc., Bus. Franchise Guide (CCH) ¶ 8906.
99. Id. at 316.
100. Id. at 317.
101. Id.
and arbitrary conduct required under the South Carolina law is not directed
to the intent or motivation behind the termination of the contract.\textsuperscript{102} Here,
the supplier’s lack of malice in effecting the termination was clear because it
provided the distributor written notice that it was considering the termina-
tion six months before making its final decision.\textsuperscript{103}

The Fourth Circuit also noted that the terminated distributor conceded
that it had suffered no damages because of the performance program, having
recouped all of its investments in promoting Glenmore’s products.

\textbf{Conclusion}

There is a fine line between protecting the franchisor’s business interest
and imposing unreasonable minimum performance requirements upon an
otherwise diligent franchisee. It is the author’s view that minimum perfor-
man ce requirements can be mutually beneficial to franchisors and franchi-
sees if: (1) they can be satisfied by reasonably diligent franchisees, and
(2) they are expressly stated in the franchise agreement and uniformly and
impartially enforced throughout the franchise system. The first safeguard
provides a substantive check against overly aspirational metrics, while the
second safeguard provides procedural protection against capricious decisions
by franchisors.

Without substantive safeguards, minimum performance requirements im-
pose upon franchisees a recipe for non-compliance, on either a regular or occa-
sional basis. Often times, this situation can arise where the franchisor es-

tablishes a “one-size fits-all” standard that does not take into account a
particular franchisee’s local market, or where it has established its business
in a territory where the system has not been tested, does not consider actual
historical performance in the franchisee’s market when establishing the cri-
teria, does not take into account seasonal adjustments in sales volumes, and
does not consider a franchisee’s actual efforts to develop its territory.

Without procedural safeguards, franchisors are able to unfairly utilize a
widespread lack of compliance with selective enforcement against otherwise
diligent franchisees. For example, if the franchisor imposes highly aggressive
minimum performance requirements that can be consistently achieved only
by a minority of franchisees, uniformity and impartiality of enforcement will
require a franchisor to adjust the metrics accordingly. Without uniformity
and impartiality, the franchisor can abuse the minimum performance re-
quirements by selectively waiving compliance in the majority of violations,
but selectively enforcing the requirements against disfavored franchisees.
Absent reasonably uniform enforcement, minimum performance standards
are nothing more than a Sword of Damocles hanging over the heads of un-
suspecting franchisees.

\textsuperscript{102} Id.
\textsuperscript{103} Id.
Franchise (& Distribution) Currents

Jason B. Binford, Earsa R. Jackson, and Marleí Morís

ANTITRUST


Wabash, which manufactures semitrailers, offered a dealership agreement to Ervin Equipment. Wabash later terminated the dealer’s agreement, and the dealer asserted causes of action against Wabash under the Indiana Franchise Act and the Indiana unfair practices statute and for breach of contract in conjunction with its allegation that the manufacturer terminated the agreement without good cause and proper notice. The dealer sought a preliminary injunction to prevent Wabash from terminating the agreement. Wabash moved to dismiss these claims. The court dismissed the claims under the Indiana Franchise Act and breach of contract, but left the unfair practices act claim. The court denied the dealer’s motion for a preliminary injunction.

The dealer then amended its complaint to add causes of action for conspiracy under the Sherman Act. The dealer alleged that Wabash conspired with other Wabash dealers to terminate it and impose illegal territorial restraints on Wabash dealers. Wabash moved to dismiss this claim as well; however, the court concluded that the dealer did allege sufficient facts to state a claim at this stage of the case.

In response to the amended complaint, Wabash asserted two counterclaims: (1) sham litigation and (2) abuse of process. Wabash alleged that the dealer was using the litigation for the improper purpose of running up the costs incurred by the manufacturer and im-
proper motive. The dealer moved to dismiss these claims pursuant to Federal Rule of Civil Procedure 12(b)(6). The court acknowledged that Rule 12(b)(6) required it to accept as true all allegations by the nonmoving party for purposes of determining the motion to dismiss; however, the court explained that it is “not required to accept threadbare recitals of a cause of action’s elements, supported by mere conclusory statements.” Ashcroft v. Iqbal, 556 U.S. 662, 663 (2009). The court rejected the counterclaims as conclusory because the dealer was clearly attempting to preserve its ability to distribute the manufacturer’s products.

The court further explained that sham litigation is not an independent cause of action but merely an exception to the Noerr-Pennington doctrine. Noerr-Pennington provides a party immunity under the First Amendment from antitrust claims asserted against it based on the party petitioning the court for relief. Eastern R.R. Presidents Conference v. Noerr-Pennington Freight, Inc., 365 U.S. 127 (1961). Sham litigation has two elements: (1) objectively baseless claims such that no reasonable litigant would have a realistic expectation of success; and (2) baseless suit filed to interfere with the opposing party’s business relationship. The court found no sham litigation as a matter of law, given that two of the dealer’s original claims survived a motion to dismiss.

The court then examined Wabash’s counterclaim for alleged monopolization under Section 2 of the Sherman Act based on the dealer’s alleged predatory conduct. The court stated that a claim under Section 2 of the Sherman Act requires more than conclusory statements, including (1) predatory or anticompetitive conduct, (2) specific intent to monopolize, and (3) dangerous probability of achieving monopoly power. Spectrum Sports v. McQuillan, 506 U.S. 447, 456 (1993). The court determined that Wabash failed to allege that the dealer maintained a certain percentage of market power. Wabash merely alleged the dealer was the “largest seller of used dry van semitrailers in the country.” Absent an allegation that the dealer maintained at least 50% of the market share, a manufacturer’s claim fails as a matter of law to allege a Section 2 Sherman Act claim. Bailey v. Allgas, Inc., 284 F.3d 1237, 1250 (11th Cir. 2002) (“[A] market share at or less than 50% is inadequate as a matter of law to constitute monopoly power.”).

Abuse of process is not a federal cause of action, so the court looked to state law for guidance. Indiana does recognize such a claim when there is proof of an ulterior purpose and a willful act in the use of the process not proper in the regular conduct of the proceedings. Hart v. Mannina, 798 F.3d 578, 593 (7th Cir. 2015). For many of the same rationales discussed above, the court found no abuse of process and denied the manufacturer’s motion to dismiss. The court explained that the remaining dealer causes of action would survive a motion to dismiss at this time. Should the litigation reveal the dealer falsified any information or otherwise misrepresented facts to the court, the court noted, Wabash could avail itself of relief under Federal Rule of Civil Procedure 11 for sanctions against the dealer, its attorney, or both.
ARBITRATION


In this case, the court took up the issue of whether a declaratory judgment action filed by a franchisee is subject to arbitration and, if so, where the arbitration should be conducted. The franchisee entered into a ten-year franchise agreement in 2011. In April 2016, the franchisee closed the business and did not relocate. At some time thereafter, the franchisor attempted to collect amounts from the franchisee that the franchisor maintained were owed under the franchise agreement. The franchisee then filed a declaratory judgment action on June 17, 2016, seeking a declaration that it did not owe the franchisor any money. The franchisor filed a motion and demand for arbitration with American Arbitration Association (AAA). The franchisee attempted to enjoin the arbitration by seeking a temporary restraining order, but this injunctive relief was denied. The franchisor filed a motion to compel arbitration and dismiss the action or, alternatively, to stay the action before the court while arbitration proceeded.

The franchise agreement contained an arbitration clause as follows:

Except for matters relating to the collection of monies owed to [the franchisor] by [the franchisee] and/or as otherwise explicitly exempted herein, any controversy or claim arising out of or relating to this agreement or with regard to its interpretation, formation or breach of any other aspect of the relationship between [the franchisees] and [the franchisor] . . . which is not settled through negotiation or mediation, shall be arbitrated in accordance with the Commercial Arbitration Rules of the [AAA]. Unless required otherwise by state law or by mutual agreement, the parties agree to arbitrate in Boston, Massachusetts. The parties agree further that the Arbitrators may tender an interim ruling, including injunctive relief, and all claims of any type by either party, including defenses, are included in the jurisdiction of the arbitration.

The court held that a written arbitration agreement is “valid, irrevocable, and enforceable” in much the same way as any other contract or contractual provision. 9 U.S.C. § 2; see also Rent-A-Center, West, Inc. v. Jackson, 561 U.S. 63, 67 (2010). Further, the court noted that when there is a dispute about whether parties should proceed in arbitration, a court must consider (1) whether an arbitration agreement exists and (2) whether it encompasses the dispute at issue. The party resisting arbitration bears the burden of proving the claims are not suitable for arbitration. Green Tree Fin. Corp.-Alabama v. Randolph, 531 U.S. 79, 91 (2000).

Normal contract interpretation rules apply to interpretation of arbitration provisions; any doubts are resolved in favor of arbitration. “[A]rbitrability ‘is left to the court unless the parties clearly and unmistakably provide otherwise.’” Momot v. Mastro, 652 F.3d 982, 987–88 (9th Cir. 2011). The arbitration clause at issue required that “any controversy or claim arising out of or relating to this Agreement or with regard to its interpretation . . .” be referred to arbitration. The court read this language broadly enough to find
a clear intent on the part of the parties to arbitrate even the declaratory relief claim.

Further, in incorporating the AAA’s rules, the parties adopted the AAA’s rule that the parties agree to arbitrate arbitrability. The franchisee challenged whether the adoption of those rules was “clear and unmistakable” evidence of the parties’ intention given the franchisee’s lack of business sophistication to understand the significance of adopting AAA’s rules. In the absence of the Ninth Circuit providing guidance on whether lack of sophistication in the commercial context is enough to shift the scale away from compelling arbitration, the court looked to two other district court cases. Neither case foreclosed the possibility that an unsophisticated party could clearly and unmistakably delegate arbitrability to an arbitrator by merely incorporating the AAA rules. See Galen v. Redfin Corp., No. 14-cv-05229-THE, 2015 WL 7734137 (N.D. Cal. Dec. 1, 2015) and Zenelaj v. Handybook Inc., 82 F. Supp. 3d 968, 973 (N.D. Cal. 2015). More interesting is the fact that the court rejected the franchisee’s assertion that it was unsophisticated, citing the complicated nature of the transaction involved to acquire the business initially and the fact that the franchisee had its own attorney. This experience was sufficient for the court to deem the franchisee sophisticated enough to possess the “modicum of sophistication” necessary to understand the franchise agreement’s terms even though the franchisee may not have been represented by counsel as to the franchise agreement itself.

The franchisee next argued that there was a contradiction in the franchise agreement that warranted disregarding the arbitration provision. The franchise agreement contained language that the parties consented to the “jurisdiction of any appropriate court to enforce the provision of this section and/or to confirm any award rendered by the panel of arbitrators.” The court held that this provision did not manifestly contradict the arbitration language and added that the provision did not take the arbitrability away from the arbitration, but instead merely meant that any arbitration award can be enforced in a court of law.

The court next determined where arbitration would take place. The arbitration clause designated Boston. The California addendum to the franchise agreement stated Orange County. The franchisee argued this provision should not be enforced because there was no meeting of the minds on the location of the arbitration; however, the court determined that this question (mutual assent) was one the parties placed with the arbitration as well. However, the plaintiff correctly argued that arbitration cannot be compelled to occur outside the district pursuant to the Ninth Circuit’s holding in Continental Grain Co. v. Dant & Russell, 118 F.2d 967, 968–69 (9th Cir. 1941).

Finally, the court noted that, according to the Ninth Circuit, it may stay or dismiss an action pending completion of arbitration in the court’s discretion. Sparling v. Hoffman Construction Co., 864 F.2d 635, 638 (9th Cir. 1988). The court chose to stay the action pending a determination by the arbitrator of whether the claims are arbitrable.

The issue of the enforceability of an arbitration provision against a non-signatory comes up fairly often; however, the more typical situation is one in which the franchisor sues a franchisee and non-signatory. In this case, the wife of the franchise developer initiated a suit against Subway under a 2009 development agreement, alleging she had rights under the agreement and asserting violations of the Kentucky Business Opportunity Law and Consumer Protection Act. The development agreement required all claims to be arbitrated.

Subway filed a motion to dismiss all the claims, given the arbitration provision, or at least stay the provisions pending arbitration. The non-signatory wife sought to amend the original complaint in an attempt to escape dismissal. The court noted that if a party can demonstrate that an amendment would be futile, the court need not grant leave to amend. Federal Rule of Civil Procedure 15(a)(2). The non-signatory argued that she was not a party to the agreement on paper but that she invested in the business and was not in the development agreement at the insistence of Subway. One claim involved the issue of whether the development agreement amounted to a franchise agreement, potentially requiring Subway to make disclosures. Another claim related to alleged tortious interference related to Subway’s approval of proposed transfer of rights under the development agreement. The court zeroed in on the fact that the claims pursued by the non-signatory arose solely as a result of the development agreement.

The developer argued that Subway had waived the right to enforce the arbitration provision; however, although the court acknowledged cases holding waiver, the present case did not involve any appreciable delay in filing a motion to dismiss. “There is a strong presumption in favor of arbitration and waiver of the right to arbitration is not to be lightly inferred.” O.J. Distributing, Inc. v. Hornell Brewing Co., Inc., 340 F.3d 345, 355–56 (6th Cir. 2003) (quoting Cotton v. Stone, 4 F.3d 176, 179 (2nd Cir. 1993)) (ellipsis deleted).

The court further reasoned that this ruling would avoid cherry picking of provisions in the contract to enforce while omitting the applicability of other less favorable provisions such as the mandatory arbitration provision.

According to the court, dismissal, rather than a stay, was appropriate because all the claims at issue were subject to arbitration.

ATTORNEYS FEES


This case is discussed under the topic heading “Statutory Claims.”
This case is discussed under the topic heading “State Disclosure/Registration Laws.”

**BUSINESS OPPORTUNITY LAWS**

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

This case is discussed under the topic heading “Statutory Claims.”

**CHOICE OF FORUM**

Challenges to forum selection clauses come up frequently in franchise cases, especially in matters in which the franchisee claims protection under a franchise protection statute of a state different from the law of the forum selected in the agreement. The U.S. District Court for the Northern District of Ohio was asked to determine whether a case originally filed in that district, the home state of the franchisees, should be transferred to federal district court in Arizona pursuant to a forum selection clause in the franchise agreement. The franchisees opposed transfer given that the arrangement was subject to the Ohio Business Opportunity Protection Act, Ohio Rev. Code Ann. § 1334.01 et seq. Specifically, the franchisees alleged that the franchisor failed to provide the required five-day right to cancel. The franchisees sought rescission of the franchise agreements, statutory damages, treble damages, and attorneys fees.

The court concluded that, when faced with a challenge to the enforcement of a forum selection clause, it must follow the direction of the U.S. Supreme Court’s opinion in *Atlantic Marine Construction Co. Inc. v. U.S. District Court for the Western District of Texas*, 134 S. Ct. 568, 581 (2013), and first determine whether (1) the forum selection clause is valid and enforceable and (2) whether the clause is mandatory or permissive. If the clause is valid, enforceable, and mandatory, “[t]he forum selection clause must be given ‘controlling weight in all but the most exceptional circumstances.’”

The forum selection clause at issue stated:

[T]he parties agree any actions arising out of or related to this Agreement must be initiated and litigated in the state court of general jurisdiction closest to Phoenix, Arizona or, if appropriate, the United States District Court for the District of Arizona. Franchisee acknowledges that this Agreement has been entered into in
the State of Arizona, and that Franchisee is to receive valuable and continuing services emanating from Franchisor’s headquarters in Arizona, including but not limited to training, assistance, support and the development of the System. In recognition of such services and their origin, Franchisee hereby irrevocably consents to the personal jurisdiction of the state and federal courts of Arizona as set forth in this Section. (Emphasis added)

Given the mandatory nature of the clause, the court determined that it did not need to consider any private interest factors because those were presumed to favor the preselected forum. Atlantic Marine, 134 S. Ct. at 582. The court noted that it may still consider public interest factors such as judicial economy and docket congestion, as well as whether one court might be more appropriate for addressing the legal issues in the case. The court determined that neither of these factors weighed in favor of the franchisees’ preferred forum; the court granted franchisor’s motion to transfer the case to the U.S. District Court for the District of Arizona.

CHOICE OF LAW

This case is discussed under the topic heading “Statutory Claims.”

CLASS ACTIONS

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

This multidistrict litigation resulted from Volkswagen’s installation in nearly 600,000 Volkswagen and Audi branded “clean diesel” vehicles of a defeat device that allowed the cars to pass emissions tests. The U.S. District Court for the Northern District of California examined and approved a proposed settlement agreement submitted by one of the plaintiffs, J. Bertolet, Inc., in a class of Volkswagen-branded franchise dealers.

On September 30, 2016, the plaintiff filed an amended and consolidated class action complaint against Volkswagen Group of American, Inc. and Volkswagen AG (together, Volkswagen), in addition to Bosch GmbH and Bosch LLC, on behalf of the franchise dealer class asserting federal claims under the Automobile Dealers’ Day in Court Act, 15 U.S.C. § 1221 et seq., and the Racketeer Influenced and Corrupt Organizations Act, 18 U.S.C. § 1962(C)-(D). The complaint also asserted on behalf of only certain
dealerships: (1) Florida state claims for violations of Fla. Stat. Ann. § 320.64(4), breach of contract, and fraudulent concealment; and (2) Illinois state claims for violations of the Illinois Motor Vehicle Franchise Act, fraud by concealment, and breach of contract. Along with the complaint, the plaintiff filed a proposed class action settlement seeking the court’s preliminary approval. The settlement was negotiated among two groups of franchisees, two law firms representing those groups, and Volkswagen and related entities. The court preliminarily approved the settlement on October 18, 2016. The plaintiff then moved the court for final approval of the settlement. On January 18, 2017, the court held a fairness hearing regarding final approval. In this opinion, the court granted final approval of the settlement, concluding that the settlement was fair, reasonable, and adequate.

The settlement agreement defined the relevant settlement class as “all authorized Volkswagen dealers in the United States who, on September 18, 2015, operated a Volkswagen branded dealership pursuant to a valid Volkswagen Dealer Agreement,” but excluded dealers that opted out of the settlement. In total, the class consisted of 651 authorized Volkswagen dealers. The settlement provided a maximum payment amount of $1.208 billion, with individual dealers receiving a cash payment of approximately $1.85 million. Volkswagen also agreed to continue making certain incentive payments at the amounts being paid as of the date of the settlement for a period of twelve months. Further, Volkswagen agreed to allow class members to defer, for two years after the opt-out deadline, any obligations to renovate or construct dealership facilities or to make other capital investments and additionally agreed to repurchase any affected vehicles for which it was unable to provide an emissions modification kit, among other benefits. In exchange for the benefits of the settlement, class members agreed to release claims essentially against any person or entity that could be responsible in any way whatsoever for the conduct asserted in the complaint. Excluded from the released claims were those claims against Bosch GmbH and Bosch LLC or any of their related entities and agents.

In conducting its final settlement approval analysis, the court explained that Ninth Circuit policy favors class action settlements, but because settlement class actions create unique due process concerns, court approval is necessary and the court must look after the interests of absent class members by determining if the settlement is fundamentally fair, adequate, and reasonable. Before granting final approval of a settlement, the court also had to entertain objections to the treatment of the litigation as a class and the terms of the settlement.

Turning to the treatment of the settlement as a class, the court summarily determined that the class satisfied the requirements of Federal Rules of Civil Procedure 23(a) and (b) based on its reasoning in its earlier order granting preliminary approval to the settlement. The court then turned to the requirements of Rule 23(c), noting that individual notice must be provided to class members who are identifiable through reasonable effort. The
court noted that there were 651 class members, each of whom was notified of the settlement via overnight express delivery. Class counsel also contacted each class member to ensure delivery, maintained a publicly available case website with relevant information, and maintained a toll-free support hotline to answer franchise dealer questions. To comply with the Class Action Fairness Act, notice of the settlement was also mailed to the U.S. Attorney General and the attorneys general of all fifty states. The court found that these efforts ensured adequate notice. Accordingly, the court granted final class certification.

Next, the court assessed the fairness, adequacy, and reasonableness of the settlement. The court noted that pre-class certification settlements must meet a higher bar than post-class certification settlements to ensure that collusion has not taken place. The first factor examined by the court was the strength of the plaintiffs’ case. The court found that this factor did not favor settlement because liability was conceded; thus, only damages were in dispute, and the declaration of the plaintiff’s expert reliably showed that the damages would be substantial and likely recoverable. Second, the court analyzed the risk, expense, complexity, and likely duration of further litigation. It found that this factor favored settlement because there are always risks in litigation; the dealers faced an uncertain future (saddled with thousands of vehicles that they could not sell, representing as much as thirty-five percent of their total vehicle sales); Volkswagen could severely limit and potentially prohibit recovery under several critical damages theories at trial; and protracted litigation would jeopardize the cooperation between Volkswagen and the dealers and, consequently, the success of the consumer action settlements. Third, the potential difficulties in obtaining and maintaining class certification favored final settlement approval because the class could be decertified at a later date due to the size of potential recoveries and the sophistication of class members. Fourth, the settlement amount, which was the most important factor, favored final approval because its value was at the top end of the likely exposure faced by the plaintiffs. Fifth, the court examined the extent of discovery completed and the stage of the proceedings. It noted that discovery is not necessary where the parties have sufficient information to make an informed decision about the settlement. It specifically found that class counsel had sufficient information to make an informed decision based on an extensive pre-filing investigation and extensive review of discovery materials produced by Volkswagen. Therefore, this factor also favored settlement approval. Sixth, the class counsel’s considerable experience and belief that the settlement provided more than adequate benefits to class members further favored settlement. Seventh, the court found that the presence of a government participant also favored approval because notice was provided to federal and state officials and no officials objected. The court found this particularly notable given the heavy state and federal interest involved in actions of this type. Eighth, the court considered the reactions of class members. It found that the class members’
interest in the settlement was high based on hundreds of calls class counsel answered from class members. Only seven dealers (one percent of class members) opted out of the settlement, and only eight dealers (one percent of class members) filed objections to the settlement. Furthermore, 539 class members (eighty-four percent) had taken the step of completing their individual releases in order to initiate benefits under the settlement. The court therefore found that this factor strongly favored settlement.

Even so, the court addressed objections to the settlement by eight dealers. The objections centered on the settlement payment they would receive. These objections were summarily rejected because they did not establish that the settlement formula was unfair or unreasonable. One dealer objected that the release language was too broad, but the parties modified the language to satisfy the dealer’s concerns. Another dealer claimed that the settlement violated the California Vehicle Code, which prohibits a manufacturer from obtaining from a dealer a waiver that constrains its rights to file an action with the California New Motor Vehicle Board, but the code expressly carves out settlements in civil actions. Finally, a dealer who became a Volkswagen dealer in August 2016 and, thus, fell outside the class definition, attempted to object to the class definition. But as a non-class member, the dealer had no standing to object to the settlement, held the court.

In conclusion, the court found that the above factors (known as the Churchill factors) favored settlement. But because the settlement was reached prior to class certification, the court was required to examine additional factors (known as the Bluetooth factors) to ferret out collusion. The court concluded that none of the Bluetooth factors were present, however, because: (1) class counsel would not be compensated through the settlement; (2) the parties did not negotiate a “clear sailing” agreement for the payment of attorneys fees separate from class funds; instead, class counsel would not seek more than $36.24 million in fees, which Volkswagen agreed not to contest; and (3) the settlement did not provide for the reversion to the defendants of funds not awarded to class members. The court therefore granted final approval of the class settlement.

Finally, using its power under the All Writs Act, 28 U.S.C. § 1651(a), the court enjoined all class members who had not opted out of the settlement from participating in any state court litigation related to the released claims, except to dismiss or stay released claims.

Following the U.S. District Court for the Northern District of California’s approval of the class action settlement discussed earlier, one of the class members, City Chevrolet, filed a motion to enforce the settlement, and a non-class member, Mission Bay Motors, Inc., sought to intervene to oppose
the motion. The question presented to the court was whether City Chevrolet or Mission Bay, which purchased a Volkswagen dealership from City Chevrolet on August 1, 2016, was entitled to settlement payments from Volkswagen under the settlement. The court granted City Chevrolet’s motion to enforce the settlement.

Mission Bay objected to the class definition, which required class members to have operated a Volkswagen branded dealership on September 18, 2015. In its order approving class settlement, the court concluded that Mission Bay was not a class member and, therefore, lacked standing to object. Afterward, Mission Bay commenced a state court action in the County of San Diego against City Chevrolet and Volkswagen alleging that, as the express contractual assignee of City Chevrolet, Mission Bay was entitled to any income paid by Volkswagen after August 1, 2016, which would include any settlement proceeds. Volkswagen attempted to delay payment under the settlement until the state court litigation was resolved.

The district court first rejected Mission Bay’s request to intervene in order to object to the settlement and oppose City Chevrolet’s motion to enforce the settlement. Mission Bay sought permissive intervention under Federal Rule of Civil Procedure 24(b)(1). The court found that Mission Bay could not satisfy the first factor for intervention, which requires that a party share a common question of law or fact with the main action, because any rights to which City Chevrolet was entitled under the settlement were separate and apart from any rights set forth in the purchase agreement between City Chevrolet and Mission Bay.

The district court then turned to City Chevrolet’s motion to enforce the settlement. Volkswagen admitted that City Chevrolet was entitled to its settlement payment, but because of its concern about potential double liability, it withheld all settlement payments and requested that the court defer distribution of the settlement payment until after the state court resolved the issue. The district court denied Volkswagen’s request and required Volkswagen to make the settlement payment to City Chevrolet. In so doing, the court found that Volkswagen would not be subject to double liability for the settlement proceeds because Mission Bay was not a party to the settlement and, thus, had no claim to the settlement proceeds. To the extent Mission Bay believed it was entitled to recover any funds from City Chevrolet pursuant to its asset purchase agreement, it could attempt to recoup them through its pending state court action. The court, however, acknowledged that Mission Bay could file an independent claim against Volkswagen, because it was not a party to the settlement. But even so, any such suit would not subject Volkswagen to double liability under the settlement because Mission Bay would be seeking damages apart from the settlement. Ultimately, City Chevrolet had complied with the terms of the settlement and Volkswagen was obligated to begin making payments to City Chevrolet. The court therefore granted City Chevrolet’s motion to enforce the settlement agreement.
CONTRACT ISSUES


This case involved 111 franchisees of the fitness center Curves that brought suit in Missouri state court against Curves, generally asserting claims related to Curves’ alleged misrepresentations relevant to the plaintiffs’ decision to enter into the franchise agreements and also alleging subsequent breaches of the agreements by Curves. Curves removed the cases to the U.S. District Court for the Eastern District of Missouri. The Missouri district court dismissed some of the cases based on statute of limitations and granted Curves’ motion to transfer venue to the U.S. District Court for the Western District of Texas based on a venue selection clause in the franchise agreements.

The plaintiffs dismissed certain claims and agreed to summary judgment on others, leaving only Curves’ motion seeking dismissal of sixty-two breach of contract claims. The plaintiffs alleged that Curves failed to provide any meaningful support following execution of the franchise agreements. Curves argued that, according to a particular provision of the franchise agreement (Section 7(A)), Curves had the sole discretion on whether to provide such support. The court disagreed that the franchise agreement terms precluded the plaintiffs from being able to state a breach of contract claim against Curves. First, the court noted that other provisions in the agreements—separate and apart from Section 7(A)—used language such as “must” and “will” that affirmatively imposed obligations upon Curves. Second, the court analyzed the language in Section 7(A) that provided Curves with a great deal of discretion of when to provide services to franchisees. The court held that if Section 7(A) were interpreted to provide Curves with absolute discretion, the entire section would be meaningless or illusory. The court also noted that even if Section 7(A) provided “a rather low bar” for Curves to meet in providing services to franchisees, Curves still had to act reasonably in exercising its discretion of whether or not to provide such services. Therefore, the court refused to dismiss the claim on the basis that the franchisees could potentially state a claim that Curves had failed to meet the standard for providing services under the agreement.

The court next turned to a clause in the franchise agreements known as the reasonable business judgment clause. Generally speaking, the clause provided that Curves was entitled to a reasonable business judgment standard in any action taken by Curves that required its approval or consent. Curves argued that the clause protected Curves from any suit related to its decision not to provide franchisees with support. The court disagreed, noting that the clause was inapplicable to mandatory obligations under the agreement. Thus, if the franchisees could show that the support obligations were mandatory, the clause was irrelevant. The court also noted that merely applying a reasonable business judgment does not absolutely foreclose the possibility of bringing a claim against a party. The court noted that corporate officers and
directors are entitled to a reasonable business judgment standard, but they could still be held liable under certain claims, including bad faith breaches of their fiduciary duties. Moreover, the terms of the reasonable business judgment clause prohibited Curves from taking action not intended to benefit the entire Curves system. The court held that it was an issue of fact as to whether Curves’ refusal to provide support was unreasonable and not intended to benefit the system.

The court then addressed the statute of limitation issues as applied to each grouping of plaintiffs. Although the facts differed for each group, the court noted Curves’ common argument that the four-year statute of limitations had expired for a large number of the plaintiff franchisees because they entered into their franchise agreements more than four years previously and they further acknowledged their opinion that Curves had failed to provide support from “day one.” The court held that such acknowledgments did not necessarily trigger the running of the statute of limitations because the plaintiffs’ expectation that services should be provided from the first day of operation was not necessarily the same thing as Curves being in breach of contract for failing to provide such services. The court held that it remained an issue of fact as to when the breaches occurred.

Finally, the court addressed certain releases signed by various plaintiff franchisees. Again, the facts differed from plaintiff to plaintiff and, therefore, required the court to separately analyze the different plaintiff groups. However, the analysis generally focused on whether the releases were procedurally or substantively unconscionable. A release is procedurally unconscionable under applicable Texas law if the facts surrounding the bargaining process show that the process is unfairly one-sided. A release is substantively unconscionable if, “given the parties’ general commercial background and the commercial needs of the particular trade or case, the clause involved is so one-sided that it is unconscionable under the circumstances existing when the parties made the contract.” The court further noted that whether the releases were unconscionable was an issue of law and that the terms must be “sufficiently shocking or gross to compel the court to intercede.”

The court held that some of the releases were enforceable although others were not. The court was especially critical of an assignment provision in certain of the releases that purported to assign to Curves all current and future claims against Curves. The court held that such an assignment was against public policy because it ran “directly counter to Texas’ broad protections for freedom of contract” and because certain claims, such as those based on intentional conduct, recklessness, or gross negligence, could not be waived under Texas law. Certain other releases, however, were enforced as narrowly drafted and applicable to the relevant time frame.


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

The enforceability of post-termination obligations is often litigated, but in this case the defendant and former franchisee developed a rather novel idea for why the post-termination noncompete and nonsolicitation clauses did not apply. She took the position that those obligations applied only if the agreement was terminated. Because the franchisee did not renew the agreement, the franchisee argued that the noncompete and nonsolicitation clauses were not triggered.

The defendant operated an H&R Block franchise from September 1984 until September 1, 2014. The franchise agreement contained an automatic renewal provision, which stated as follows:

The initial term of this Agreement begins on the date hereof and ends five years after such date, unless sooner terminated by Block [for cause]. Unless Franchisee is in default hereunder or under any agreement with or obligation to Block or any subsidiary or affiliate of Block, this Agreement shall be automatically renewed for successive Renewal Terms. Franchisee may terminate this Agreement effective at the end of the initial term or any Renewal Term, but only upon at least 120 days written notice to Block prior to the end of such term.

Prior to the expiration of the last five-year term, the franchisor provided notice that it would not be renewing the 1984 version of the franchise agreement but would offer the franchisee the “current form” of the franchise agreement. The franchisee declined to sign the new franchise agreement, and the term expired on September 1, 2014. Despite language in the franchise agreement prohibiting competition in or within 45 miles of the franchise territory or soliciting H&R Block customers or other franchisee’s customers, the franchisor alleged that the franchisee continued operating at the same location offering tax services.

The franchisor filed an action alleging breach of contract. The franchisee asserted: (1) the affirmative defense of unclean hands; (2) that the noncompete clause was unenforceable due to unlimited geographic scope; (3) that the noncompete clause served no legitimate interest of franchisor and was unduly burdensome to the franchisee; and (4) that the parties’ established course of dealing and language in the franchise agreement forbade the franchisor from unilaterally refusing to renew the franchise agreement under its original terms. The franchisee also bought a counterclaim for the franchisor’s failure to honor the automatic renewal provision in the 1984 contract.

The franchisor moved to dismiss the counterclaim and strike the affirmative defenses. The franchisee also moved to amend to add a counterclaim based on both breach of contract and breach of the implied covenant of good faith and fair dealing. The franchisee operated her franchise in New York and argued that New York law applied, rather than Missouri law as designated in the franchise agreement.

The court began the analysis by noting that a motion to dismiss a counterclaim is governed by the same standard as a motion to dismiss a complaint
under Federal Rule of Civil Procedure 12(b)(6). Survival of a motion to dismiss, the court stated, requires that the “complaint contain sufficient factual matter, accepted as true, to ‘state a claim to relief that is plausible on its face.’” Quoting Ashcroft v. Iqbal, 556 U.S. 662, 678 (2009) (quoting Bell Atl. Corp. v. Twombly, 550 U.S. 544, 570 (2007)). All allegations in the complaint are accepted as true for purposes of this assessment and all inferences are drawn in favor of the party asserting the claims.

The basis for the franchisee’s counterclaim, which was the subject of the motion to dismiss, was the fact that the franchisor did not renew the franchise agreement in 2014 under the same terms as the 1984 agreement. The franchisor relied on the agreement’s choice of law provision designating Missouri law and argued that under Missouri law, “automatic renewal provisions, such as the one at issue here, must be construed to allow either party to elect not to renew the agreement at the end of any term.” The court noted that the Missouri Supreme Court made clear that a contract intended to be perpetually renewed must adamantly state the same for the parties’ agreement to be enforceable. H&R Block Tax Servs. LLC v. Franklin, 691 F.3d 941, 944 (8th Cir. 2012) (quoting Preferred Physicians Mut. Mgmt. Grp., Inc. v. Preferred Physicians Mut. Risk Retention Grp., Inc., 961 S.W.2d 100, 103 (Mo. Ct. App. 1998)). If Missouri law governed, the franchisor would clearly be permitted to elect not to renew without cause; however, the court was required to determine whether New York or Missouri law governs.

A federal court sitting in diversity applies the substantive law of the state in which it sits, including choice of law rules. In re Coudert Bros. LLP, 673 F.3d 180, 186 (2d Cir. 2012) (internal citation omitted). Given that the court sat in New York, it first considered New York’s choice of law rules, which typically enforce choice of law provisions unless the chosen law violates a fundamental principle of justice. Welsbach Elec. Corp. v. MasTec N. Am., Inc. 859 N.E.2d 498, 500–01 (N.Y. 2006). The court considered that the franchisor’s principal place of business was in Kansas City, Missouri, and that this alone was enough to create a reasonable relationship between the designated state law (Missouri) and the parties. The next inquiry was whether applying Missouri law would offend any fundamental policy in New York.

New York, like Missouri, disfavors perpetual contracts. However, New York draws a distinction between perpetual contracts and indefinite contracts. Indefinite contracts are those that do not provide a fixed term but are terminable upon the happening of a specific condition or event. Payroll Express Corp. v. Aetna Cas. & Sur. Co., 659 F.2d 285, 292 (2d Cir. 1981). Indefinite contracts are enforceable in New York. The court deemed the franchise at issue an indefinite contract because it could go on indefinitely or end at the end of the five-year term if the franchisee is in default. Barring no default, New York law would dictate that franchisor could not choose to renew without cause.
The analysis does not end there, however. Although application of Missouri law or New York law would yield a different result, the court turned to whether applying Missouri law would violate any fundamental New York policy. The court pointed out that the franchisee did not cite any support that New York had taken a fundamental policy stance on the distinction between perpetual contracts and indefinite contracts. Thus, Missouri law was applicable, and the franchisor did not breach the contract. Consequently, the franchisee’s counterclaim had to be dismissed.

The court further determined that it may strike a pleading pursuant to Rule 12(f) for any “insufficient defense or redundant, immaterial, impertinent, or scandalous matter.” The court noted that there is a general prohibition against striking affirmative defenses “unless it appears to a certainty that plaintiff would succeed despite any state of facts which could be proved in support of the defense.” William Z. Salcer, Panfeld, Edelman v. Environ Equities Corp., 744 F.2d 935, 939 (2d Cir. 1984) (internal quotation omitted). There are three prongs to this consideration: “(1) there is no question of fact which might allow the defense to succeed; (2) there is no question of law which might allow the defense to succeed; and (3) the plaintiff would be prejudiced by inclusion of the defense.” SEC v. McCaskey, 56 F. Supp. 2d 323, 326 (S.D.N.Y. 1999).

The franchisee withdrew her affirmative defense relating to geographic scope; however, she maintained her affirmative defense of unclean hands based on the alleged wrongful ending of the franchise agreement. Given that the defense was based solely on the assumption that the nonrenewal of the original terms was wrongful, the court held that this affirmative defense must be stricken because there was no way the franchisee could prevail.

Regarding motions to amend, a court should freely permit a party to amend when justice so requires pursuant to Rule 15(a)(2). Granting such a motion is left to the district court’s discretion. “A district court has discretion to deny leave for good reason, including futility, bad faith, undue delay, or undue prejudice to the opposing party.” McCarthy v. Dun & Bradstreet Corp., 482 F.3d 184, 200 (2d Cir. 2007).

The franchisee also sought leave to amend to add counterclaims for breach of contract and breach of the covenant of good faith and fair dealing and additional affirmative defenses related to unclean hands premised on the contract claim. This breach of contract claim was based on the franchisor’s attempt to enforce the noncompete and nonsolicitation provisions when these provisions are allegedly triggered only by a termination rather than a nonrenewal. The court determined that the argument was unpersuasive because the very language in the agreement did not limit the obligations to termination and actually referred to “other disposition of this franchise” as well. The court held that “other disposition” encompassed nonrenewal. Thus, the court held that it must deny the franchisee’s motion to amend given there was no basis for argument that the post-termination covenants were not triggered.

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


Mark Neubauer was a FedEx delivery independent contractor pursuant to a standard operating agreement (SOA). The SOA provided that it was governed by the laws of Pennsylvania. Neubauer was granted a proprietary interest in serving FedEx customers within a certain area, known as the primary service area (PSA). The SOA permitted a contractor to assign its rights to another party, but that FedEx had to approve the assignment and that, upon assignment, FedEx would enter into a new SOA with the assignee on substantially the same terms. The SOA also provided that any consideration to be paid by the assignee on to the assignor on account of the assignment was strictly a matter between the assignor and the assignee and that FedEx was not a party to the assignment transaction.

In 2011, FedEx advised Neubauer that it would not be renewing the SOA when it expired according to its terms. FedEx further advised that it intended to move contractors such as Neubauer to a new system under an independent service provider agreement (the ISP agreement), rather than the terms of the SOA. The ISP agreement differed from the SOA in that, when an agreement was assigned, the assignee would obtain only the remaining term under the agreement, rather than being entitled to a new agreement with a full term. Neubauer voluntarily agreed to transition to the new agreement terms and, in exchange for a $10,000 payment, executed a release whereby he agreed not to sue or demand arbitration from FedEx as a result of the transition.

In 2014, FedEx terminated its relationship with Neubauer based on alleged breaches of the ISP agreement. Neubauer assigned his rights to another contractor, hoping that FedEx would enter into a new full term agreement with the assignee. However, FedEx agreed to permit the assignee to operate only for the remaining term of the ISP agreement. Neubauer sued FedEx bringing claims for breach of contract, fraud, constructive fraud, fraudulent inducement, violation of North Dakota’s Franchise Investment Law, and violations of North Dakota’s RICO Act. FedEx moved in the U.S. District Court for the District of North Dakota to dismiss the matter under Federal Rule of Civil Procedure 12(b)(6) for failure to state a claim. The district court granted FedEx’s motion. Neubauer then appealed to the Eighth Circuit.

As to the breach of contract claim, the court held that the SOA provisions did not apply because they expired in 2011. Neubauer also argued that he had an enforceable agreement with FedEx that permitted assignment, even if the SOA had expired. The court disagreed, noting that the SOA plainly
stated that FedEx was not a party to any assignment agreement. Neubauer further argued that language in the SOA prevented FedEx from altering the SOA in any way. The court again disagreed, noting that the language was taken out of context and that Neubauer’s interpretation would lead to the absurd result of forbidding “any modification of the SOA in perpetuity, even if the SOA expired and the parties agreed to a new contract with different terms.”

The court next considered Neubauer’s fraud claims. Neubauer argued that FedEx knowingly made misrepresentations to him to induce him to enter into the SOA, the ISP agreement, and the release. The court noted the requirement under Federal Rule of Civil Procedure 9(b) that allegations of fraud must be pleaded with particularity, including “such facts as the time, place, and content of the defendant’s false representations, as well as the details of the defendant’s fraudulent acts, including when the acts occurred, who engaged in them, and what was obtained as a result.” The court held that Neubauer’s general statements and conclusory allegations against FedEx had not met the Rule 9(b) standard and therefore were properly dismissed.

The court then turned to Neubauer’s allegations that FedEx sold him an unregistered franchise in violation of North Dakota’s Franchise Investment Law. The court noted that for such a claim to survive dismissal, Neubauer was required to plead facts sufficient to show that Neubauer was a franchisee, meaning: “(1) he was granted the right to engage in the business of offering, selling, or distributing good or services under a marketing plan or system prescribed in substantial part by the franchisor; (2) the operation of his business pursuant to such a plan was substantially associated with FedEx’s trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and (3) he was required to pay directly or indirectly, a franchise fee.” (quoting N.D. CENT. CODE § 51-19-02(5)(a), internal quotation marks deleted). The court noted that Neubauer delivered and picked up FedEx packages, but did not allege facts sufficient to show that he had a right to offer, sell, or distribute his services to individual customers. Moreover, the court noted that the SOA explicitly stated that Neubauer was an independent contractor and that Neubauer received payments not from customers, but directly from FedEx. For these reasons, the court held that Neubauer had failed to plausibly state a claim that he was a franchisee.

Finally, the court addressed Neubauer’s RICO claims under North Dakota law. The court dismissed the claim for the same reason as the fraud claims. Specifically, Neubauer had failed to plead any facts with particularity that FedEx had engaged in criminal racketeering.


In 2012, Pilrang Boe Owa entered into a franchise agreement with Advanced Fresh Concepts Franchise Corporation (AFCFC), whereby Owa operated a
sushi counter on premises leased by AFCFC from Fred Meyer. Owa was provided a percentage of the sushi sales; Meyer reported such sales to AFCFC. Meyer was not a party to any agreement with Owa. The franchise agreement between AFCFC and Owa stated that Owa was an independent contractor and not an employee of AFCFC.

Owa was a Korean native who spoke little English. She alleged that Meyer’s employees harassed, bullied, and discriminated against her while she was working at the premises. In 2016, Owa filed suit against AFCFC and Meyer in Washington state court alleging claims for discrimination, as well as loss of consortium based on Owa’s husband leaving and seeking a divorce during the relevant time period. Meyer removed the action to the U.S. District Court for the Western District of Washington and filed a motion to dismiss the claims against it.

Owa’s claims were based on alleged violations of the Washington Law Against Discrimination (WLAD), as well as state law governing loss of a consortium. The court first turned to the WLAD claims, which included five sub-parts: (1) retaliation, (2) failure to provide a reasonable accommodation, (3) race-based harassment, (4) unlawful discrimination, and (5) discrimination by association.

The court held that the claims for retaliation, failure to provide reasonable accommodation, and race-based harassment required an employer/employee relationship under Washington law. Owa attempted to show such a relationship based on the “payroll method test” whereby a party will be considered an employee if his or her name appears on the other party’s payroll. Owa submitted some evidence regarding policies and procedures for her operation of the sushi counter, but failed to show that she was listed on Meyer’s payroll. Therefore, the court dismissed these claims based on Owa’s failure to show an employer/employee relationship.

The court next addressed unlawful discrimination, which is not limited to employer/employee relationships. However, the claim does require some sort of contract relationship. Because Owa was unable to show any sort of contractual relationship between her and Meyer, the court dismissed that claim as well. In addition, the discrimination by association claim was dismissed because such claims are not recognized under Washington law.

The court then turned to the loss of consortium claims. The court noted that Washington law classifies the two spouses at issue as either the “deprived” spouse or the “impaired” spouse. The deprived spouse suffers the loss and services from the impaired spouse. Owa claimed that she was both an impaired spouse, based on alleged injuries from Meyer, and a deprived spouse, based on her being deprived of her husband’s affection and services when he filed for divorce. The court held that Owa had failed to identify any legal authority that she can have a claim as both a deprived and impaired spouse. The court noted that if Owa truly was the impaired spouse, she was not the proper party to bring the claim. The court therefore dismissed the claim without prejudice as improperly pleaded.
The court further addressed Owa’s claim of Meyer’s alleged tortious interference with her business expectancy under the franchise agreement. The court noted that such a claim required a showing of the following elements: (1) the existence of a valid contractual relationship or business expectancy; (2) the defendants had knowledge of that relationship; (3) an intentional interference inducing or causing a breach or termination of the relationship or expectancy; (4) defendants interfered for an improper purpose or used improper means; and (5) resultant damage. The court held that Owa had met the first and second elements because there was a contract between her and AFCFC and, because sales were reported to Meyer, Meyer was aware of the relationship. However, the court held that there were no facts in evidence suggesting that Meyer acted with an improper purpose or used means to interfere with Owa’s business expectancy. Owa offered no evidence on why she was eventually removed from the premises or Meyer’s role, if any, in that event.

Finally, the court addressed Owa’s claim for wrongful termination in violation of public policy. Owa alleged that Meyer had created a harassment-based work environment. The court noted that the elements for wrongful termination are: (1) the existence of a clear public policy, (2) that discouraging the conduct in which the defendant engaged would jeopardize the public policy, and (3) the public policy linked conduct caused the dismissal. The court held that Owa had failed to allege facts showing a causal link between a clear public policy and her dismissal. Owa alleged that she was dismissed because she injured her hand, but she provided no facts linking the injury to her dismissal or otherwise linking her dismissal to Meyer discriminating against her.


The U.S. District Court for the Northern District of Illinois granted in part and denied in part the Sears franchisor’s motion to dismiss several counterclaims raised by a former franchisee, Appliance Alliance, LLC, and its owners, Brent and Minena Turley, who owned and operated six former franchised Sears stores. Sears filed a lawsuit alleging that Alliance and the Turleys breached the parties’ franchise agreements. The defendants responded by bringing numerous counterclaims against Sears and several third-party Sears entities and individuals, including breach of contract; conversion and trespass (conversion); tortious interference with contract and existing and prospective business relations (tortious interference); defamation, business disparagement, and unfair competition; breach of fiduciary duty, economic duress and business coercion, oppressive conduct, and constructive trust; violations of the Texas Business Opportunity Act (TBOA) and the Texas Deceptive Trade Practices Act (TDTPA); and fraud.

First, the court analyzed the Sears parties’ motion to dismiss the claims for breach of contract, conversion, tortious interference, and unfair compe-
tition against third-party defendants Sears, Roebuck & Co. and Sears Holding Corporation. Because Sears Roebuck and Sears Holding were not parties to the franchise agreements underlying the defendants’ breach of contract claim and the counterclaims did not allege that Sears Roebuck and Sears Holding were involved in the alleged actions, the court construed the relevant counterclaims as attempting to pierce the corporate veil. The court explained that to impose liability under the alter ego doctrine, the defendants would need to demonstrate that the Sears franchisor was so controlled in its affairs that it was a mere instrumentality of Sears Roebuck or Sears Holding and that observance of the separate existence of the entities would sanction a fraud or promote injustice. The court found that the defendants failed to allege the fraud or injustice, but instead merely alleged that a judgment against only the Sears franchisor would be useless because Sears Roebuck or Sears Holding own and control the franchisor. Because the defendants failed to plead a fraud or injustice, mere allegations that the Sears entities “worked together” were insufficient as a matter of law. Accordingly, the court dismissed these counterclaims without prejudice.

Next, the court turned to the Sears parties’ motion to dismiss the breach of contract, TBOA, TDTPA, and fraud counterclaims against an individual third-party defendant, Samantha Wilks, a Sears employee who was assigned to oversee the defendants’ franchised Sears stores. The court summarily dismissed with prejudice the breach of contract claim against Wilks because no contract with her was pleaded. Further, the court found that all of the allegations concerning the Texas statutory claims and the fraud claim related to statements allegedly made to the defendants during the sale of their franchises. Because Wilks was not involved in the sale, she could not be liable for those actions. The court therefore dismissed these claims with prejudice, finding that amendment would be futile.

The court then turned to the remaining claims, which were primarily against the franchisor. First, the court rejected Sears’s motion to dismiss the breach of contract claim against it, finding that the claim provided adequate notice based on the allegations of wrongful termination of the franchise agreements and improper retention of the defendants’ funds and property.

Second, the court turned to Sears’s motion to dismiss the defendants’ tortious interference claims. The tortious interference with contract claim properly pleaded that the Sears parties interfered with the defendants’ leases. Likewise, the defendants sufficiently alleged their tortious interference with existing business relations claim because the complaint alleged that Sears unlawfully locked the defendants out of their store, thereby interfering with their existing business relationships with employees and suppliers. The court, however, dismissed without prejudice the defendants’ claim of tortious interference with prospective business relations because the complaint did not identify “any specific future employees, suppliers, or customers” on which the claim was based; it identified only existing business relationships.
Third, the court denied the motion to dismiss the defendants’ unfair competition claim. The defendants alleged that the Sears parties engaged in unfair competition by defaming them and disparaging their business reputation. The court noted that unfair competition has an “amorphous existence” under Texas law because it generally is a derivative tort that encompasses “all statutory and nonstatutory causes of action arising out of business conduct which is contrary to honest practice in industrial or commercial matters.” Therefore, to pursue this claim, the defendants had to plead “some underlying cause of action giving rise to their allegations of unfair competition.” Because the defendants sufficiently pleaded their unfair competition by supporting it with independent allegations of defamation and business disparagement, the court denied the motion to dismiss.

Fourth, the defendants’ breach of fiduciary duty claim was also insufficient as a matter of law. The court began its analysis with the general rule that franchisors do not owe franchisees a fiduciary duty, but noted that such a duty can arise where the relationship is “one of particular trust and confidence.” Although the defendants offered “a laundry list of actions” that the Sears parties purportedly took in the course of the franchise relationship to show “total domination and control” to rise to the level of “particular trust and confidence,” including requiring certain uniforms and décor and fixing store hours and prices, the defendants simply did not allege how such measures differed from that of a typical franchisor-franchisee relationship. Without more, the list did not give rise to a fiduciary duty.

Fifth, the court declined to dismiss the defendants’ claim for economic duress. Under Texas law, that claim requires: (1) a threat of unlawful activity; (2) an illegal exaction, fraud, or deception; and (3) imminent restraint of the threatened party without a means of protecting itself. The court found a properly pleaded claim based on the complaint allegations that (1) Sears imposed improper requirements on the defendants to manufacture unlawful grounds to terminate the franchises; (2) Sears’s threat of termination forced the defendants to turn over the keys to their stores; and (3) because of Sears’s control, the defendants had no way of protecting themselves.

Sixth, the court dismissed with prejudice the defendants’ oppressive conduct claim, finding no applicable statutory or common law cause of action for oppressive conduct.

Finally, the court turned to the defendants’ claims for violations of the TBOA, the TDTPA, and fraud. The Texas statutory claims were based on allegations that the franchisor misrepresented commissions and returns the defendants would earn, failed to pay the defendants a promised marketing fee, and failed to disclose the “overall competitive structure” surrounding the franchise and the control Sears would exert. Similarly, under their fraud claim, the defendants alleged that the Sears parties made four different misrepresentations and omissions: (1) a promise to pay the defendants a two percent marketing fee; (2) a failure to disclose an intent to impose various pric-
ing and competitive conditions; (3) statements about the minimum average commissions the defendants should expect to receive; and (4) failure to disclose competition that defendants would face from other franchisees and Sears. The Sears parties moved to dismiss all of these claims for failure to comply with Federal Rule of Civil Procedure 9(b), which requires one to plead the “who, what, when, where, and how” of an alleged fraud.

The court found that the claims were insufficiently pleaded in three respects. First, simply claiming that, in buying their franchises, the defendants spoke with “Sears representatives” who made certain misrepresentations and reviewed “offering circulars” and Sears’s “Franchise Disclosure Document” with some misrepresentations was insufficient to identify the source of the fraudulent statements because the parties’ relationship spanned many years. Second, identifying an indeterminate time period, such as the date the defendants purchased their initial franchises and the period of time leading up to that purchase and the purchase of their second set of franchises, was also insufficient under Rule 9(b). The court noted that, based on the circumstances of this case, the defendants should have been able to plead certain misrepresentations “down to the month (or even the day) they occurred.” Third, some of the fraud allegations amounted to promissory fraud, which is actionable under Texas law only where the promise is made with the intention of deceiving and with no intention of carrying out the underlying promise. Here, the defendants merely alleged that Sears promised to pay the defendants a marketing fee in the future, but pled no fraudulent intent. Accordingly, the court dismissed the TBOA, the TDTPA, and fraud counterclaims without prejudice.


This case is discussed under the topic heading “Statutory Claims.”

**CORPORATE VEIL PIERCING**


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

**DAMAGES**


This case is discussed under the topic heading “Statutory Claims.”
DEFINITION OF FRANCHISE

This case is discussed under the topic heading “State Disclosure/Registration Laws.”

_Neubauer v. FedEx Corp.,_ Bus. Franchise Guide ¶ 15,921, 849 F.3d 400 (8th Cir. 2017)
This case is discussed under the topic heading “Contract Issues.”

DISCRIMINATION

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

FRAUD

_Neubauer v. FedEx Corp.,_ Bus. Franchise Guide (CCH) ¶ 15,921, 849 F.3d 400 (8th Cir. 2017)
This case is discussed under the topic heading “Contract Issues.”

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

This case is discussed under the topic heading “Statutory Claims.”

FTC FRANCHISING RULE

This case is discussed under the topic heading “Statutory Claims.”

GOOD FAITH AND FAIR DEALING

This case is discussed under the topic heading “Statutory Claims.”
LABOR AND EMPLOYMENT


The plaintiffs, employees of a Jack in the Box franchise, filed a putative class action against Jack in the Box, alleging Jack in the Box (1) was a joint employer, (2) was liable for violations of the minimum wage and overtime provisions of the Fair Labor Standards Act (FLSA) and Oregon wage and hour statutes, (3) failed to pay wages upon termination in violation of Oregon statutes, (4) took wrongful deductions in violation of Oregon Revised Statutes § 652.610, and (5) used a wrongful method of payment in violation of Oregon Revised Statutes § 652.110. Jack in the Box filed a motion for partial summary judgment in which it argued it was not liable for the minimum wage and overtime claims of the employees for the period after March 29, 2010, at which time it franchised several corporate-owned restaurants to a franchisee and did not retain the power to hire and fire the franchisees’ employees or control their day-to-day work activities.

In a detailed decision, the court applied the Bonnette factors and granted Jack in the Box’s motion for partial summary judgment, finding that Jack in the Box did not have the power to hire or fire the franchisees’ employees and was not responsible for or involved in the franchisees’ employees work schedules, hours of employment, salaries, insurance, fringe benefits, or hours of work.

The court noted that the Ninth Circuit applies an “economic reality” test to determine the existence of a joint employment relationship. In Bonnette v. California Health and Welfare Agency, 704 F.2d 1465, 1469 (9th Cir. 1983), the Ninth Circuit held that the economic realities test focuses primarily on four factors: “whether the alleged employer (1) had the power to hire and fire the employees; (2) supervised and controlled employee work schedules or conditions of employment; (3) determined the rate and method of payment; and (4) maintained employment records.” 704 F.2d at 1470. Later in Torres-Lopez v. May, 111 F.3d 633, 646 (9th Cir. 1997), the Ninth Circuit identified five “regulatory factors” similar to those set out in Bonnette that courts should consider: (1) the nature and degree of control of the workers; (2) the degree of supervision, direct or indirect, of the work; (3) the power to determine the pay rates or the methods of payment of the workers; (4) the right, directly or indirectly, to hire, fire, or modify the employment conditions of the workers; and (5) preparation of payroll and payment of wages. 111 F.3d at 646 (citing 29 C.F.R. § 500.20(h)(4)(ii)).

The court was not persuaded by the plaintiffs’ argument that Jack in Box’s provision of (1) training to the individuals in the person-in-charge position, (2) “Hiring the Right People” handbook and Consistent Hiring Process Guidelines, (3) labor scheduling software, and (4) a payroll system made it a joint employer of plaintiffs and other employees of the franchisee. The
court found that all such examples cited by the plaintiffs were merely non-mandatory advisory materials and tools provided by Jack in the Box to which franchises could refer but were not mandated to use. With regard to the payroll system provided and maintained by Jack in the Box, the court specifically noted, “ministerial functions are insufficient to support plaintiffs’ argument that [the defendant] controls labor relations. Providing a ‘payroll service to a franchisee’s employees does not in any manner create an indicia of control over labor relations sufficient to demonstrate that the franchisor is a joint employer.’” Applying the Bonnette factors and considering Jack in the Box’s relationship with the franchisee as a whole, the court concluded that the plaintiffs did not establish as a matter of law that Jack in the Box is their joint employer.

The plaintiffs, employees of a McDonald’s franchisee, brought suit against McDonald’s for violations of the California Labor Code, both individually and on behalf of a putative class. The U.S. District Court for the Northern District of California previously granted McDonald’s partial summary judgment, finding that McDonald’s was not a joint employer because it did not directly or indirectly control the terms of employment, was not suffering or permitting plaintiffs to work, and was not engaging in an actual agency relationship with the plaintiffs. The court, however, previously found that a reasonable jury could find that McDonald's was a joint employer by virtue of an ostensible agency relationship. (For a summary of the court’s prior ruling, see the Winter 2017 Currents under the topic heading “Labor and Employment.”) McDonald’s then filed a second motion for summary judgment, arguing that ostensible agency is not a viable predicate on which to impute liability for the plaintiffs’ Labor Code claims.

Beginning its analysis with the definition of “employer” for purposes of Labor Code violations, the court looked to the Industrial Welfare Commission’s (IWC) wage orders for guidance. The IWC actually defines the employment relationship and thus who may be liable under the Labor Code. “Employer” is defined as one who “directly or indirectly, or through an agent or any other person employs or exercises control over the wages, hours, or working conditions of any person.” The court went on to consider the plaintiffs’ argument that the Labor Code permits violations under an ostensible agency theory because the IWC’s definition includes the phrase “through an agent,” but found that the phrase is expressly restricted to an entity that “employs or exercises control over” the workplace. The court further rejected that any agent acting within his or her ostensible authority binds the principal. The court explained that the plaintiffs failed to identify any specific authority for the application of ostensible agency principles where application was inconsistent with the statutory definition at issue. Finally, the court rejected the plaintiffs’ policy arguments, noting that al-
though courts are to construe wage statutes broadly, the principle does not permit courts to rewrite applicable legislation. The court further noted that the “factual predicate” of the plaintiffs’ policy arguments—that McDonald’s can remedy the alleged Labor Code violations—was already previously rejected by the court. Based on the foregoing, the court concluded that applying osten-
sible agency principles to hold McDonald’s liable for labor code violations would be inconsistent with the plain language of the IWC’s wage orders and, accordingly, entered summary judgment in favor of McDonald’s.

As to the plaintiffs’ claims for declaratory relief and for relief under California’s Unfair Competition Law and Private Attorneys General Act, the court also entered summary judgment in favor of McDonald’s because these claims were merely derivative of the plaintiffs’ Labor Code claims.

NON-COMPETE AGREEMENTS


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

RELEASES


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

STATE DISCLOSURE/REGISTRATION LAWS


The Sixth Circuit analyzed whether the plaintiff, Brian Lofgren, and the defendants, AirTrona Canada and Salvatore Barberio, entered into a franchise agreement under the Michigan Franchise Investment Law (MFIL), and, if so, whether Lofgren could rescind the agreement and seek restitution under MFIL based on AirTrona’s failure to provide required disclosure statements. The Sixth Circuit affirmed the U.S. District Court for the Eastern District of Michigan’s ruling that AirTrona and its agent, Barberio, attempted to sell to Lofgren a franchise business for sanitizing automobiles at car dealerships, the agreement should be rescinded because AirTrona failed to provide a disclosure statement, and Lofgren should recover payments related to the franchise sale and attorneys fees. The district court’s ruling followed a bench trial against only Barberio because the court had entered a default judgment against AirTrona.

In 2009, Lofgren purchased a franchise from AirTrona Green Technologies, the predecessor of Airtrona, and in return, AirTrona Green Techno-
logies provided Lofgren with the equipment necessary to start his franchise. In 2010, AirTrona formed and began offering a newer sanitization process that actually cleaned the interiors of used vehicles to eliminate the source of odors; the old process simply reduced odors. In 2011, Barberio presented Lofgren with a business plan to upgrade Lofgren’s old franchise to the new sanitization process. During the course of negotiations, Barberio promised Lofgren that Lofgren would earn profits of $3,000 to $6,000 per month. At the conclusion of negotiations, AirTrona sent Lofgren an invoice that stated that Lofgren would receive one “Franchise Michigan Location” and identified Barberio as the salesperson for the deal. Lofgren never realized the profits promised by Barberio, and the business failed in 2013. In August 2013, Lofgren sued AirTrona and Barberio. After a bench trial on the claims against Barberio, the district court found that Barberio was an employee who had violated the MFIL and that rescission was proper. Barberio appealed.

First, the Sixth Circuit rejected Barberio’s argument that Lofgren was not granted a franchise by AirTrona in 2011. Although Barberio claimed that the transaction merely expanded Lofgren’s existing franchise by buying new equipment, the Sixth Circuit found that the older cleaning process franchise was materially different from the newer cleaning process franchise and an invoice AirTrona sent to the plaintiff in August 2011 explicitly stated that the agreement was for a franchise. The Sixth Circuit also rejected Barberio’s argument that the MFIL incorporates a franchise adherence requirement through the language “prescribed by the franchisor” that was absent from the 2011 upgrade. According to Barberio, Lofgren ran his Michigan business independently from AirTrona, so AirTrona did not “prescribe” a marketing plan as required by the statute. The Sixth Circuit disagreed, reading the “prescribed by a franchisor” language to require general adherence to a franchisor’s business plan, not to mandate a complete sacrifice or independence by the franchisee. The court found that Lofgren’s business was reliant on AirTrona and Barberio for training, obtaining business relationships for the upgraded business model, business equipment, uniforms, and promotional support. Because this reliance is at the heart of the MFIL, there was no question that the relationship between AirTrona and Lofgren’s upgraded business was a franchise that had multiple “prescriptions” tying them together. The Sixth Circuit also concluded that Lofgren was charged a franchise fee, rejecting the argument that the charge was just for the new equipment. Although the court acknowledged the impracticality of requiring a franchisor to generate new disclosure documents each time it adds a new product or service, it upheld the district court’s finding that Lofgren was charged for more than the value of the equipment and the extra charge amounted to a franchise fee.

Barberio next argued that he was an independent contractor working for AirTrona and, thus, exempt from liability as an employee under the MFIL, but the Sixth Circuit disagreed. The MFIL provides for personal liability for an employee who materially aids in the act or transaction constituting a vi-
olation. Using an “economic realities” test that looks at “the totality of the circumstances surrounding the economic realities of the employment relationship,” the court found that Barberio was an employee because he (1) was named the CEO/COO of AirTrona, (2) held himself out as an employee, (3) was involved in developing company strategy, and (4) personally negotiated this transaction on behalf of AirTrona. Furthermore, Barberio did not qualify for the employee safe harbor provision of the MFIL because he had intimate knowledge of the transaction; to reap the benefit of the safe harbor, an employee must have no knowledge of the underlying facts.

Finally, the Sixth Circuit rejected Barberio’s argument that the remedies granted by the district court were improper. First, although Barberio claimed that rescission was improper for a technical violation, rescission is explicitly allowed by the plain language of the MFIL. Second, the court affirmed the final restitution award granted to Lofgren, rejecting Barberio’s argument that he should not be personally liable (because he was an employee of AirTrona and made the deal with Lofgren) and further rejecting the argument that the restitution amount should exclude amounts paid to a third-party generator manufacturer. Although the generator was not delivered to Lofgren, the invoice made clear that it was AirTrona’s responsibility to ensure delivery of the generator and stated that all inquiries should be directed to Barberio, indicating his responsibility for the delivery. Last, the court approved the attorneys fees award of $45,822.13 because the MFIL provides for “reasonable attorney’s fees and court costs” for violations of the statute. Although a portion of the fees were spent litigating against AirTrona (not Barberio), Barberio was jointly and severally liable with AirTrona. The court, however, denied Lofgren’s request for attorneys fees for the appellate proceeding.

This case is discussed under the topic heading “Statutory Claims.”

STATUTE OF LIMITATIONS

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

STATUTORY CLAIMS

The plaintiff, Beck Chevrolet Co., initially appealed multiple adverse rulings related to its claims under New York’s Franchised Motor Vehicle Dealer
Act. The Second Circuit denied several of the plaintiff’s appeals in an earlier opinion but certified several questions to the New York Court of Appeals concerning the proper scope and application of the Dealer Act. Following guidance from the New York Court of Appeals, the Second Circuit reversed, in part, and ultimately remanded to the U.S. District Court for the Southern District of New York for further consideration.

The Second Circuit first examined Section 463(2)(gg) of the Dealer Act, which makes it unlawful for a franchisor to use an unreasonable, arbitrary, or unfair sales or performance standard in determining a franchised automobile dealer’s compliance with a franchise agreement. Beck contended that a statewide average sales performance standard used by General Motors LLC to determine expected sales performance for its dealers was unlawful because it failed to adjust for certain local characteristics (such as brand popularity) beyond adjusting for the local popularity of general vehicle types. The New York Court of Appeals agreed, explaining that § 463(2)(gg) forbids the use of standards that are not based in fact or responsive to market forces because performance benchmarks reflecting a market different from the dealer’s sales area cannot be reasonable or fair. Therefore, to comply with the Dealer Act, a franchisor intending to use statewide data for other dealers must account for market-based challenges that affect dealer success. Applying these principles, the New York Court of Appeals held that GM’s exclusion of local brand popularity or import bias rendered the standard unlawful. And, not only is it unlawful to terminate a dealer on the basis of a below-average sales performance, it is also unlawful to use the performance standard, alone or in conjunction with other metrics, to assess a dealer’s compliance with its franchise agreement. Accordingly, the Second Circuit found that GM’s performance standard was unlawful and reversed the district court’s ruling.

Next, the Second Circuit examined whether GM’s changes to Beck’s service area constituted an “unfair” modification under § 463(2)(ff) of the Dealer Act. It certified the following question for determination by the New York Court of Appeals: “Does a change to a franchisee’s [service area] constitute a prohibited ‘modification’ to the franchise under § 463(2)(ff), even though the standard terms of the Dealer Agreement reserve the franchisor’s right to alter the [service area] in its sole discretion?” Before any modification to a franchise agreement that may substantially and adversely affect the dealer, section 463(2)(ff) requires ninety days’ written notice stating the specific grounds for the modification. A franchisee may challenge a modification as unfair. Then the burden shifts to the franchisor to prove that the modification is fair. A modification is unfair if it is not undertaken in good faith, is not undertaken for good cause, or would adversely and substantially affect the dealer under an existing franchise agreement.

Answering the certified question, the New York Court of Appeals concluded that a modification to a franchisee’s service area is a “modification” under the Act because it may significantly impact the franchise agreement. A franchisor may therefore not insulate itself from the Dealer Act by reserv-
ing the right to modify a service area in the franchise agreement; otherwise, a franchisor could easily circumvent the Act’s purpose by reserving the right to change franchise terms at will. Even so, only modifications that substantially and adversely affect the dealer’s rights, obligations, investment, or return on investment are prohibited under the Dealer Act. Therefore, a revision to the service area is not perforce violative of § 463(2)(ff); rather, such changes must be assessed on a case-by-case basis by considering its impact on the dealer. Because the district court originally found that the modification at issue was not a modification under the Dealer Act and did not examine the modification’s impact on the dealer, the Second Circuit vacated the district court’s judgment and remanded to the district court for resolution.

The plaintiff was an independent representative of automotive industry principals. The defendant produced parts, components, and assemblies used to manufacture automobiles. The parties entered an exclusive sales agreement under which the plaintiff was to be the exclusive sales representative of the defendant to specific customers. The agreement provided for commissions to be paid to the plaintiff for all business secured pursuant to the agreement, even sales made after the termination of the agreement, and for automatic yearly renewals absent written notice of termination. The parties believed that the agreement had been terminated when the lawsuit was filed, although neither had served the other with a written notice of termination.

The U.S. District Court for the Northern District of Illinois granted cross motions for summary judgment. The court granted the plaintiff summary judgment on his breach of contract claim because there was no dispute that the plaintiff procured business for the defendant or that the defendant did not pay the plaintiff commissions on those sales. The court also granted the plaintiff’s request for a declaratory judgment for payment of future sales commissions on all business the plaintiff secured on behalf of the defendant. The court, however, granted summary judgment in favor of the defendant on the plaintiff’s Illinois Sales Representative Act (ISRA) claim and claim for damages for “anticipated future sales.”

The ISRA requires commissions due at the time of termination of a contract to be paid within thirteen days of termination. 820 Ill. Comp. Stat. 120/2. The Act is intended to protect sales representatives from being denied commissions that are due or may become due after a contract is terminated; therefore, the ISRA applies only where a contract has been terminated, not where a contract is still in effect. The defendant contended that the agreement was still in effect because neither party had complied with the termination provisions of the agreement. Those provisions required the parties to give each other written notice of termination; otherwise, the agreement automatically renewed for successive one-year terms. The plaintiff disputed that strict compliance with the termination provisions was necessary because
the defendant’s breach of the agreement prevented him from taking advantage of the terms of the agreement and the defendant should not be able to profit from its breach. Relying on Seventh Circuit case law, the court adopted the defendant’s view and concluded that the ISRA did not apply because the parties’ agreement remained in effect since neither party had given written notice of termination to the other. Moreover, compliance with the termination provisions did not require the plaintiff to forfeit anything and did not excuse the defendant’s obligation to pay commissions.

With respect to the plaintiff’s request for damages for anticipated future sales, the court found such expectation damages inappropriate because the plaintiff had not yet suffered any injury related to future sales and he could only expect to receive commissions after the defendant received payment from customers. Accordingly, the court granted summary judgment in favor of the defendant on this and the ISRA claim.


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


The plaintiff, Len Stoler, Inc., a former operator of an Audi dealership in Maryland, brought suit against Volkswagen Group of America, Inc., d/b/a Audi of America, for violations of the Maryland Transportation Code (MTC). Stoler filed suit after selling its dealership to a third party after Stoler signed an agreement, at Audi’s request, to construct a new facility that would sell Audi vehicles exclusively. Stoler was given the choice of building the new facility or being denied bonus payments he was currently receiving. The U.S. District Court for the Eastern District of Virginia granted in part and denied in part the parties’ cross motions for summary judgment.

First, the court analyzed Stoler’s claim that Audi violated the MTC’s requirement that distributors offer the same consumer rebates, dealer incentives, price or interest rate reductions, and finance terms to all dealers of the same line-make. Stoler contended that Audi illegally implemented a two-tiered bonus program, which offered more generous incentives to exclusive Audi dealers than it offered to non-exclusive Audi dealers. The court disagreed and awarded summary judgment in favor of Audi because Audi offered Stoler and other dealers the same bonus opportunities. Although Stoler asked the court to focus on the disparate results of the incentive program offer, an offer that some dealers accepted and others did not, the relevant inquiry was on the scope of the offer, and the offer was made to all Maryland Audi dealers. Seeking to avoid this result, Stoler argued for the first time in a supplementary summary judgment brief that Audi treated new dealers differently from established dealers by offering them an easier path to receive the
higher bonus payments. Because this new claim was not made in the complaint, the court declined to decide it.

Next, the court examined Stoler’s claim that Audi violated the MTC by requiring Stoler to operate an exclusive Audi facility. MTC § 15-207(h)(2)(i) specifically prohibits a vehicle distributor from requiring a dealer “to alter or replace an existing dealership facility.” Stoler contended that Audi required him to build a new facility when in 2008, and as part of Audi’s Retail Capacity Guide, Audi implemented a market opportunity guide (MOG) that provided a sales projection for each dealer as calculated by Audi and that required Maryland dealers to agree to operate an exclusive facility if their respective MOG exceeded 400 units. The court determined that the MOG did not violate the MTC because the law does not prohibit an exclusivity requirement if it is either previously agreed to or uniformly applied to dealers across Maryland.

The court found that both circumstances were present and either would be independently sufficient to warrant summary judgment in favor of Audi. First, although the MOG was implemented nearly a decade after Stoler initially signed the dealer agreement, the agreement incorporated Audi’s Standard Provisions and Retail Capacity Guide, which explicitly provided that Audi could prescribe new facility standards “from time to time,” “taking into consideration . . . reasonably foreseeable future requirements.” Indeed, those prescribed standards, specifically the Retail Capacity Guide and MOG calculation, required Stoler to build an exclusive facility, and “it was reasonable to anticipate that a dealership, over the course of two decades, may need to become exclusive.” Second, the court found that Audi uniformly applied the MOG to all Maryland dealers; thus, it could not be said to have “required” Stoler to alter or replace a dealership facility. Further, the court rejected Stoler’s additional argument that Audi did not uniformly apply its decisions regarding whether a dealer must operate out of exclusive facilities because, in applying its MOG formulas, Audi had unique inputs and outputs for each Audi dealer. Audi used the same MOG formulas and calculation methods for each dealer, the court found.

The court then analyzed Stoler’s claim that Audi violated MTC § 15-207(h)(2)(ii) by denying or threatening to deny a “benefit generally available to all dealers,” a bonus in this case, based on Stoler’s failure to operate out of an exclusive facility. This claim too was without merit. To violate the law, Audi would have needed to withdraw a “benefit generally available to all dealers”; the bonus was a dealer incentive, not a benefit. Drawing a distinction between benefit and incentive, the court noted that an incentive includes conditions or criteria that the recipient must meet, while a “benefit generally available” is a useful aid that each Audi dealer receives by the mere fact of being an Audi dealer. The court found plenty of examples of such benefits, including service mailers, next-day parts delivery, and training, to name a few. By contrast, the bonus program required dealers to satisfy cer-
tain conditions to earn the bonus. Therefore, Audi was entitled to summary judgment on this claim.

The court next turned to Stoler’s claim that Audi violated the MTC by reducing the price of its automobiles or changing the financing terms in exchange for dealers’ agreeing to maintain exclusive sales or service facilities or building sales or service facilities. As an initial matter, the court rejected Audi’s argument that Stoler lacked standing to bring this claim for lack of injury. Stoler’s injury could be found in the sale of its business, millions of dollars in lost sales, and diminution in franchise value, all resulting from Audi’s requirement that it build an exclusive facility. Regarding the merits of this price reduction claim, genuine issues of material fact precluded an award of summary judgment to either party. The parties presented conflicting evidence as to whether Audi’s exclusive bonus program actually reduced the price of its automobiles, and factual disputes regarding Stoler’s alleged damages also existed.

Audi also moved for summary judgment on Stoler’s coercion claim. Stoler alleged that Audi violated MTC § 15-207(b) by coercing it into signing a facility agreement to build a new, exclusive facility by threatening to deny future bonus payments. Audi disputed that any such alleged threat was “coercion” under the Act because the bonus program was an incentive, not a benefit. The court disagreed with such a narrow reading of the statute, which defines “coercion” to include threats of “harm . . . or other adverse consequences” and noted that loss of bonus payments constitute such harm. Further, the court observed that “the offering of an incentive program does not immunize a distributor from a potential coercion claim.” The court went on to deny summary judgment to Audi because there were disputed factual issues as to (1) whether Audi attempted to persuade or coerce Stoler into an agreement to build an exclusive dealership and (2) whether Stoler suffered damages by signing the facility agreement.

Finally, the court examined Audi’s three affirmative defenses: a covenant not to sue contained in the facility agreement and two equitable defenses (unclean hands and in pari delicto). The court first weighed the covenant-not-to-sue defense, which Audi also brought as a counterclaim. Specifically, in the facility agreement Stoler agreed not to sue Audi “with respect to any alleged damages [Stoler] may suffer as a result of [Stoler]’s failure to perform its obligations under the [facility] agreement.” The court found the affirmative defense mooted by its grant of summary judgment to Audi on Stoler’s bonus/benefit claim. The court further found that the counterclaim failed because no damages would result from the bonus claim since summary judgment was granted in favor of Audi on that claim. Moreover, neither Audi’s attorneys fees nor its expert fees were recoverable damages in Maryland as a matter of law. Accordingly, summary judgment on Audi’s counterclaim was awarded to Stoler.
With respect to Audi’s equitable defenses, Audi argued that: (1) Stoler knowingly entered into the facility agreement, which Stoler claimed to be illegal in this litigation; (2) Stoler fraudulently represented in the facility agreement to having been fully advised of its legal nature; and (3) Stoler falsely stated in the agreement that its representatives and legal counsel had reviewed the applicable laws before signing the agreement. Stoler contended that the affirmative defenses failed as a matter of law because: (1) it could not be at fault given Audi’s grossly unequal bargaining power; (2) in pari delicto could not apply where Stoler was part of a class protected by the allegedly violated statute; and (3) contract provisions cannot provide a basis for an unclean hands or in pari delicto defense. The court rejected Stoler’s argument that alleged misrepresentations in the facility agreement could not form a basis for the defenses, but ultimately found that there was a genuine factual dispute as to Audi’s equitable defenses because it was unclear if Audi had coercive or grossly unequal bargaining power at the time Stoler signed the facility agreement. It therefore denied Stoler’s motion for summary judgment on these two defenses.

*Neubauer v. FedEx Corp.*, Bus. Franchise Guide (CCH) ¶ 15,921, 849 F.3d 400 (8th Cir. 2017)
This case is discussed under the topic heading “Contract Issues.”

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

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

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

The U.S. District Court for the Western District of Oklahoma granted in part and denied in part Sonic’s motion to dismiss counterclaims brought by a franchisee of two Florida Sonic restaurants with the rights to develop twenty more Sonic restaurants in Florida. Sonic initiated the lawsuit asserting claims of breach of contract and unjust enrichment against the franchisee under Oklahoma law. Sonic alleged that the franchisee failed to pay all amounts due under the contracts and was therefore unjustly enriched by re-
taining “POP Kits” and other property of Sonic. The franchisee brought counterclaims for failure to provide proper financial disclosures in the franchise disclosure documents (FDDs) and making false representations regarding profitability and desirability of the restaurants under both Florida and Oklahoma law. Sonic moved to dismiss the counterclaims.

As a threshold matter, the court first had to determine whether Oklahoma or Florida law applied to the franchisee’s counterclaims. Sonic argued that Oklahoma law should apply because the parties’ agreements contained an Oklahoma choice of law clause and because the most significant relationship test required application of Oklahoma law to the franchisee’s tort claims. Conversely, the franchisee argued that the agreements provided that the law of the state in which the restaurants were located governed franchise disagreements (here, Florida law) and that it had asserted claims under the laws of both states. Because the court was sitting in diversity, it applied the choice of law provisions of the forum state (Oklahoma). That required the court to apply the law of the state (1) chosen by the parties, (2) where the contract was made or entered into, or (3) the place of performance if indicated in the contract. Applying those factors, it was clear based on the plain language of the choice of law provision in the license agreement that Oklahoma law governed the agreement itself, and that, under limited circumstances, the franchise laws or regulations of the state in which the Sonic restaurant was located also applied. Based on this provision, the court concluded that the parties intended for both Oklahoma and Florida law to apply to disputes involving the agreement and that the franchisee could assert counterclaims stemming from both Oklahoma and Florida law.

As to tort claims, the court found that Oklahoma choice of law rules applied the law of the state with the most significant relationship to the parties. This test considers: (1) the place where the injury occurred; (2) the place where the conduct causing the injury occurred; (3) the domicile, residence, nationality, place of incorporation and place of business of the parties; and (4) the place where the relationship, if any, between the parties occurred. Here: (1) the injured party (the franchisee) resided in Florida; (2) the alleged breach and fraudulent acts occurred within Sonic’s headquarters in Oklahoma, which was reinforced by a clause in the license agreement stating that any breaches would be deemed to have occurred at Sonic’s corporate headquarters; (3) Sonic was located in Oklahoma and Delaware and the franchisee was located in Florida; and (4) all contracts between the parties were issued from Sonic’s headquarters in Oklahoma. Accordingly, the court determined that Oklahoma law applied to the franchisee’s tort claims for breach of the covenant of good faith and fair dealing and fraud.

Turning to the merits of the franchisee’s counterclaims, the court first weighed the franchisee’s claim of breach of the implied covenant of good faith and fair dealing. The franchisee alleged that Sonic abused its discretionary authority, failed to exercise its authority in good faith, and the alleged conduct was a willful and malicious breach of that duty. Although
Oklahoma recognizes an implied covenant in every contract, its breach is usually not recoverable as a tort independent from breach of contract. However, an independent bad faith claim can exist where there is a “special relationship” between the parties, such as a contract of adhesion and an elimination of risk. The court here found that the parties’ franchise relationship was simply a traditional commercial relationship and that there was no evidence that the agreement was an adhesion contract or that Sonic eliminated its risk in the agreement. Accordingly, the court found that no amendment could save the counterclaim and dismissed it with prejudice.

With respect to the defendants’ fraud claim, Sonic argued that the claim failed to meet the heightened pleading standards of Federal Rule of Civil Procedure 9(b), which requires specification of “the time, place and contents of the false representation, the identity of the party making the false statement[,] and the consequences thereof.” The court found that the franchisee met the time requirement by stating that the fraud occurred in late 2007, prior to the signing of each license agreement. The court next found that the location of the fraud was properly pleaded because the counterclaim stated the location of the restaurants and the territories in question and the location a representative of Sonic visited when he allegedly made representations to the franchisee. Without analysis, the court then concluded that the contents of the fraudulent statements were sufficiently described. Further, the court found that the identity of the person making the statements was established by naming a representative of Sonic. This was sufficient because the Tenth Circuit does not require naming specific individual sources of statements where the statements are the result of group action (e.g., a corporation’s board of directors). The court therefore denied Sonic’s motion to dismiss the fraud counterclaim.

The franchisee also claimed that Sonic violated the Florida Franchise Act (FFA) by misrepresenting the prospects or chances of success of the Sonic franchises. More specifically, the franchisee claimed that Sonic assured it of the viability of a location despite knowing that it needed to generate at least $4 million in revenue to turn a profit and that no similar location had generated that level of revenue. Sonic argued that this claim failed because the license agreement expressly disclaimed all representations regarding profitability, including oral representations. The court concluded, however, that the FFA provides a remedy for any intentional words or conduct by the franchisor that concern the chances of success of the franchise, were relied upon by the franchisee to its detriment, and are untruthful, regardless of the disclaimer. Therefore, the court allowed the franchisee’s FFA claim to proceed.

Next, the court examined the franchisee’s claim under the Florida Deceptive and Unfair Trade Practices Act (FDUTPA). To state a FDUTPA claim, the franchisee had to show a deceptive act or unfair trade practice, causation, and damages. The franchisee contended that because the FDUTPA adopts any violation of the Federal Trade Commission (FTC) Act and Sonic failed
to comply with the Franchise Rule, the claim survived a motion to dismiss. Sonic again argued that a disclaimer in the license agreement defeated the claim and that the claim was not alleged with sufficient specificity under Rule 9(b). The court rejected the pleading argument, but held that Florida courts bar recovery under FDUTPA if the party signs a contract with terms that contradict the alleged misrepresentations, such as the disclaimer here. Because the franchisee was barred from seeking relief under the FDUTPA given the disclaimer he signed in the license agreement, the court dismissed the claim with prejudice.

The court then examined the Oklahoma Business Opportunity and Sales Act (OBOSA) counterclaim that Sonic was no longer exempt from certain filing requirements with the Oklahoma Department of Securities when it provided allegedly false and misleading information in the FDDs or, in the alternative, that Sonic failed to deliver the FDDs. The franchisee also alleged that Sonic’s FDD violated the OBOSA by containing fraudulent or deceitful information. Seeking dismissal, Sonic argued that the franchisee improperly pleaded this claim in the alternative. The court rejected that argument because alternative pleading is permissible in Oklahoma. Moreover, outstanding questions of fact regarding whether the FDD was provided and was sufficient remained. Accordingly, the OBOSA claim stood.

Finally, the court turned to the counterclaim that Sonic violated the Oklahoma Consumer Protection Act (OCPA). Sonic argued that the claim should be dismissed because the FTC has the authority to regulate franchisors and the OCPA exemption applies, making this claim inapplicable. The OCPA exemption provides that actions or transactions are exempt where regulated by a regulatory authority of Oklahoma or the United States. The court noted that the franchisee did not dispute Sonic’s proposition that the FTC has authority to regulate Sonic’s activity as a franchisor; in fact, the franchisee had alleged breach of the Franchise Rule. Because the OCPA exemption makes no requirement of a private cause of action and the FTC regulates the conduct at issue, the court dismissed the claim with prejudice.

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

TORTIOUS INTERFERENCE

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

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

**UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES**


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


This case is discussed under the topic heading “Statutory Claims.”

**VICARIOUS LIABILITY**


This case is discussed under the topic heading “State Disclosure/Registration Laws.”