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Welcome to the Summer issue of the *Franchise Law Journal*. As you receive this issue, we are only a few weeks away from the 41st Annual Forum on Franchising to be held October 10–12 in Nashville. The Program Co-Chairs, Julie Lusthaus and Michael Gray, have assembled a great program, and I hope you will be able to join us there.

When you receive this issue, the *Franchise Law Journal* will be under new leadership. My three-year term as Editor-in-Chief ended on August 1st, and I am very pleased that Dan Oates has succeeded me. Dan is a partner in the Seattle office of Miller Nash Graham & Dunn LLP and has been an Associate Editor of the *FLJ* since 2014. For a number of years Dan has updated the index of *FLJ* articles published on the Forum’s website, providing an important franchise law research tool. He will do a great job as Editor-in-Chief.

It has been my great pleasure and privilege to serve as your Editor-in-Chief for the past three years, and I have many people to thank for making my job such a good experience. First of all, thank you to you our faithful readers without whom—to paraphrase Yogi Berra—none of this would have been necessary. A huge thank you to our authors as well. You all have taken substantial time out of your busy personal and professional lives to write for the *FLJ* and contribute to the excellent scholarship that is one of the cornerstones of the Forum on Franchising. Thank you also to all of the editors who have served with such distinction for the past three years. Each of you has contributed greatly to the Forum by your incisive editing of the articles we publish and by writing the Currents section of each issue of the *FLJ*, and I am very grateful for all of your contributions.

Thank you to the two Chairs of the Forum with whom I have worked—Karen Satterlee and Eric Karp. Karen and Eric have always supported and

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encouraged our work on the *FLJ* and I appreciate their support. I also am very grateful to my colleagues at Cline Williams, particularly Trent Bausch and my other colleagues in the Franchise and Distribution Practice Group, who have been very generous in their encouragement of my work and the time I have spent on the *FLJ*. Special thanks to my intrepid Legal Assistant, Shelley Holtz, who did a wonderful job of translating my random scribbles into coherent edits of articles, and to my wife of 38 years, Ellen Batenhorst, who was my go-to person on issues of grammar and style. She now knows more about franchise law than any retired high school English teacher you can find anywhere.

The last person I want to thank is Wendy Smith, our wonderful Managing Editor. Wendy’s desk is the last stop for everything that appears in the *FLJ*. We are very grateful for the skillful way she takes the excellent drafts we receive from our authors and turns them into polished articles. In addition, she serves as a great sounding board and fount of institutional knowledge for the *FLJ*. She does so many things to make our job as editors easier, and all of the editors and I owe her a huge debt of gratitude.

In preparing this final column, I looked back at the issues of the *FLJ* over the past three years. It is interesting to see the wide variety of topics our authors have written on during that time. Clearly, the joint employer issue was the gift that kept on giving to the *Journal* over the past few years; during my term we have published six articles on that topic from a number of different perspectives. Although I am reluctant to single out articles, a few have stood out over the past three years. The first article in my first issue was one on the business judgment rule by two longtime Forum stalwarts—Ron Gardiner and Brian Schnell. Dawn Newton and Shannon McCarthy provided us with a very interesting article on franchising marijuana businesses, and Peter Lagarias and Bruce Napell caused us to brush up on our Greek history when presenting lessons from Thucydides in an article on statutory and common law fraud actions.

We have a great variety of articles for your consideration in this issue. We lead off with *Franchising in the United Kingdom* by John Pratt and James Barrett. John is a franchise lawyer in London who is well-known to many members of the Forum. John and James provide a very helpful primer on franchising in the U.K., including a very timely discussion of the General Data Protection Regulation adopted by the European Union.

Next we have *Don’t Tread on Me: A Defense of State Franchise Regulation* by Caroline Fichter, Andrew Malzahn, and Adam Matheson. The authors provide a spirited defense of state franchise regulation in response to an earlier *FLJ* article on territorial limitations on state franchise statutes by Dan Oates, Vanessa Wheeler, and Katie Loberstein. I think it is safe to say that Dan will be the first Editor-in-Chief of the FLJ who finds his writings questioned in the first issue that comes out after he becomes EIC. We follow that with *Try Poking It With a Stick: Post-Term Noncompetes in California Certainly Look Dead*
by Theo Arnold. This lively look at noncompete law in California shows why this issue is a source of frustration to lawyers seeking to enforce post-term noncompetes in the Golden State. Don’t miss the footnote that addresses the legal travails of the San Diego Chicken.

David Gurnick has written several excellent articles during my term as Editor-in-Chief. In *Unconscionability in Franchising*, David and Sam Wolf provide a very interesting review of the law in this area, with particular emphasis on California. We follow that with *What’s in a Name? State Business Opportunity Statutes as Franchise Disclosure Laws* by long time Forum member Stan Dub. Stan provides a very helpful perspective on the scope of business opportunity laws and their role in franchise disclosure issues. We round out the articles in this issue with James Mulcahy and Filemon Carrillo’s *Leegin, Ten Years Later: Did Vertical Agreements Remain Unlawful Per Se Where Adopted To Facilitate A Price-Fixing Horizontal Scheme?* We wanted to look back at the *Leegin* decision after ten years and James and Filemon give us a very interesting and helpful perspective on this case. We round out this issue with an excellent *Currents* section edited by Trish Treadwell, Earsa Jackson, and Elliot Ginsburg. Special thanks to Larry Weinberg, who edited the article on franchising in the UK, the first in a series of articles on franchise laws in other countries.

In closing, I leave you with this parting thought. We in the Forum on Franchising are so fortunate to participate in a professional group that has such a high level of engagement by its members. We are equally fortunate to have such a collegial membership in which lawyers who represent franchisors and lawyers who represent franchisees can zealously represent their clients’ widely disparate interests but do so in an atmosphere of mutual respect and maintain personal friendships. In an era where civility and mutual respect are sorely lacking in our public life and discourse, we are blessed to be members of such a group. Please do your best to continue to maintain this level of civility, and, of course, show your support of the Forum by writing for the *Franchise Law Journal*.

Thank you.
Save the Date!

Mark your calendars for the
41st Annual Forum on Franchising
Nashville, TN
October 10–12, 2018
This article provides an overview of the legal landscape and related best practices to consider when expanding a franchise business into the United Kingdom. The U.K. government has a flexible open door policy for those setting up businesses or expanding into the country. Any foreign-owned or foreign-managed enterprise receives the same treatment as a U.K.-owned or U.K.-managed enterprise and is subject to the same regulations. There are no separate regulations for the franchising sector, and as a result the U.K.’s general contract, tort, commercial, and company laws apply.

I. British Franchise Association

Franchising in the U.K. is subject to self-regulation by the British Franchise Association (BFA) in accordance with its code of ethics (BFA Code), which incorporates the European Code of Ethics for franchising promulgated by the European Franchise Federation. The BFA, the voluntary governing body for franchising in the U.K., was established by a small group of

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1. According to the NatWest/BFA survey, the annual survey of franchising in the U.K., franchising in the U.K. has been consistently growing, with an increase of seventy percent in people employed in franchising over the last ten years. Profitability of franchisees is high, remaining at eighty-nine to ninety-one percent even during the economic downturn from 2007/2008. Not only does the U.K. have a large homegrown market, but foreign franchisors are attracted to the U.K. for a number of reasons. The United States and Australia, two countries with high levels of overseas franchise expansion, often choose the U.K. as the first country for international expansion not only because the same language is spoken and its legal system is similar (i.e., a common law rather than a civil law system) but also because the U.K. has no franchise legislation. As a result, entering the U.K. market is a relatively simple way to enter the European market.

2. BFA Code of Ethics, available at www.thebfa.org

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franchisors in 1977 to represent the interests of the franchise sector and improve the standards of franchising.

The BFA is a standards-based organization that requires its members to comply with its standards as set out in the BFA Code and technical bulletins. Certain key standards and technical bulletins are discussed later in this article.

The BFA’s requirements and the BFA Code apply to BFA members only but, in Drivertime Recruitment Ltd. v DST Ltd., a case involving the winding up of a franchisor that was not a BFA member, the U.K. High Court recognized the BFA Code’s importance in assessing the behavior of franchisors generally.

In Drivertime Recruitment Ltd., Drivertime, the franchisor, sold franchises in the temporary driver recruitment industry. Between 2000 and 2003, Drivertime sold forty-seven franchises (receiving the equivalent of over $1 million), of which only one unit was still operating at the end of 2003. The court found that Drivertime failed to disclose its very high failure rate to potential franchisees and deliberately evaded BFA requirements mandating disclosure of prior disputes, any involvement in litigation, and details about those involved in the franchise business. The court further found that Drivertime was concerned primarily with selling new franchises instead of supporting or developing its existing network. In analyzing the facts and reaching this conclusion, the court viewed the BFA Code as establishing franchising best practices, particularly in light of the fact that individuals behind Drivertime were familiar with the BFA Code because of their previous involvement with a franchise company that had been a member.

The Drivertime Recruitment Ltd. judgment is a warning to all franchisors that are not BFA members and do not follow the BFA Code. Those franchisors may nonetheless be held to the same standards when franchise disputes arise.

II. Regulation of Franchising: A Brief Overview

Successive U.K. governments have made it clear they are not contemplating franchise regulation. Because complaints about franchising are rare, they see no reason for legislation requiring disclosure or enforcing standards in the franchisor-franchisee relationship.

Franchise self-regulation in the U.K. is made easier by a number of factors. The BFA is a respected body that imposes quality standards; many franchisors wish to join the BFA because membership shows a commitment to ethical franchising and makes franchisee recruitment easier. The U.K. is relatively small, thereby facilitating awareness of franchisors’ activities. Unlike in the United States, only a small number of franchise bankers, lawyers, and

4. Drivertime Recruitment Ltd. at para 35 to 36.
5. The role of U.K. banks should not be underestimated when considering expanding a franchise program in the U.K. U.K. banks gather and retain a great deal of information about franchisors and their franchisees and will not fund franchisees of systems that have experienced a
consultants undertake a substantial amount of franchising work, a fact that facilitates frequent and open discussions about the activities of specific franchisors. Negative information about franchisors can be quickly disseminated.

A. Initial Requirements for Franchising in the U.K.

A foreign franchisor must satisfy no specific requirements before offering franchises in the U.K. other than those that apply to all franchisors, save that the BFA requires a foreign franchisor to demonstrate that it has operated an outlet with success for a reasonable time in at least one pilot unit in the U.K. before starting its franchise recruitment. Company-owned units can provide the basis for a pilot operation, but to gain the right experience, the pilot should be operated by a manager on an arm’s-length basis. In the case of a master franchisee of a non-U.K. franchise system, the BFA requires a U.K. outlet to have been operated before the franchise may participate in BFA-sponsored franchise exhibitions. The franchisor must also be the owner of, or have obtained the legal right to use, the trade name, trademarks, and other distinguishing identification of the franchise system.

The BFA Code requires franchise recruitment advertising to be “free of ambiguity and misleading statements,” and when “direct or indirect references to future possible results, figures or earnings” are made, they must be objective and not misleading. When financial projections are provided, the franchisor should clearly state the basis of these projections, e.g., whether they are based on the performance of company-owned units, the pilot franchise, or the average performance of all existing franchisees. The franchisor should clearly state that the figures are provided for illustrative purposes only and do not necessarily mean that a franchisee will achieve the same results. When a franchisor’s literature provides guaranteed levels of turnover or earnings, an accompanying statement must note that this is not a guarantee of profitability. The statement must be in an easily readable format and must appear in reasonable proximity to the guarantee.

The BFA Code also requires “full and accurate written disclosure of all information material to the franchise relationship within a reasonable time prior to the execution of . . . binding documents.” Two points are important to note: (1) Disclosure requirements are not a legal obligation; and (2) What constitutes material information is an inherently vague concept.

The BFA’s Guide to the Code of Ethics (BFA Guide) sets out the types of information that should be provided, including: the business and financial

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6. Between twelve and twenty-four months is generally considered reasonable.
7. BFA Code, 2.2(ii).
8. BFA Code, 3.1, 3.2.
10. BFA Code, 3.3.
position of the franchisor; the people involved in the franchise company; the franchise proposition, i.e., what exactly is being offered, a realistic description of the business format, how much pilot testing has been done, and the pilot operation’s financial performance; the franchisees; financial projections; and the contract.11

The BFA also requires that a copy of the BFA Code be supplied to prospective franchisees before execution of a franchise agreement. In practice, relatively few U.K. franchisors, whether BFA members or not, provide a formal disclosure document that complies with these requirements.

The BFA requires its members to refund prospective franchisees’ pre-contract deposits if they do not proceed and enter into the franchise agreement, although franchisors may retain related and verifiable third-party expenses they incur in connection with the prospective franchisee’s application. Franchisors that belong to the BFA are required to inform prospective franchisees in writing of the deposit amount required, the purpose for which it will be used, when the deposit should be paid, and how much of it will be refundable if the prospective franchisee decides not to proceed with purchasing the franchise.12

B. Continuing Requirements

The traditional position in the U.K. is that there is no general duty requiring parties in contracts to act in “good faith” toward each other. However, in Yam Seng Pte Ltd v International Trade Corporation Ltd,13 the court showed a willingness to imply elements of good faith in what was termed “relational” contracts, such as franchise contracts. Prior to this decision, it was not uncommon for the franchise agreement itself to impose an obligation on franchisees to act in good faith toward the franchisor—but not the other way around. Since the Yam Seng decision, more franchisors incorporate express obligations of good faith into their franchise agreements in order to mitigate the risk of the court imposing wider and less certain implied obligations. The question as to whether the courts will impose any implied good faith term into franchise agreements is far from certain and, indeed, a number of recent cases would suggest a strong judicial resistance to do so.14 Nevertheless, the BFA Code has recognized the development

12. BFA Guide, 8.1.2, 8.1.3.
14. In MSC Mediterranean Shipping Co v Cottonex [2016] EWCA Civ 789, Lord Justice Moore-Bick, who gave the leading judgment in the Court of Appeal, rejected the trial judge’s reliance on a general principle of good faith in the following terms: “the better course is for the law to develop along established lines rather than to encourage judges to look for what the judge in this case called ‘some general organising principle’ drawn from cases of disparate kinds.”

And he went on to say: “There is in my view a real danger that if a general principle of good faith were established it would be invoked as often to undermine as to support the terms in which the parties have reached agreement.”
and has incorporated an obligation on both the franchisor and franchisee to exercise “good faith and fairness” in their dealings with each other.\footnote{BFA Code, 2.4(ii).}

Almost all U.K. franchise agreements contain an express provision for immediate termination in the event of a franchisee’s material and incurable breach, e.g., abandonment, insolvency, nonpayment, and misrepresentation. Paragraph 2.4(ii) of the BFA Code requires that in other cases a franchisee be given notice of any contractual breach and be granted, where appropriate, a reasonable time to remedy a default. Generally, thirty days is considered to be reasonable. The BFA Code would not prevent a franchisor from terminating immediately for a very serious breach that goes to the heart of the franchisee/franchisor relationship.

The franchisor also has an overriding common law right to terminate if a franchisee commits a repudiatory breach, i.e., a breach so serious that it suggests that the breaching party no longer wishes to be bound by the terms of the agreement. The non-breaching party may choose to accept the repudiatory breach, end the franchise relationship, and seek damages, or allow the agreement to continue and seek damages.

The BFA Code requires the contract to state “the basis, including the notice that both parties must give, for any renewal of the agreement.”\footnote{BFA Code, 5.5(ix).} Renewal is not a requirement, but if renewal is available, the basis should be described in the contract. Most franchise agreements lasting five years (the usual contract term in the U.K.) generally should contain two “guaranteed” renewals while franchise agreements lasting ten years generally should contain one “guaranteed” renewal and set out the conditions for renewal. In practice, renewal will typically be granted if the following conditions are satisfied:

1. The franchisee is not in breach of the franchise agreement at renewal and has not committed a breach of the franchise agreement such that the franchisor would have been entitled to terminate the franchise agreement.
2. If applicable, the franchisee may be required to refurbish the premises and/or update its equipment and vehicle.
3. The franchisee has met the franchisor’s performance requirements.
4. The franchisee enters into the franchisor’s then standard form franchise agreement.
5. The franchisor is released from any claims that the franchisee may have.

C. Competition Law

certain agreements and reflects Article 101 of the Treaty on the Functioning of the European Union (TFEU). The Chapter II Prohibition reflects Article 102 of the TFEU and regulates businesses that have such a dominant position in their market that they are able to abuse that position. No franchise system currently operating in the U.K. is likely to have a dominant position under the Competition Act. Accordingly, this article will not discuss the Chapter II Prohibition.

In enacting the Competition Act, legislators aimed to ensure that the U.K. competition legislation adopted a similar approach to that of the European Union, on which many other Member States (such as Ireland and France) have based their own competition legislation. Indeed, Section 60 of the Competition Act sets out the principles that U.K. authorities and courts must apply when interpreting the provisions of the Act, with a view to ensuring consistency with European law. It is unlikely that the United Kingdom’s withdrawal from the European Union will lead to a repeal of or substantial amendments to the Competition Act.

The Chapter I Prohibition prohibits agreements that have an effect on trade and restrict competition in the U.K. or any part of the U.K. The effect on trade and competition can be actual or potential but must be appreciable. A Chapter I Prohibition violation results in the offending provision, and sometimes the whole agreement, being deemed void, and the parties may be liable for penalties of up to ten percent of their turnover in the U.K. Further, third parties, such as customers or franchisees who have been harmed by such agreements, can claim damages in the U.K. courts.

The wording of the Chapter I Prohibition is very similar to that of Article 101 of the TFEU, except that Article 101 (as explained further later) requires an effect on trade between Member States of the European Union before it applies, whereas Section 2(1) of the Competition Act only requires an effect on trade within the U.K. itself. When an agreement falls within the scope of Section 2(1), it could also fall within Article 101.

Section 9 of the Competition Act, using very similar wording to that of Article 101(3), exempts agreements that contribute to “improving production or distribution” or “promoting technical or economic progress,” provided that the agreement’s restrictions do not go further than necessary and/or result in the possibility of “eliminating competition in respect of a substantial part of the products in question.” If a franchise agreement is exempted under EU law, it will also be exempted under U.K. law.

19. Competition Act, § 9(a)–(b).
III. EU Rules Overview

EU competition rules apply in the U.K. Articles 101 and 102 of the TFEU are the primary sources of EU competition law. Article 101, which has the greatest impact on franchising, regulates anticompetitive agreements, decisions, and concerted practices. Article 102 regulates abuses of a dominant position but so far has not been applied to franchising within the EU.

To avoid having to deal with a large number of notifications of agreements seeking an exemption under Article 101(3), the European Commission has published a “block” exemption that applies to all vertical agreements, including franchise agreements. The block exemption sets out those provisions that cannot be contained in a vertical agreement in order for that agreement to be exempt. In addition to publishing its block exemption and guidelines to the block exemption, the Commission has published a Notice on Agreements of Minor Importance and a Recommendation in relation to Small and Medium Sized Businesses (SMEs). The effect of the Notice and Recommendation is that franchise agreements entered into by SMEs will not, in the view of the European Commission (but that view does not bind the European Court of Justice), be regulated by Article 101 in the absence of “hardcore” restrictions in the agreements. In practice, however, most European franchisors comply with the block exemption because of the additional certainty that it provides, and many franchisors do not find compliance to be particularly detrimental to their commercial objectives. If an agreement is exempted by the “block” exemption, it will also be exempted by the Competition Act 1998. The Regulation will expire

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20. Articles 101 and 102 were initially Articles 85 and 86 of the Treaty of Rome and then subsequently Articles 81 and 82 of the EC Treaty. Although the Article numbering has changed, no changes to the drafting of the provisions have been made.

21. Vertical agreements are agreements between businesses at different levels of trade, such as franchisors and franchisees, and are considered by European antitrust bodies to be unlikely to give rise to serious competition law issues.


26. These are restrictions set out in Article 4 of the vertical agreement block exemption and relate to price fixing or the territories/customers in which/to whom supplies can be made. Block Exemption Regulation, art. 4, 2010 O.J. at 5.
on May 31, 2022, and the U.K. government will need to decide whether, post-Brexit, to adopt the regulation that replaces it.

The effect of entering into an agreement that violates Article 101(1) is that either the whole agreement or the offending provisions, depending on the seriousness of the violation, will be void and unenforceable. In addition, the parties may be liable to fines which could be up to one million euros (approximately U.S. $1.23 million) or, if greater, ten percent of worldwide turnover of the business concerned, including turnover of its associated companies.

An effect on trade between Member States is an essential element for bringing Article 101 into play, but the European Court indicated in Pronuptia de Paris GmbH Schillgallis27 that franchise agreements are capable of affecting trade between Member States “even if they are concluded between enterprises established in the same Member State” if they “prevent the franchisees from setting themselves up in another Member State.”28 In this case, Pronuptia de Paris GmbH had granted three exclusive franchises to Firma Pronuptia de Paris Irmgard Schillgallis for Hamburg, Oldenburg, and Hanover. The case reached the European Court after Pronuptia de Paris GmbH had successfully sued for nonpayment of franchise fees; the franchisee counterclaimed that the franchise agreements did not comply with EU law. Although the three franchises were all based in Germany, the court indicated that certain clauses, such as those having the effect of market sharing, can affect trade between EU Member States. However, the court determined that franchise agreements were different from dealership agreements that use a selective distribution system and accepted that if a restrictive contract clause was strictly necessary to protect the franchisor’s know-how and the franchise system, it would not constitute a restriction of competition. In addition, via its observations on the types of clauses usually contained in franchise agreements, the court acknowledged the “practical importance of many of the normal franchising practices to the successful operation of a franchising network.”29

The European Commission believes that agreements between businesses with relatively small market shares are unlikely to give rise to competition law issues and as a result the block exemption applies only if the franchisor and the franchisee each have a market share in the whole, or in a substantial part, of the EU of no more than thirty percent. The franchisor’s market share is calculated on the market in which products and services are sold to consumers and, in the case of franchisees, it is calculated on the market in which they purchase products.30 In practice, very few franchisors will have a market share of more than thirty percent, and no franchisees will exceed the thirty percent figure.

29. Pronuptia at paras 15–22.
30. Block Exemption Regulation, art. 9.
IV. EC Rules: Specific Issues

The block exemption prohibits three contractual provisions often found in franchise relationships. The first two are hardcore provisions, which are so serious that if a franchise agreement contains them, the whole agreement may be void and unenforceable. Contractual provisions relating to noncompete covenants are not deemed to be “hardcore”: offending provisions are unenforceable, but the whole agreement remains enforceable.31

A. Resale Price Maintenance

The setting of prices, including setting minimum prices, is strictly prohibited. This prohibition applies to express contract terms as well as “extracontractual pressure” on franchisees to comply with prices.32 Maximum and recommended selling prices are permitted as long as they are not a disguised form of price fixing, i.e., such prices must be genuine recommendations and not in any sense mandatory. For example, if a franchisor recommends a price but offers favorable treatment only to those franchisees that comply with the recommendation, prohibited price fixing is likely to have occurred.

Despite this prohibition, the Guidelines to the block exemption—but not the block exemption itself—contemplate that resale price maintenance is permissible in a number of situations: sales promotions during the introduction of a new brand;33 short-term (generally two to six weeks) low-price campaigns,34 and in order to prevent free riding by dealers that do not provide presales services,35 particularly with respect to expensive or complex products such as jewelry, fashion clothing, or IT equipment.

B. Exclusive Territories

Franchisors can prevent franchisees from actively selling in an exclusive territory or to a specific customer group of another franchisee, or even in the exclusive territory or customer group reserved to the franchisor, but franchisees cannot be prevented from passive selling outside their territory or customer group. In this context, “active” selling means “actively approaching individual customers” (e.g., by sending unsolicited direct mail and e-mails and making unsolicited visits). Conversely, “passive” selling means “responding to unsolicited requests from . . . customers.”36 The use of the Internet to advertise or sell products constitutes passive selling; accordingly, a restriction on the use of the Internet by franchisees is generally not permitted. Franchisors can, of course, impose quality and “look and feel” restrictions on their franchisees’ websites. As a result, franchisors that wish to

32. Block Exemption Regulation, art. 4(a).
discourage their franchisees from having individual websites ensure that their own website has high search engine recognition and allocate inquiries to the franchisee in whose territory such inquiries originate.\textsuperscript{37}

C. Noncompetition Covenants

The regulation of in-term competition has two elements in the U.K. First, franchisors may prohibit franchisees from engaging in a competing business while the franchise agreement is in effect. Second, limitations exist on a franchisor’s ability to impose exclusive purchase obligations on franchisees. Specifically, a franchisor cannot oblige a franchisee, for a period exceeding five years, to purchase more than eighty percent of the franchisee’s total purchases of the contract goods or services from the franchisor, its nominated supplier, or both. The five-year period can be extended on renewal of the franchise agreement. If the franchisor owns or leases the premises from which the franchisee trades, the purchase obligation can be imposed for the period of the franchisee’s occupation of the premises.\textsuperscript{38}

Post-termination noncompete covenants are also regulated and are prohibited unless the covenant relates to the supply of competing goods or services. The covenant is enforced only in relation to “premises and land” where the franchisee has been operating, which has the effect of excluding vehicle-based franchises;\textsuperscript{39} the covenant is “indispensable” to protect the franchisor’s know-how (the determination of whether a covenant is indispensable hinges upon the franchisor’s know-how being “substantial,” namely that it is “significant and useful to the buyer for the use, sale or resale of the contract goods or services”;\textsuperscript{40}) and the duration of the noncompete covenant does not exceed one year.\textsuperscript{41} Nevertheless, U.K. courts do usually allow post-termination noncompete obligations to apply for twelve months in the territory granted to a franchisee.\textsuperscript{42}

V. Franchise Litigation

The U.K. consists of three separate jurisdictions: England and Wales, Scotland, and Northern Ireland. The laws of England and Wales on the one hand and Northern Ireland on the other are very similar. Likewise, the laws of England and Wales and the laws of Scotland are similar even though the judicial systems are different. In many cases, the final court of appeal in relation to Scottish matters is the Supreme Court in London.

\textsuperscript{37} Commission Notice: Guidelines on Vertical Restraints, paras. 52–53.
\textsuperscript{38} Block Exemption Regulation, art. 5.2.
\textsuperscript{39} Block Exemption Regulation, art. 5.3(b).
\textsuperscript{40} Block Exemption Regulation, art. 1.1(g).
\textsuperscript{41} Block Exemption Regulation, art. 5.3(c).
\textsuperscript{42} Block Exemption Regulation, art. 5.3(d).
A. Areas of Litigation

U.K. courts have addressed franchise issues principally in two areas: enforcement of post-termination noncompete covenants and allegations of breach of contract and/or misrepresentation by a franchisor.

As described earlier, all properly drafted agreements in the U.K. contain post-termination noncompete covenants. These covenants are only enforceable insofar as they are reasonable and, where applicable, comply with the EU’s block exemption for vertical agreements. In the U.K., it is customary to draft such covenants in a way that facilitates the “blue pencil” test, i.e., those provisions that are considered unreasonable can be deleted, leaving the enforceable elements. This approach results in the imposition of a series of similar but slightly different noncompete obligations on franchisees. Typically, a noncompete obligation that restricts the franchisee for longer than twelve months is likely to be considered unreasonable in the U.K. With respect to the geographical scope of noncompete covenants, U.K. courts typically allow the restriction to apply to the territory granted to a franchisee provided that the majority of the franchisee’s customers are not based in a less extensive area.

B. Legal Costs

The U.K. civil procedure rules governing litigation require the parties to attempt to resolve their disputes before initiating litigation and to consider the use of alternative dispute resolution (ADR). This includes but is not limited to: mediation, early neutral evaluation, arbitration, adjudication, expert determination, negotiation, and conciliation. In addition, the trend of the court’s decisions with respect to the award of costs following the outcome of a trial has been to penalize any party that has unreasonably refused to mediate its dispute. If a party unreasonably refuses to mediate, the court can reduce that party’s award of costs if it is the victorious claimant or increase the proportion of the claimant’s costs it is required to pay if it is the unsuccessful defendant.

A major distinction between the U.S. and U.K. legal systems is that, generally speaking, U.K. law awards the winning party its legal costs of bringing the action, including attorney fees. The costs awarded usually do not cover all of the winning party’s legal costs but typically still cover sixty percent to seventy percent of those costs. Because of the risk to a losing party of having to pay considerable costs, the legal expenses insurance market is flourishing in the U.K. This is commonly in the form of “after the event” insurance. Both damages based agreements (permitting lawyers to be paid by reference

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44. “After the event insurance” is a type of legal expenses insurance policy that provides coverage for legal costs incurred in the pursuit or defense of litigation and arbitration. It is typically purchased after a legal dispute has arisen.
to a percentage of the damages received) and conditional fee agreements (so
that the lawyers can increase their standard rates by up to 100 percent if they
are successful) are permitted subject to strict conditions.

C. Injunctions

In some cases, it may be necessary to restrain the activities of a current or
former franchisee very quickly. In such cases, courts may grant an interim
injunction to one of the parties to the litigation. The most common franchise
scenario that gives rise to injunctions is where a franchisee competes with a
franchisor after termination of the franchise.

In emergencies, interim injunctions can be obtained within a matter of
hours without the involvement of the other party. An interim injunction
can only be granted after litigation has started or, in an emergency, if an un-
derstanding is given that litigation will be started immediately. The usual pur-
pose of the injunction is to preserve the status quo until the parties’ rights
have been determined. In general terms, the court must be persuaded that
there is a good reason why the defendant’s rights should be restricted before
the court knows whether the claimant will succeed in the litigation.

The claimant does not have to prove the merits of its underlying claim at
the injunction hearing, but it must show that it has a good arguable claim.
The court will not pre-judge the litigation but must be persuaded that a se-
rious question is at issue. If this is established, the court has discretion to
grant the injunction; in reaching its decision, the court will apply the “bal-
ce of convenience” test. In other words, the court will weigh the likely in-
convenience or costs for the defendant if an injunction is granted against the
harm caused to or costs for the claimant if it is not. Because the court cannot
assume that one or the other party will ultimately win the case, this test al-
 lows the court to effectively balance the risks of injustice. In practice, how-
ever, the balance of convenience is likely to be tipped in favor of the party
that, as it appears to the court, has the better case in the litigation.

A key factor in the court’s balancing exercise is whether any potential in-
justice could be adequately compensated by monetary damages. In other
words, if damages can be quantified and the defendant has the ability to
pay, the court is likely to refuse the injunction. If an injunction is granted,
the court will require an undertaking from the claimant to pay financial com-
ensation to the defendant and seek evidence of the claimant’s ability to pay
if the claimant is ultimately unsuccessful. Often, U.K. courts refuse an in-
junction application but order an expedited trial, requiring a full hearing to
take place within weeks rather than months.

D. Class Actions

Class actions are not available in the U.K., but it may be possible for fran-
chisees to bring a representative action whereby the court will accept that a
decision in relation to one member of the group will apply to all members of
the group. So far, no such representative actions have been brought by a group of franchisees.

E. Alternative Dispute Resolution

At all stages in the dispute, the civil procedure rules encourage parties to consider ADR. The BFA operates an informal conciliation, mediation, and arbitration scheme to resolve franchise disputes. Informal conciliation is the BFA’s “entry level” dispute resolution program, whereby the aggrieved party can send its complaint to the BFA using a prescribed form, and the BFA forwards the complaint to the other party, thus facilitating a dialogue. With mediation, the party requesting a referral to mediation must first confirm to the BFA that it has attempted, albeit without success, to resolve the dispute directly with the other party. Once this confirmation is provided, the party must complete an application form and return it to the BFA. The BFA will then contact each party to arrange the mediation.

It is not uncommon for a franchise agreement to include a clause requiring the parties to consider forms of ADR before commencing court proceedings, except when urgent injunctive relief is required. As in the United States, the U.K. injunctive relief exception to ADR does not need to be mutual in order to be enforceable.

VI. Other Relevant Legislation

Although no franchise-specific legislation exists in the U.K., a number of statutes have an impact on franchising. These statutes are briefly reviewed below.

A. Trading Schemes Act 1996

The Trading Schemes Act 1996 (1996 Act) was passed to regulate pyramid selling schemes, that is, schemes where participants are rewarded for recruiting other participants rather than for supplying the products or services that, at least notionally, the scheme has been set up to sell. The 1996 Act regulates, but does not outlaw, such schemes by regulating advertisements for participants, specifying what information must be given to participants when they are invited to join a scheme, and giving participants the right to cancel within fourteen days of entering into the agreement with the scheme promoter. Unfortunately, due to poor drafting, an unintended consequence of the 1996 Act is that it regulates franchise agreements because they fall within the broad statutory definition of trading schemes.

The 1996 Act defines a trading scheme as “any arrangements made in connection with the carrying on of a business, whether those arrangements are made or recorded wholly or partly in writing or not.”

46. Section 1(8).
pears to include virtually all agreements into which businesses enter, but not all such trading schemes are subject to regulation. The 1996 Act applies to trading schemes if two conditions are satisfied. The first condition is that the prospect is held out to a “participant” (in the franchising context, a franchisee) of receiving payment or a benefit related to a number of specified matters, including the supply of goods or services to others. In all franchise systems, franchisees provide either goods or services to customers in return for payment, so this condition is always satisfied. The second condition is that a “promoter” (in the franchise context, a franchisor) must supply goods and/or services. The goods or services so provided are to be used or supplied to or for other people (customers) under arrangements entered into by participants (franchisees), or to or for people introduced to the promoter (the franchisor) by participants (franchisees). This condition is, again, likely to be satisfied in most franchise systems.

The 1996 Act imposes criminal sanctions for breach of its provisions. Civil consequences also arise so that a participant could sue a promoter for breach of statutory duty or, alternatively, could refuse to pay for goods or services.

Fortunately for franchisors, the Trading Schemes (Exclusion) Regulations 1997 (Exclusion Regulations)\(^{47}\) have the effect of taking a trading scheme out of the application of the 1996 Act in two situations that are relevant to franchising. Franchisors are exempt from the 1996 Act if the trading scheme is:

- a single-tier trading scheme, which is a scheme where the only members are the promoter (the franchisor) and one or more participants (franchisees), and all other participants (franchisees) operate at the same level (in other words, franchisees cannot create another tier by appointing subfranchisees or taking on self-employed people); or

- a trading scheme where the promoter (the franchisor) and all participants (franchisees) are registered for value-added tax (VAT), the sales tax that applies throughout the EU.

Although no prosecutions or civil actions against a franchisor, or indeed anyone else, have been reported under the 1996 Act, franchisors must comply with the 1996 Act. Most franchisors seek to ensure that both exceptions apply by requiring franchisees to be VAT registered and by preventing franchisees from creating another tier by subcontracting or recruiting self-employed people to assist with the franchised business.

B. EU General Data Protection Regulation and Data Protection Act 2018

Until earlier this year, the Data Protection Act 1998 (DPA 1998)\textsuperscript{48} governed the processing of personal information concerning living and identifiable individuals. As of May 25, 2018, this act was overhauled by the EU General Data Protection Regulation (GDPR)\textsuperscript{49} and the Data Protection Act 2018 (DPA 2018).\textsuperscript{50} Enacted in Spring 2018, the DPA 2018 repealed and replaced the DPA 1998.

The GDPR applies to the “processing” of “personal data,” terms that are defined very broadly.\textsuperscript{51} Any business operating in the U.K. that holds information about individuals, whether employees, customers, or anyone else, is affected by the GDPR. A breach of data protection laws can lead to criminal as well as civil liability. Most obligations under the GDPR fall upon the “data controller,” defined as “the natural or legal person, public authority, agency or other body which, alone or jointly with others, determines the purposes and means of the processing of personal data.”\textsuperscript{52} Separate duties and obligations are imposed on “data processors,” defined as “a natural or legal person, public authority, agency or other body which processes personal data on behalf of the controller.”\textsuperscript{53} Franchisors will usually be data controllers, but depending on the arrangement between the parties, franchisees may be either data controllers or data processors.

Under the GDPR, anyone who processes personal information (e.g., names, addresses, and so on) for customers, suppliers, franchisees, or clients must comply with the seven data principles set out in the GDPR. These require personal data to be: processed lawfully, fairly and transparently; collected for specific and legitimate purposes; adequate, relevant, and limited to what is necessary; accurate and up to date; kept for no longer than necessary; and appropriately secure. The data controller should be able to demonstrate compliance with these requirements.\textsuperscript{54}

In many franchise systems, the franchisor states that it owns the customer list related to the franchised business and, as such, requires its franchisees to report customer information to the franchisor; such information is likely to include “personal data.” As a result, franchisors insert provisions in their franchise agreements requiring franchisees to comply with all applicable data protection legislation, which may include an obligation to obtain the consent of the data subject before passing the data on to the franchisor. The BFA also requires franchisors to obtain franchisees’ consent to their own personal


\textsuperscript{50} Currently the Data Protection Bill is available at https://services.parliament.uk/bills/2017-19/dataprotection.html.

\textsuperscript{51} GDPR, Art. 4(1), 4(2).

\textsuperscript{52} GDPR, Art. 4(7).

\textsuperscript{53} GDPR, Art. 4(8).

\textsuperscript{54} GDPR, Art. 5.
data being passed on to the BFA; this enables the BFA to check that franchisees in a member’s network are satisfied with the franchisor’s performance.

Foreign franchisors must be aware of the restrictions imposed by the GDPR with respect to exporting data abroad. If data is likely to be transferred to a franchisor that is located outside of the European Economic Area (EEA) (for example, if a U.S. franchisor appoints a master franchisee for the U.K. and imposes an obligation in the master franchise agreement to forward trading data to the franchisor), the data transfer can only occur if one of the following conditions exist:

- The European Commission considers the destination country as having an adequate level of data protection laws.\(^{56}\)

- The franchisor has provided appropriate safeguards.\(^{57}\) If the franchisor is based in the United States, this would be by way of having signed up for the Privacy Shield scheme.\(^{58}\) Currently, the United States does not meet the EC standard of an adequate level of data protection laws; thus, unless the U.S. franchisor complies with the Privacy Shield scheme, a U.K. franchisee is prohibited by law from transferring customer data and information to a U.S.-based franchisor. Those that participate in the Privacy Shield scheme must publicly declare their commitment to comply with the seven Privacy Shield principles and fully implement them.\(^{59}\) The Privacy Shield principles are enforced by the Federal Trade Commission and the U.S. Department of Transportation.

- The franchise agreement contains standard data protection clauses adopted or approved by the Commission, which allow such a transfer.\(^{60}\)

If the data transfer is permitted, foreign franchisors should be aware that the territorial scope of the GDPR extends beyond the borders of the European Union. It applies to the processing of personal data by a controller or processor in the European Union, regardless of whether the processing takes place in the European Union or not. Further, it applies to the processing of

\(^{55}\) Countries included within the EEA include Austria, Belgium, Bulgaria, Croatia, Republic of Cyprus, Czech Republic, Denmark, Estonia, Finland, France, Germany, Greece, Hungary, Iceland, Ireland, Italy, Latvia, Liechtenstein, Lithuania, Luxembourg, Malta, Netherlands, Norway, Poland, Portugal, Romania, Slovakia, Slovenia, Spain, Sweden, and the U.K.

\(^{56}\) GDPR, Art. 45.

\(^{57}\) GDPR, Art. 46.

\(^{58}\) The Privacy Shield scheme is a framework established by the U.S. Department of Commerce and the European Commission to provide a mechanism to comply with data protection requirements when transferring personal data between the EU and the United States. The scheme functions by way of self-certification of compliance with the scheme. See Privacy Shield Framework, available at https://www.privacyshield.gov/welcome.

\(^{59}\) The Privacy Shield establishes seven principles that must be adhered to by organizations that self-certify, relating to the following issues: (1) Notice; (2) Choice; (3) Accountability for Onward Transfer; (4) Security; (5) Data Integrity and Purpose Limitation; (6) Access; (7) Recourse, Enforcement, and Liability.

\(^{60}\) GDPR, Art. 46.
personal data of data subjects within the European Union when the controller or processor is not in the European Union, where the processing relates to the offering of goods or services or the monitoring of the behavior of data subjects within the European Union.

Where the GDPR applies to a franchisor or franchisee that is not established in the EU, an EU representative must be appointed, subject to limited exceptions. The representative should be established in one of the EU Member States where the data subjects are and whose personal data are processed in relation to offering goods or services, or whose behavior is monitored.

The purpose of the DPA 2018 is to address the implementation of the GDPR into U.K. law and to extend the GDPR legislation into domestic areas that it would not otherwise reach, such as law enforcement and intelligence services activity. When the U.K. leaves the EU, the DPA 2018 will allow for the GDPR to be incorporated into U.K. domestic law.

C. Unfair Contract Terms Act 1977 (UCTA)

U.K. franchise agreements commonly contain exemption clauses seeking to limit or exclude the franchisor’s liability for representations made to a franchisee during contract negotiations. The enforceability of exemption clauses is determined by reference to the Unfair Contract Terms Act 1977 (UCTA), which states that such clauses in “standard-form” documents, like franchise agreements, are enforceable to exclude liability for fraudulent or negligent misrepresentations only if they are fair and reasonable.

What this means, in practice, is that clauses that attempt to exclude a franchisor’s liability arising from any misrepresentation during contract negotiations are likely to be deemed unfair and therefore unenforceable, because, on the face of it, the clause would exclude liability for fraudulent misrepresentations. It is less clear whether the exclusion of liability for negligent misrepresentation would be found to be fair and reasonable, although generally franchisors will find it difficult to persuade a court that such a clause would be fair and reasonable. Accordingly, most U.K. franchise agreements specifically exempt from the exclusion clause liability for fraudulent misrepresentation. Fraudulent misrepresentations include those made with knowledge of their falsity, without belief in their truth, or recklessly as to their truth. U.K. courts have been very willing to conclude that financial information provided by a franchisor to prospective franchisees that is not based on the actual average performance of franchisees in that system is fraudulent in nature.

62. UCTA Section 11.
D. Bribery Act 2010

The Bribery Act 2010 (Bribery Act)63 introduced a tough new regime prohibiting the offering or taking of bribes, in the U.K. or elsewhere, and created a strict liability offense for companies and partnerships that fail to prevent bribery within their organization.64 The new provisions can be found in Section 7 of the Bribery Act. In theory, franchisors could be liable under Section 7 if their franchisees accept or give bribes. As a result, they must establish “adequate procedures” to prevent bribery.65 The Bribery Act does not define what constitutes adequate procedures, although the Ministry of Justice has published formal guidance on this issue.66

Franchisors should provide training on bribery to franchisees, insert clear policy statements relating to bribery in the operations manual, instigate monitoring and review procedures, and ensure that their franchise agreements contain a provision giving them the right to terminate the franchise agreement if a franchisee violates the Bribery Act. Adopting these recommendations is a sensible precaution, but, in practice, relatively few franchisors will be liable under Section 7 for the actions of their franchisees. Franchisees are unlikely to be “associated,” as required by the Act,67 with their franchisor unless they perform services for their franchisor under, for instance, “national account” contracts.

E. Modern Slavery Act 2015

The Modern Slavery Act 201568 requires commercial organizations (defined as organizations that supply goods or services and have a turnover above a certain threshold69) to publish a ‘slavery and human trafficking statement’ for each financial year. The statement should disclose the steps taken to ensure that slavery and human trafficking does not take place within the business. In determining whether the franchisor’s turnover exceeds the threshold, only the franchisor’s turnover is to be considered, and not any turnover of franchisees. However, a franchisor that must make a statement may find it beneficial for its brand to report on the steps taken to ensure

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64. Bribery Act, §§ 1–2.
the franchise as a whole is free from slavery. If the turnover of a franchisee exceeds the threshold, it is required to produce its own statement.\textsuperscript{70}

\section*{VII. Other Practical Issues}

In addition to addressing the myriad issues that can impact franchisors from a legal perspective, franchise systems looking to expand into the U.K. must consider various practical considerations that will impact the success of the franchised businesses. These considerations include:

\subsection*{A. Trademarks}

The U.K. has adopted a “first to register” system for protecting intellectual property, meaning that once a trademark is registered, the registrant can stop any other third party from using a mark that is the same as or similar to the registered trademark. Unfortunately, this also means that franchisors that fail to file registration applications for their marks first in the U.K. may face difficulties in their U.K. expansion efforts. Thus, when a franchisor first contemplates expansion into the U.K., a key component of the initial analysis should involve a search of the Trade Mark Registry to establish if there are any competing registrations and, if there are not, registering key marks in the U.K.

\subsection*{B. Corporate Structure and Tax Considerations}

Regardless of the commercial motivation to expand into the U.K., the corporate structure and legal and tax considerations must be treated with care. There are five commonly referred to methods of franchising, which are briefly summarized below.

- Direct franchising: The franchisor grants franchises to franchisees within the U.K.
- Branch/subsidiary: The franchisor establishes a U.K. subsidiary or branch operation, which will then act as the franchisor.
- Joint venture: The franchisor partners with a third party that has an existing business in and knowledge of the U.K. market, and they will act as the franchisor.
- Master franchise agreement: The franchisor appoints a master franchisee that will act as the franchisor.
- Development agreement: The franchisor grants a development agreement to a U.K. entity, which will be obliged to open outlets rather than appointing sub-franchisees.

Each method has advantages and drawbacks, particularly in relation to its tax implications and levels of control over the U.K. arm. Whether or not to utilize a U.K. company or a foreign entity within the U.K. market will be a key tax consideration and is likely to be determined by the level of involvement the franchisor intends to have in the market. Corporate and tax advice should be sought on how to structure an expansion to the U.K.

C. Premises

In England and Wales, land is held either by way of freehold or leasehold. If the business model requires the use of prime retail outlets, a franchisor may have to lease the property and grant a sublease of the premises to franchisees, because landlords can be reluctant to rent directly to start-up businesses (like franchisees). The grant of a sublease by a franchisor provides the franchisor with much greater control over the outlet as compared to allowing a franchisee to lease the property in its own name. This is particularly so following the termination of the franchise relationship because the franchisor will, when granting the sublease, ensure that the sublease terminates when the franchise agreement terminates. As a result, it is much easier from a practical standpoint for a franchisor to enforce its post-termination noncompete covenants and prevent the former franchisee from operating from its former premises. If the lease and sublease procedure is adopted, it is important for the franchisor to exclude the lease from the provisions of the Landlord and Tenant Act 1954; if the lease is not excluded, the franchisee would have “security of tenure” and thus could not be evicted from the premises following expiration of the lease.71

If a franchisor does not lease the property in question and instead allows franchisees to enter into leases directly with the landlord, a deed of option can be used to oblige the franchisee to take all steps necessary to transfer the premises to the franchisor upon termination of the franchise agreement. Conditional lease assignments, which are used in the United States and give the franchisor greater protection, are very unusual in the U.K. because landlords generally are unwilling to agree to future assignment of leases.

D. Employment and Labor Considerations

The U.K. has extensive employment laws, including antidiscrimination laws prohibiting discrimination on grounds of sex, race, sexual orientation, disability, religion, and age. In addition, employees must receive details of their employment terms and must receive certain minimum periods of notice before their employment is terminated. The U.K. employment laws, however, are less protective of employees than those of many other European countries.

In the U.K., the law has not been extended to treat franchisees as the employee or agent of the franchisor. It would be very unusual for a franchisee to be treated as an employee under English law. That said, the decision in *AutoClenz Ltd. v Belcher & Ors*\(^{72}\) found that a franchisee was indeed a “worker” for the purposes of enjoying certain employment rights. This was an extremely unusual case that involved car valeters, who had signed contracts to provide car cleaning services but really did not have a business of their own. The facts of *AutoClenz* are unlikely to apply to franchisees in other franchise systems, although the key point is that simply calling an employee a franchisee and requiring that person to enter into a franchise agreement is not decisive, because English courts will scrutinize the reality of the relationship.

An issue that does frequently arise in an employment context involves situations in which the franchisor takes over the operation of a former franchised business or a neighboring franchisee takes over a franchise. In either case, the Transfer of Undertakings (Protection of Employment) Regulations 2006 (TUPE) are likely to apply.\(^{73}\) Where TUPE applies, there is an automatic transfer of employment rights from the transferor (i.e., the former franchisee) to the transferee (i.e., the franchisor or the neighboring franchisee), and such employees are given certain protections.\(^{74}\) Given the risk of TUPE application, many franchise agreements in the U.K. specifically require a franchisee to indemnify the franchisor against such liability.

U.S. franchisors wishing to establish a place of business in the U.K. using their U.S. personnel will have to comply with the U.K.’s immigration laws and obtain entry clearance prior to their arrival. Effective April 6, 2011, a permanent annual cap has been placed on non-EU immigration to the U.K.\(^{75}\) A U.K. business (including a U.K. subsidiary of a U.S. company) that wishes to bring in skilled workers from outside the EEA must first register with the U.K. Border Agency and then “sponsor” its employees. When sponsoring an employee, the employee is assigned an electronic Certificate of Sponsorship, which then allows that employee to apply for visa clearance in his or her home country before coming to the U.K. Once a business becomes a sponsor, it becomes responsible for the employee’s actions while the employee is in the U.K.; i.e., the employer could be subject to a fine if the em-

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74. These rights include protection against dismissals connected with the transfer where dismissal is deemed to be automatically unfair unless an economic, technical, or organizational reason entailing changes in the workforce exists. *Id.* § 7.
75. This means that only 20,700 people from outside the EU can be brought in to work in skilled professions. An additional 1,000 “exceptional talent” visas will be granted to those who “will make the biggest contribution to science and the arts in the U.K.” Home Office, *Tiers 2 and 5: guidance for sponsors, available at* https://www.gov.uk/government/uploads/system/uploads/attachment_data/file/616206/Tier_25_guidance_05-2017.pdf.
ployee does not comply with or otherwise breaches any of his or her visa conditions.\textsuperscript{76}

It is important to remember that all visas are granted for a limited period and need to be extended before expiration. Requirements for visa renewal can differ from those required on initial entry to the U.K., and there is no guarantee that a renewal will be granted.

\textbf{VII. Conclusion}

U.S.-based franchisors looking to expand into the U.K. must first explore the many legal and practical issues that no doubt will impact the franchise program abroad. Franchisors remain attracted to U.K. expansion opportunities because of the ease of setting up a business, the relative ease of obtaining financing, the lack of any language barriers, and the absence of complex franchise disclosure and registration laws.

Don’t Tread on Me: A Defense of State Franchise Regulation

Caroline B. Fichter, Andrew M. Malzahn, and Adam Matheson

In the words of U.S. Supreme Court Justice Louis Brandeis, “it is one of the happy incidents of the federal system that a single courageous state may, if its citizens chose, serve as a laboratory, and try novel social and economic experiments without risk to the rest of the country.” ¹ Brandeis urged that if courts are to be “guided by the light of reason,” they “must let [their] minds be bold,” and argued that “to stay the experimentation in things social and economic is a grave responsibility,” adding that when courts are asked to exercise this power, “we must be ever on our guard.” ²

In the context of franchising, states have attempted to stop widespread abuses in the franchise industry by enacting statutes that both protected in-state franchisees from unscrupulous franchisors and punished bad-actor franchisors by prohibiting the most common abuses in the sale of franchises and the franchise relationship. ³

The Federal Trade Commission explicitly recognized the importance of state regulation when it promulgated the Federal Trade Commission Rule on Franchising in 1979 (the FTC Rule). The FTC Rule states that “[t]he Federal Trade Commission does not intend to annul, alter, or affect, or exempt any persons subject to the provisions of this part from complying with the laws or regulations of any State, municipality, or other local government

². Id. at 311.

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with respect to franchising practices except to the extent that those laws or regulations are inconsistent with any provisions of this part, and then only to the extent of the inconsistency.” 4 The FTC explained that the FTC Rule set a floor, not a ceiling, for franchise legislation: “a law or regulation of any State, municipality, or other local government is not inconsistent [with the FTC rule] if the protection such law or regulation affords any prospective franchisee is equal to or greater than that provided by this part.” 5 The FTC encouraged states to enact more stringent franchise regulations, explaining that “the commission believes it is possible for state and local governments to enact franchise measures which provide greater protection, either because the governments are able to allocate greater resources to enforce efforts in this area or because their governments might uncover problems and devise solutions which are unknown at this time.” 6

A recent Franchise Law Journal article written by Daniel Oates, Vanessa Wheeler, and Katie Loberstein (the Oates Article) 7 argues that state franchise statutes are outdated, 8 less critical for today’s franchisees, 9 and unconstitutional. Nothing could be further from the truth. State statutes are the embodiment of legislatures utilizing their judicially recognized rights as “laboratories of democracy” to protect franchisees and deter unethical practices in franchising according to each state’s unique values and regulatory philosophy. Each state has tailored franchise statutes to address its own concerns and serve its values. States with a traditionally robust approach to consumer protection and securities regulation have drafted franchise statutes that protect franchisees and prohibit resident franchisors from engaging in sharp business practices. 10 Other states have taken a more laissez-faire approach and drafted statutes limited to protecting only franchises operating

4. 16 C.F.R. § 437.2 n.2.
5. Id.
8. The Oates Article incorrectly describes state franchise statutes as “largely unchanged for nearly fifty years.” Id. at 185. This assertion ignores the fact that most states have amended their statutes at least once since they were enacted. In 2015, California dramatically amended its franchise statute, making California now “home to the toughest franchisee-protection” laws in the nation. See Rochelle Spandorf, New California Franchise Relations Act: A Game Changer for Franchisors Operating in California, available at https://www.dwt.com/The-New-California-Franchise-Relations-Act-A-Game-Changer-for-Franchisors-Operating-in-California-10-28-2015/.
9. The Oates Article claims that the statutes were “hastily enacted” after a few “less-than-savory entrepreneurs” bilked franchisees out of their life savings. Oates Article, supra note 7, at 214. Not only does this argument minimize the fact-finding and drafting efforts of a half dozen state legislatures, but it implies that any statute enacted after a tragedy is inherently suspect. Under this theory, the safety legislation that was passed after the Titanic’s sinking should be repealed. The comparison may seem absurd, but, like the Titanic’s passengers, a franchisee in a bad system has purchased something that does not perform as promised, is in the middle of a disaster, and has no viable escape route.
10. See, e.g., CAL. CORP. CODE § 31000 et seq. (1971).
in their state. These laws are equally or more important today than when they were enacted because there remains an extreme imbalance of power between franchisors and franchisees. Courts have repeatedly ruled a state may regulate the franchise relationship, even if some aspect of that relationship occurs outside its borders, without violating the Dormant Commerce Clause.

What follows here is a response to the Oates Article. It is organized into three main sections. Part I examines the history of franchise regulation and how states have enacted legislation to protect franchisees and punish unscrupulous franchisors. Part II responds to and adds to the state-by-state survey in the Oates Article. Part III presents recent empirical research and other arguments demonstrating why franchisees are still in need of protection. Part IV explains why the extraterritorial application of state franchise statutes does not pose constitutional concerns.

I. History of Franchise Regulations

The promise of franchising is that individuals can make money by realizing the American Dream: owning their own business. Ideally, franchising benefits both franchisors (by providing a way to distribute a product or service without making a significant capital investment) and franchisees (by providing a way to make use of an established business model). Franchising began growing in the 1950s. During the early franchise booms, consumers complained of franchise sales abuses, including misrepresentations about the value of a franchise; false claims related to earning potential; unfair refusal by franchisors to honor refund provisions; and failure to disclose material facts about franchise offerings.

In the 1960s, Congress held numerous hearings. Various bills were introduced, but they failed to address the abuses in the franchise arena. In 1971, the FTC initiated a rule-making process to address franchise abuses but the FTC Rule would not actually go into effect until October 21, 1979.

First faced with inaction, and then with serious delay at the federal level, several states acted to protect franchisees and punish bad-actor franchisors. In 1970, California became the first state to enact legislation regulating franchises with the California Franchise Investment Law. Washington and Wisconsin followed suit in 1971 and 1972. Fifteen states enacted legislation specifically regulating the offer and sale of franchises, and as many as eigh-

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12. See infra, Part IV.
14. Id.
17. Id. at 58; see also Cal. Corp. Code §§ 31000 to §§ 31513 (1970).
teen states have enacted statutes that regulate some aspect of the franchise relationship. Some of these statutes were enacted before the implementation of the FTC Rule, while others were enacted after. All state legislatures that passed franchise statutes have revisited those statutes at least once since the FTC implemented the FTC Rule.

II. Responses and Additions to the Oates Article’s State-by-State Survey

The Oates Article categorizes state franchise laws as “strict,” “moderate,” and “questionably broad.” Categories aside, the limitations imposed by state boundaries do not foreclose franchisee claims. Specifically, state franchise acts can and should apply to out-of-state franchisees.

A. Franchisees Are Protected Regardless of Whether a Territorial Limit Is Strict, Moderate or Broad

1. “Narrow” Territorial Limits Are Applicable Only to Portions of State Franchise Acts

A closer look at the states with narrow extraterritorial provisions reveals that the narrow limitations apply only to portions of the particular act. Although some state franchise statutes require that a franchisee maintain a “place of business” in that state, an out-of-state franchisee’s ability to bring claims is not entirely foreclosed in these states.

In Connecticut, certain provisions of the Connecticut Franchise Act (CFA) are limited to franchise agreements that require the franchisee to establish or maintain a place of business in Connecticut. These limitations, however, apply only to franchise termination, while all other provisions of the CFA apply to franchisees irrespective of whether the franchisee maintains a place of business in Connecticut.

Similarly, portions of the Hawaii Franchise Investment Law (HFIL) are territorially limited. Relying on select HFIL provisions to claim that it is narrowly tailored, the Oates Article omits other provisions of the HFIL that are not similarly limited. For example, the antifraud section makes it unlawful for “any person in connection with the offer, sale, or purchase of any franchise directly or indirectly” to engage in various actions, only

18. ABA FORUM ON FRANCHISING, FUNDAMENTALS OF FRANCHISING, Appendix C (Rupert M. Barkoff et al., eds., 4th ed. 2015).
21. See HAW. REV. STAT. § 482E-3(a) (2004) (“It is unlawful for any person to sell a franchise in this State unless such person has presented to the prospective franchisee or the franchisee’s representative, at least seven days prior to the sale of the franchise, an offering circular containing [various information.]”); HAW. REV. STAT. § 482E-5(a) (“Every person selling franchises in this State shall at all times keep and maintain a complete set of books, records, and accounts of such sales and shall thereafter at such times as are required by the director make and file in the office of the director a report setting forth the franchises sold by it and the proceeds derived therefrom.”).
one of which is specifically limited to actions within Hawaii. The HFIL goes on to state that “[a]ny person who is engaged or hereafter engaged directly or indirectly in the sale of a franchise or in business dealings concerning a franchise, either in person or in any other form of communication, shall be subject to this chapter, shall be amenable to the jurisdiction of the courts of this State, and shall be amenable to the service of process as provided by law and rule.” The plain language of the statute directly contradicts any contention that the HFIL is of limited scope and applies only to Hawaiian residents or franchises located in Hawaii.

2. Franchise Statutes with Territorial Limits May Still Apply to Out-of-State Franchisees

Even with a narrow extraterritorial limit, franchise statutes may still apply to out-of-state franchisees. For example, the Indiana Franchise Act (IFA) applies to franchises not physically located in Indiana. The IFA makes it “unlawful for any person in connection with the offer, sale, or purchase of any franchise, or in any filing made with the commissioner, directly or indirectly . . . to engage in any act which operates or would operate as a fraud or deceit upon any person.” The IFA applies to the offer of a franchise if the “offeree or franchisee is an Indiana resident.” Thus, a resident of Hammond, Indiana, who operates a franchise in Illinois may have a cause of action under the IFA even if the franchise is not located in Indiana.

The Iowa Franchise Act (IAFA) applies only to a new or existing franchise that “is operated in the state of Iowa.” The IAFA further states that “[t]he


It is unlawful for any person in connection with the offer, sale, or purchase of any franchise directly or indirectly:

(1) To make any untrue statement of a material fact in any offering circular or report filed with the director under this chapter or willfully to omit to state in any offering circular or report, any material fact which is required to be stated therein.

(2) To sell or offer to sell a franchise in this State by means of any written or oral communication which includes an untrue statement of a material fact or omits to state a material fact necessary in order to make the statements made in light of the circumstances under which they were made not misleading.

(3) To employ any device, scheme, or artifice to defraud.

(4) To engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(5) To violate any order of the director.


25. Ind. Code § 23-2-2.5-2 (2008). See, e.g., 7E Fit Spa Licensing Grp. LLC v. 7EFS of Highlands Ranch, LLC, No. 115CV01109TWMPMB, 2016 WL 4761562, at *9 (S.D. Ind. Sept. 13, 2016) (implying that the IFA would have applied to a franchise operating outside of Indiana if the court had found that the limited liability company operating the franchise was a resident of Indiana).

26. Iowa Code § 523H.2 (1995); see also Iowa Code § 537A.10.2. (2000), which has substantially similar language and applies to franchise agreements entered into on or after July 1, 2000.
provisions of this chapter do not apply to any existing or future contracts between Iowa franchisors and franchisees who operate franchises located out of state.” The Iowa legislature amended the latter provision in 1995 to clarify that the IAFA did not apply “between Iowa franchisors and franchisees who operate franchises located out-of-state.” Based on the latter provision, franchisors have argued that an Iowa franchisor dealing with an out-of-state franchisee who operates a franchise within Iowa does not need to comply with the IAFA.

The Iowa Supreme Court addressed this very argument in *Holiday Inns Franchising, Inc. v. Branstad*. There, the court reviewed the legislative intent of the IAFA, which it noted was “to provide greater power to franchisees and place greater restrictions on the powers of franchisors.” Rejecting the franchisor’s argument, the court reasoned that:

> nothing in the legislative history of this chapter supports the plaintiffs’ contention that the general assembly intended to benefit Iowa franchisors in their dealings with out of state franchisees by excluding them from the reach of the chapter when the out of state franchisee operates a franchise within the borders of the state of Iowa.

3. State Franchise Acts Are Interpreted in Accordance with the Spirit of the Statute

Several franchise statutes protect franchisees regardless of location. The Michigan Franchise Investment Law (MFIL) applies to “all written or oral arrangements between a franchisor and franchisee in connection with the offer or sale of a franchise. . . .” The Michigan legislature directed courts to “broadly construe” the MFIL “to effectuate its purpose of providing protection to the public.” The Oates Article claims that the MFIL “appears to have a drafting mistake” because it is not limited to franchises “in this state.” But the legislature’s choice not to include an “in this state” limitation reflects not poor drafting but rather an intent to provide broad protection to franchisees. Specifically, the MFIL requires that the franchise sale be “made” in Michigan.

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27. *Id.*
29. 537 N.W.2d 724 (Iowa 1995).
30. *Id.* at 729.
31. *Id.*
34. Oates Article, supra note 7, at 194–95.
35. See *Mich. Comp. Laws § 445.1504(2)–(3) (1984).* This can be accomplished numerous ways, including: (1) if the offer to sell is made in Michigan; (2) an offer to buy is accepted in Michigan; (3) if the franchisee is domiciled in Michigan; or (4) if the franchised business is or will be operated in Michigan. *See Ward’s Equip., Inc. v. New Holland N. Am., Inc., 493 S.E.2d 516, 520–21 (Va. 1997) (applying Michigan law).*
also fits with the legislators’ purpose that the MFIL be broadly construed to protect the public.

The Florida Franchise Misrepresentation Act (FFMA) is also interpreted pursuant to the spirit of the law. The FFMA makes it unlawful, when selling or establishing a franchise or dealership, for any “person” intentionally to make various misrepresentations. 36 The FFMA defines a “person” as “an individual, partnership, corporation, association, or other entity doing business in Florida.” 37 Notably, unlike the language in other state statutes that indicate the statute applies to franchises physically located in that state, the FFMA merely requires that the party do business in Florida.

In 2006, the U.S. District Court for the Southern District of Florida clarified what “doing business in Florida” requires in Lady of America Franchise Corp. v. Malone. 38 Lady of America Franchise Corp. (LOA) argued that the FFMA did not apply because the former franchisee, Malone, operated a franchise in Michigan. 39 The franchisor was a Florida corporation with its offices in Florida, and the parties’ agreement contained a choice-of-law provision applying Florida law. The court reasoned that “even though Malone’s franchise was not located in Florida, LOA, a franchisor that does business in Florida, is the ‘person’ that allegedly made the misrepresentations” and is subject to the FFMA. 40 Accordingly, the court denied LOA’s motion to dismiss.

B. Franchisees Are Protected by Other State Statutes

Franchisees that are harmed by franchisors, but without recourse due to the territorial limitations in state franchise statutes, might still assert claims under other state statutes. For example, the Connecticut Unfair Trade Practices Act (CUTPA) provides that “[n]o person shall engage in unfair methods of competition and unfair or deceptive acts or practices in the conduct of any trade or commerce.” 41 The definition of “person” includes a corporation, limited liability company, and any other legal entity. 42 Connecticut courts have determined that even if the Connecticut Franchise Act does not apply, the “conduct of the [franchisor] may still violate CUTPA where the [franchisor’s] actions violate the public policy of this state as expressed ‘within at least the penumbra of some common law, statutory, or other established concept of unfairness.’” 43 Thus, although some provisions of the Connecticut Franchise Act are limited to franchises that maintain a place of busi-

39. Id.
40. Id.
41. CONN. GEN. STAT. § 42-110b(a) (1976).
42. CONN. GEN. STAT. § 42-110a(3) (2004).
ness in that state, Connecticut does not leave other franchisees without a remedy.

The Indiana Deceptive Franchise Practices Act (IDFPA) also applies to franchisees even if they do not operate a franchise in Indiana. The IDFPA prohibits a franchise agreement from containing certain provisions in an agreement between any franchisor and a franchisee “who is either a resident of Indiana or a nonresident who will be operating a franchise in Indiana.” Like the Indiana Franchise Act, the IDFPA applies to residents of Indiana (regardless of whether they operate a franchise in Indiana) and non-residents (who operate a franchise in Indiana).

III. Franchisees Still Need Statutory Protection at the State Level

In making its argument that extraterritorial application of state franchise statutes is unconstitutional, the Oates Article relies on the faulty premise that “yesterday’s” franchise laws are less or no longer necessary or as important for “today’s” franchisees. However, this assertion ignores the fact that today’s franchisees invest larger sums of money, sign more onerous franchise agreements (often on a take-it-or-leave-it basis), and often enter into the relationship without consulting an attorney. As a result, prospective franchisees and existing franchisees are equally susceptible to fraud and other abuses today as they were many years ago, and the damages resulting from this misconduct are far higher.

A. The Imbalance of Power Between Franchisors and Franchisees and the Fallacy That Franchisees Are Less Vulnerable or More Sophisticated

The franchisor/franchisee relationship has appropriately been described as “[t]he Reliance Relationship: Superiority and Inexperience.” Consider its basic structure. Franchisors purport to have developed a unique and established business model capable of replication by franchisees. This type of offering naturally attracts individuals seeking to own a business despite having no prior experience because they perceive it as a reduced-risk investment that is already “proven.” The end result is the marriage of a sophis-

46. The total Estimated Initial Investment for a Subway franchise is $147,050 to $320,700. See Subway May 1, 2017 FDD, Item 7. The total Estimated Initial Investment for a Burger King franchise is $317,100 to $3,046,600. See Burger King April 28, 2017 (as amended October 20, 2017) FDD, Item 7.
47. Oates Article, supra note 7, at 214.
48. See infra, Part IV.A.
49. Gillian K. Hadfield, Problematic Relations: Franchising and the Law of Incomplete Contracts, 42 STAN. L. REV. 927, 961 (1990) (“the reliance relationship created by the franchisor’s relative superiority and the franchisee’s relative inexperience is an essential component of the typical franchise exchange”).
icated party with a relatively unsophisticated party. Franchisors generally are large, sophisticated companies with significant legal and financial resources, whereas franchisees are individuals with fewer resources and limited business ownership or industry-specific experience, who are attracted to franchising because the franchisor has promised to train and assist them.

This imbalance of power between franchisor and franchisee, and the relative lack of sophistication of franchisees, have been repeatedly verified with empirical evidence, including by the authors in a survey of their own.

1. Franchisees Frequently Have No Prior Experience as Business Owners and No Prior Industry Specific Experience

Recent empirical evidence reveals that “new franchisees are unlikely to possess franchise unit ownership experience, or even any prior business ownership [experience].” According to one study of 307 franchisees, “only 20 percent of the sample had actually been business owners before becoming franchisees.” Another study of seventy-four franchisees in a single franchise system revealed that only 6.7 percent of franchisees had owned an independent business prior to joining the franchise system. In a survey that FranchiseGrade.com conducted of more than 1,100 franchisees nationwide, 63 percent of franchisees had never owned any type of business prior to becoming a franchisee. Moreover, a substantial percentage of franchisees have no experience in the industry or sector in which they currently operate their franchises.

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51. Service Employees International Union, Petition for Investigation of the Franchise Industry, at p. 2 (May 19, 2015), available at https://www.americanbar.org/content/dam/aba/publications/franchise_lawyer/ftc-req-for-investigation_final-may-19-2015.authcheckdam.pdf. Indeed, the top twenty-five U.S. franchisors account for 21 percent of all franchised units in the country, with combined revenue over $50 billion. Id. at p. 4 (compiling data from each of the top twenty-five franchisors’ FDDs and SEC Form 10-Ks).

52. Emerson & Benoliel, supra note 50, at 203–04. Indeed, individuals with no or little relevant experience find franchising attractive, in part, because franchising promises site selection assistance, training, and operations manuals.

53. The authors conducted a survey of franchisees nationwide across several franchise systems and received 253 franchisee responses. The results of the survey are summarized in Appendix A, infra, Tables 1–6.

54. Emerson & Benoliel, supra note 50, at 206–09.

55. Id. at 206–07 (citing Kimberley A. Morrison, An Empirical Test of a Model of Franchisee Job Satisfaction, 34 J. SMALL BUS. MGMT. 27, 30–31 Table 2 (1996)).

56. Emerson & Benoliel, supra note 50, at 216 (citing Alden Peterson & Rajiv P. Dant, Perceived Advantages of the Franchise Option from the Franchisee Perspective: Empirical Insights from a Service Franchisee, 28 J. SMALL BUS. MGMT. 46, 49–50 Table 1 (1990)).


58. In the FranchiseGrade.com study, 69 percent of franchisee respondents had no management experience in the industry in which they currently franchised before becoming a franchisee, and 48 percent had never worked in that industry. See National Survey of Franchisees 2015, supra note 57, at 10–11. Emerson and Benoliel’s review of empirical evidence yielded similar results. See Emerson & Benoliel, supra note 50, at 207.
Certain franchisors and certain franchisee recruiting websites specifically seek out inexperienced individuals. One franchisee recruiting website has a specific sub-category entitled: “No Experience Needed Franchises.” Franchisor websites similarly tout opportunities for individuals with no experience, as exemplified by another website luring individuals to franchising with the following statement:

For most careers, a degree of previous experience has to be demonstrated in order to get hired and be successful in that role [...] This practice seems straightforward and logical—and is the reality for most professionals. However, in the franchise world, this concept doesn’t quite seem to apply. A quick glance at many franchise sales websites, and you’ll see “no previous experience required.”

2. Franchisees Frequently Do Not Consult with an Attorney Prior to Signing Their Franchise Agreements

In the authors’ survey, 52 percent of franchisees did not consult with an attorney to review their franchise agreement or FDD/UFOC before purchasing their first franchise. Another survey of “franchisor” attorneys revealed that franchisees were represented by counsel at signing just 26 percent of the time; even when franchisees were represented, as one franchisor attorney commented, it was often by general practitioners unfamiliar with franchise law. Regardless, franchise agreements are often offered on a take-it-or-leave-it basis. Even if negotiated, the changes made are often few and far between.

Failing to appropriately assess the legal risks and nuances of franchising is further evidence of franchisees’ lack of sophistication. Without the aid of counsel, franchisees will have difficulty sifting through the overwhelming

62. See Appendix A, infra, Table 1. Additionally, in only 23 percent of instances did the franchisor’s salesperson expressly tell franchisees that they could hire an attorney to review their franchise agreement. See id., Table 2.
65. In the authors’ survey, 27 percent of franchisees reported that their franchise salesperson expressly stated that their franchisor would not make any changes to the franchise agreement. See Appendix A, infra, Table 3. In the FranchiseGrade.com survey, 59 percent of the franchisees did not propose any changes; 28 percent had their proposed changes rejected; and only 13 percent of franchisors accepted at least one change to the franchise agreement. See National Survey of Franchisees 2015, supra note 57, at 13.
amount of information in the FDD and franchise agreement, as well as all other prospective information. The inability to modify the one-sided provisions of a franchise agreement further compounds the imbalance of power.

3. Franchise Agreements Uniformly and Overwhelmingly Favor Franchisors

Standard, one-sided franchise agreements increase the imbalance of power. Franchise agreements are written by franchisors (and their attorneys) for franchisors. As explained in Part II(B), franchisees, compared with the franchisor, are at a significant disadvantage when it comes to their contractual rights and obligations.

4. The Majority of Franchisees Are Indeed Small Business Owners

Franchisees are often appropriately characterized as “small business owners.” In the words of the longtime franchisor attorney and advocate, Bill Killion, “franchising is still dominated by the single-unit operator. . . .” As Killion observes, FRANdata’s database of 180,000 franchisees and 255,000 unit addresses from 1,300 brands reveals that 51 percent of all units were owned by single-unit operators. The authors’ survey yielded similar results, with 47 percent of franchisees claiming to own just one unit and another 21 percent owning just two units.

5. The Franchise Structure Leaves Franchisees in a Vulnerable Position

In a typical franchise arrangement, a franchisee pays the franchisor an initial franchise fee and then incurs significant expenses to locate a site, secure a lease, build out the premises, and comply with the franchisor’s exacting standards and specifications. Frequently, franchisees take on loans, sign personal guaranties, and depend upon profits from the franchised business as their sole source of income. Moreover, an unprofitable franchisee generally has no contractual right to terminate the franchise agreement because the franchisee is losing money. The franchisee may remain bound to a lease, may obtain only minimal salvage value for highly specific supply and equipment purchases, may be personally liable for the current and future debts of the franchise, and is at risk of bankruptcy. By making a sunken investment in a highly specific business, franchisees are incentivized to stay in business

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66. See infra, Part IV.C.
67. See Peter C. Lagarias & Edward Kushell, Fair Franchise Agreements from the Franchisee Perspective, 33 FRANCHISE L.J. 3, 3 (2013) (noting that “[f]ranchise agreements are written by franchisors and seldom reflect the interests and concerns of franchisees”).
69. Id.
70. See Appendix A, infra, Table 4.
72. Id.
73. Hadfield, supra note 49, at 960.
despite losing additional money because the costs of exiting are too high.\textsuperscript{74} This leaves franchisees susceptible to franchisor “opportunism.”\textsuperscript{75}

In contrast, the franchisor’s risk is minimal. Aside from the opportunity cost of training and working with the franchisee, the franchisor has almost nothing invested. A franchisor will be paid a nonrefundable initial franchise fee and other ongoing fees until the franchisee stops operating.\textsuperscript{76} A franchisor usually reserves the right to repurchase equipment at salvage value, use it elsewhere, and resell the franchise, earning yet another franchise fee.

B. \textit{Franchise Agreements Today Are Not What They Used To Be}

Any progress made by franchisees since the first wave of franchise laws has been offset by the modern franchise agreement.

Although courts have ruled both ways on the issue, many courts still do not find a franchise agreement to be a contract of adhesion. These courts consider franchise agreements to be “commercial contracts” and follow a misguided blanket rule that all franchise agreements are freely negotiated.\textsuperscript{77} However, franchise agreements in most cases \textit{are} contracts of adhesion. The imbalance of power between franchisors and franchisees and the relative lack of franchisee sophistication found in the majority of franchise relationships render franchise agreements as adhesion contracts that are not freely negotiable.\textsuperscript{78}

Common provisions in franchise agreements demonstrate why modern franchisees still need protection through various state franchise laws.\textsuperscript{79}

1. The Franchisor’s Right to Modify the System at the Franchisee’s Expense

Franchise agreements often reference the franchisor’s unique “System” and stress the franchisee’s obligation to comply with the System in all re-

\textsuperscript{74} \textit{Id.} at 951–52.
\textsuperscript{75} \textit{Id.} Franchisee investments are so specific that, once expended, they are not easily recoverable if the franchisee goes out of business. And if franchisees do go out of business, they are likely to be sued for damages for early termination of the agreement.
\textsuperscript{76} Additionally, many franchisors seek lost future royalties and marketing fund fees from the franchisee if the franchise agreement is prematurely terminated.
\textsuperscript{77} \textit{See, e.g.,} Shaffer v. Graybill, 68 F. App’x 374, 377 (3d Cir. 2003) (“We are unaware of any relevant cases in which the court has found an adhesion contract when dealing with the purchase of a franchise rather than a consumer purchase.”); \textit{In re} Tornado Pizza, LLC, 431 B.R. 503, 513 (Bankr. D. Kan. 2010) (“In this case the Franchise Agreements were not consumer transactions, and Debtor cannot prevail under Kansas law on the premise that the termination provisions of the Franchise Agreements are unenforceable adhesion contracts.”).
\textsuperscript{78} \textit{See supra} note 65 citing empirical evidence that clearly shows that franchise agreements are almost always non-negotiable; \textit{e.g., supra} note 64 (citing cases in which courts that have correctly found that franchise agreements are contracts of adhesion).
\textsuperscript{79} The following provisions are found in most modern franchise agreements. Peter Lagarias and Edward Kushell observed the “Commonality in Franchise Agreements,” specifically, ten common one-sided provisions, in their article \textit{Fair Franchise Agreements from the Franchisee Perspective.} \textit{See Lagarias & Kushell, supra} note 67. The Service Employees International Union also reviewed the franchise agreement of fourteen large franchisors, totaling over 94,000 franchise units, and observed that the franchise agreements were all strikingly similar and one-sided. \textit{Petition for Investigation of the Franchise Industry, supra} note 51, at 7–9.
pects. Because of the unpredictability of market conditions over the long term of franchise agreements (often ten or more years), franchisors invariably reserve the right to modify the System, through the operations manual or by other directives, in the franchisor’s “sole discretion” or “business judgment,” all at the franchisee’s sole expense. Indeed, a typical business judgment rule provision leaves no doubt that a franchisor may act in its own self-interest without regard to the franchisee.

Such extensive reservations tilt the battlefield in the franchisor’s favor when tension inevitably arises from a franchisor’s modification of the System. For example, a System modification may result in franchisees being forced to fund expensive promotional programs; renovations; or equipment, software, and hardware upgrades. The franchisor’s express right to make certain changes, coupled with its unbridled discretionary standard, may even be outcome determinative in favor of the franchisor when franchisees challenge the system changes under the principle of good faith and fair dealing.

With these types of provisions, franchisees have to choose between complying with the franchisor’s directive, even if the investment is cost-prohibitive, or challenging the changes under the franchise agreement’s dispute resolution procedures and facing an uphill (and expensive) battle.

2. Territorial Provisions

Territorial provisions in franchise agreements operate as de facto reservations of the franchisor’s rights to encroach upon its franchisees. Depending on the franchise system, a franchisee may or may not receive an exclusive territory. In the worst-case scenario, a franchisee has no exclusive territory, allowing the franchisor or a third-party franchisee to operate a competing

80. See Lagarias & Kushell, supra note 67, at 7 (franchisors often reserve the right to modify the “System” “at will or under its sole discretion”); Brian B. Schnell, Ronald K. Gardner, Jr., Battle over the Franchisor Business Judgment Rule and the Path to Peace, 35 FRANCHISE L.J. 167, 168 (2015) (noting that, “[i]n recent years, however, franchisors have sought to replace or frame the good faith and fair dealing discretionary standard with a corporate law doctrine: the business judgment rule.”).

81. See, e.g., Johnson v. Arby’s Inc., Bus. Franchise Guide (CCH) ¶ 12,018 (E.D. Tenn. Mar. 15, 2000) (permitting Arby’s to require that new stores comply with its new building design in part because Arby’s reserved its “sole discretion” to implement system standard changes in its operations manual); see also La Quinta Corp. v. Heartland Props., LLC, 603 F.3d 327 (6th Cir. 2010); Burger King Corp. v. E-Z Eating, 41 Corp., 572 F.3d 1306 (11th Cir. 2009).


83. For information on the one-sided dispute resolution procedures, see infra, Part III.B.6.
franchise in any location, regardless of the proximity to, or the financial impact on, the franchisee.\footnote{For instance, the McDonald’s franchise agreement states: “[t]his Franchise establishes the Restaurant at the location specified on page 1 hereof only and that no ‘exclusive,’ ‘protected,’ or other territorial rights in the contiguous market area of such Restaurant is hereby granted or inferred. . . .” See McDonald’s May 1, 2017 (as amended Aug. 1, 2017) FDD, Exhibit B, Franchise Agreement (Traditional) § 27(e). Burger King’s franchise agreements states: “This franchise is for the specified location only and does not in any way grant or imply any area, market or territorial rights proprietary to Franchisee.” See Burger King April 28, 2017 as (amended Oct. 20, 2017) FDD, Exhibit C, Franchise Agreement § 1.}

Additionally, in nearly all franchise agreements, whether the franchisee has an exclusive or non-exclusive territory, franchisors still reserve the right to compete with their own franchisees through alternative methods.\footnote{See, e.g., Massage Envy’s April 20, 2017 FDD, Exhibit B, Franchise Agreement §§ 1(C), (D) (containing some, but not all, of the typical franchisor reservations to compete with franchisees).}

Permitting or encouraging intra-brand competition among franchisees in close proximity is especially harmful because franchisee customers generally have no allegiance to particular locations but rather to the uniform products and services offered at all franchise locations.\footnote{Lagarias & Kushell, supra note 67 at 13.} If a second franchise location is opened nearby or a franchisor begins competing over the Internet, the competition for the same customers inevitably cannibalizes sales.\footnote{Id.}

Franchisees in the 1990s had some success fighting off franchisor encroachment under the principle of good faith and fair dealing;\footnote{See Scheck v. Burger King Corp., 756 F. Supp. 543 (S.D. Fla. 1991); In re Vylene Enters., 90 F.3d 1472, 1477 (9th Cir. 1996).} however, more recently several courts ruled that if the franchise agreement expressly permits the franchisor to open a competing franchise wherever it chooses, the implied covenant of good faith and fair dealing cannot override the express terms of a franchise agreement.\footnote{See Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999) (refusing to follow Scheck v. Burger King Corp.; see also Cohn v. Taco Bell Corp., No. 92-cv-5852, 1994 WL 13769, at *6 (N.D. Ill. Jan. 14, 1994) (no breach of the implied covenant of good faith and fair dealing where a franchise agreement contains a provision that expressly permits the franchisor to open competing franchises or company stores wherever it wants); Servpro Indus., Inc. v. Pizzillo, No. M2000-00832-COA-R3, 2001 WL 120731, at *4 (Tenn. Ct. App. Feb. 14, 2001) (allegations of encroachment do not constitute a claim for breach of the implied covenant of good faith and fair dealing where there is no evidence that the franchisor “bore any kind of malice against” the franchisee, that the franchisor “wished to damage or destroy [the franchisee’s] franchise,” or that the franchisor “colluded with” a competing franchisee to expand the competing franchise allegedly at the expense of the plaintiff franchisee); but see Handlers-Bryman v. El Pollo Loco, Inc., Case No. MC026045 (Cal. Super. Ct. Mar. 30, 2017) (holding that a “reservation of rights” clause for a franchisor to put a store wherever it wanted when there was no exclusive territory was unconscionable and unenforceable).} As a result, these territorial provisions and reservations can have a devastating effect on franchisees’ profitability.

3. Restrictions on Renewal

Standard franchise agreements are for a fixed initial term and either expressly provide that the franchisee may renew the franchise only subject to
several onerous renewal conditions or that the franchisee has no right to renew.

Having no renewal right is especially harmful because the franchisee develops all the goodwill and eventually has to stop operating the franchise, cannot sell it, and has to give it back to the franchisor. Even with renewal rights, the renewal conditions can significantly alter the status quo and make the mere continuance of operating as a franchisee not feasible.

4. Conditions to Transfer

Although franchisees are generally permitted to transfer their interests in the franchise agreement, most franchise agreements, similar to renewal provisions, force the franchisee to meet a host of onerous conditions.

Conditions to transfer pose two major problems for franchisees. First, the franchisor may rely on these provisions to disrupt or slow down a sale. By disrupting the sale, the franchisor can attempt to force the franchisee to sell to a preferred buyer or purchase the franchise itself at a discount. Second, by forcing the franchisee or the transferee to modernize the franchise in accordance with current system standards, or by forcing a transferee to sign the franchisor’s then-current form of franchise agreement, a franchisor can make the franchise much less valuable and drive down the sale price.

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90. Common renewal conditions include: (1) the franchisee must sign the franchisor’s then-current form of franchise agreement (the terms of which may be materially different from the franchise agreement, including the royalty and other ongoing fees); (2) the franchisee must modernize, renovate, or update the franchise premises, equipment, operating system, or otherwise (with no limit on the expense of such requirements); (3) the franchisee must sign a release of all claims against the franchisor or its affiliates; (4) the franchisee must pay a renewal fee; and (5) the franchisee must be in compliance with, or have never defaulted on, not only that specific franchise agreement, but all other agreements entered into with the franchisor. See Dunkin’ Donuts’ April 3, 2017 FDD, Exhibit B-1, Franchise Agreement § 2.4(b) (containing some, but not all, of these typical provisions).

91. For instance, the McDonald’s current form franchise agreement expressly provides that there is “no promise or representation as to the renewal of this Franchise or the grant of a new franchise. . . .” See McDonald’s May 1, 2017 (as amended Aug. 1, 2017) FDD, Exhibit B, Franchise Agreement (Traditional) § 27(a).

92. Common transfer conditions include: (1) the transferee must sign the franchisor’s then-current form of franchise agreement (the terms of which may be materially different from the franchise agreement, including the royalty and other ongoing fees); (2) the franchisee or transferee must modernize, renovate, or update the franchise premises, equipment, operating system, or otherwise (with no limit on the expense of such requirements); (3) the franchisee must have never been in default of the franchise agreement or any other agreement entered into with the franchisor or the franchisor’s affiliates; (4) the transferee must meet the franchisor’s criteria for new franchisees; (5) the franchisee or the transferee must pay a transfer fee; and (6) the franchisee must first provide the franchisor with the right of first refusal to purchase the business on the same terms as the transferee. See, e.g., Massage Envy’s April 20, 2017 FDD, Exhibit B, Franchise Agreement § 12(D) (containing some, but not all, of these typical provisions).

93. See, e.g., Burger King Corp. v. H&H Rest., LLC, 2001 WL 1850888 (S.D. Fla. Nov. 30, 2001) (finding that Burger King Corporation did not unreasonably withhold its consent to a proposed transfer because it had the “sole discretion” to determine whether the proposed transfer was acceptable).

In most franchise agreements, cross-default provisions grant the franchisor the right to terminate a franchise agreement if the franchisee defaults under any other agreement entered into with the franchisor or its affiliates. Cross-default provisions are becoming more common and are extremely dangerous because franchisees are commonly required to enter into leases and additional ancillary “supplier,” “software,” or “hardware” license agreements with their franchisors or their affiliates, and because franchisees may enter into additional franchise agreements with their franchisor in the future. Cross-default provisions, if enforced, provide franchisors with an extreme amount of leverage over franchisees and further perpetuate the imbalance of power. By using such a provision, a franchisor can, or can threaten to, take multiple franchises away from the franchisee for numerous reasons—even if the default is an inadvertent mistake or unrelated to the operation of the franchise.


Most modern franchise agreements contain extensive dispute resolution procedures that favor the franchisor. Franchisees are often forced to agree: (1) to arbitrate in the franchisor’s home state; (2) to accept that the law applied to all disputes is the law of the franchisor’s home state; (3) to waive the right to a jury trial; (4) to limited damages; (5) to shortened statutes of limitations; (6) to not join with other franchisees as a class to file an action against the franchisor for common problems; and (7) to pay their franchisors’ attorney fees and costs if they bring a lawsuit against the franchisor and the franchisor prevails.

These provisions can make it costly, and even cost-prohibitive, for a franchisee to bring a claim against its franchisor. Additionally, these provisions limit franchisors’ litigation risks.

The modern franchise agreement has evolved from fewer than ten pages to between thirty pages (on the low end) and ninety pages (on the high end), with multiple exhibits and ancillary agreements. Prior franchise agreements were not so drastically one-sided. Today, franchise agreements have evolved to in-

95. See infra Part III.E (noting a Florida franchisee testifying about the devastating expenses for franchisees seeking to vindicate their rights according to franchise agreement dispute resolution procedures); Lagarias & Kushell, supra note 67, at 23–29 (detailing the significant costs for franchisees to follow the procedures in the franchise agreement for dispute resolution).
96. Lagarias & Kushell, supra note 67, at 23–29.
97. Id. at 4. Massage Envy’s 2017 franchise agreement is fifty-two pages, excluding attachments, and Burger King’s 2017 franchise agreement for individuals is thirty-three pages, excluding attachments. See Massage Envy’s April 20, 2017 FDD, Exhibit B, Franchise Agreement; Burger King’s April 28, 2017 (as amended Oct. 20, 2017) FDD, Exhibit C, Franchise Agreement.
98. One example of the evolving nature of franchise agreements is the relatively new “business judgment rule” provision setting forth an extremely lenient discretionary standard for franchisors. See generally Schnell & Gardner, supra note 80.
clude, in most cases, the entirely one-sided provisions noted above and many more.99 The ultimate result is the perpetuation of the imbalance of power between the franchisor and franchisee.

C. The “Balance of Information in the Age of the Internet” Does Not Diminish the States’ Legitimate Interest in Regulating Franchisors

The Oates Article argues that franchisees no longer need the protection of state franchise laws because there has been “a dramatic change in the access individuals have to information on about business, finance, and the law.”100 This has, as the Oates Article puts it, “diminished” the states’ legitimate interest in regulating franchise sales.101

On the contrary, a large number of franchisees enter into a franchise agreement with no prior franchise experience, without an attorney reviewing the FDD or franchise agreement, and without the aid of counsel in negotiating the franchise agreement’s terms.102 Inevitably, prospective franchisees will simply be unaware of the business and legal risks of entering into a franchise agreement. The Oates Article points out that prospects will have an FDD, a franchise agreement, and the Internet available to them.103 But how helpful are each of these pieces of information for someone with no background in franchising, business, or the law?

Empirical evidence, as well as common sense, suggests that the information available to franchisees is less helpful than franchisor advocates believe.104 Indeed, FDDs are dense, technical documents containing legal disclosures and financial data that are hundreds of pages in length.105 Similarly, franchise agreements are filled with legal jargon and are generally more than thirty pages long. Sifting through these documents is a daunting task for anyone. It is no surprise that empirical evidence reveals that, rather than review, analyze, and understand FDDs, many franchisees ignore the FDD altogether.106 Regardless, for those that do not completely ignore the FDD, the authors’ survey revealed that 33 percent of franchisees either disagreed

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99. Additional one-sided provisions not listed above include, but are not limited to, the franchisor’s right to restrict the sourcing of franchisee required purchases of products and services; post-term non-competition clauses preventing the franchisees from working in their former line of work; and the franchisor’s express right to sue for lost future profits (royalty and advertising fees).

100. Oates Article, supra note 7, at 214.

101. Id.

102. See supra Part IV.A.2.

103. Oates, supra note 7, at 214.

104. Emerson & Benoliel, supra note 50, at 215 (concluding that there is a false assumption that franchisees are sophisticated business people who consider all relevant information and make informed business decisions prior to entering into a franchise relationship).

105. For example, Subway’s May 1, 2017 FDD, including exhibits, is more than 500 pages, and Burger King’s April 28, 2017 (as amended October 20, 2017) FDD is more than 1,000 pages.

106. Kimberley A. Morrison, An Empirical Test of a Model of Franchisee Job Satisfaction, 34 J. SMALL BUS. MGMT. 27, 30–31, Table 2 (1996). As explained by Professors Emerson and Benoliel, a novice franchisee aspiring to own a franchise and reviewing all relevant information “will face
or strongly disagreed with the statement that the FDD was an accurate and complete description of the franchise investment.\textsuperscript{107}

The Oates Article also assumes that information on the Internet is true, accurate, and reliable and that an average franchisee is capable of sifting through the information, identifying its source, and putting it to meaningful use. The authors believe that none of these assumptions reflects reality. Similar to a prospect reviewing an FDD and franchise agreement, franchisees searching the Internet for franchise information likely face the same “overwhelmed” feeling due to the sheer amount of information available. Further, how is a prospect to know what is accurate and credible, what is helpful and not helpful, who is providing this information, and what is the provider’s motivation? Regardless, franchisors utilize merger and integration clauses to disclaim the very information that is suggested to help franchisees evaluate franchise opportunities. The franchisor’s own documents state that it is unreasonable to rely upon anything not stated in the FDD. Yet, now franchisees are “protected” by information they specifically may not rely upon?

In reality, “the balance of information in the age of the Internet” does not level the playing field for franchisors and franchisees.

D. Franchise Fraud, Deception, and Other Misleading and Abusive Practices Continue

Despite a claimed increase in franchisee sophistication, statutorily mandated disclosures, and information on the Internet, franchisees today remain susceptible to fraud, deception, and other misleading and abusive practices at the hands of their franchisors. Empirical and anecdotal evidence proves this point. For instance, franchisees have complained about many franchisor actions: (1) the franchisor’s FDD is not a complete and accurate description of the franchise investment;\textsuperscript{108} (2) franchisors continue to make financial performance representations via the Internet and outside of Item 19 of the FDD;\textsuperscript{109} (3) franchisors continue fraudulently to induce franchisees to enter into franchise agreements;\textsuperscript{110} (4) franchisors terminate franchisees

\textsuperscript{100} See Appendix A, infra, Table 5.
\textsuperscript{101} In the authors’ survey, 17 percent of franchisees stated that their franchise salesperson made statements related to sales, costs, and profits that were not included in the FDD or UFOC. See Appendix A, Table 6; see also Petition for Investigation of the Franchise Industry, supra note 51, at 12–13 (outlining blatant Item 19 violations in franchise advertisements such as “Makes more Money,” “... recently launched locations hitting one million dollars of revenue in their first year,” and “Profits, from day 1”).
\textsuperscript{110} See Checkers Drive-In Rest., Inc. v. Tampa Checkmate Food Servs., Inc., 805 So. 2d 941, 943 (Fla. Dist. Ct. App. 2001).
and then sue them for “lost future profits;” 111 (5) franchisors improperly use money from system-wide advertising funds; 112 (6) franchisors attempt to intimidate franchisees and force them out of their franchises; 113 (7) franchisors retaliate against members of franchisee associations; 114 and (8) franchisors engage in the practice of “churning.” 115

As a result, the need for franchise laws protecting franchisees in both the sales process and throughout the relationship remains important today.

E. Recent Franchise Legislation Demonstrates the Continuing Need for Statutory Protection for Franchisees

The Oates Article claims that state franchise laws have “remain largely unchanged for nearly fifty years.” 116 A survey of numerous states that continually propose and enact “pro-franchisee” laws, or propose and amend current franchise laws, stands in stark contrast not only to this claim, but also to the Oates Article’s claim that the states’ legitimate interest in regulating franchisors and franchisees has diminished over time. The testimony in support of recent franchise legislation and its stated purposes proves that inequities in the franchise relationship continue today.

For example, in 2007 Rhode Island enacted the Rhode Island Fair Dealership Act (RIFDA), which provides the typical protections found in franchise relationship laws. 117 Although RIFDA ended a seventeen-year drought in enacting franchise “relationship” laws in the United States, other efforts have been made but came up short. 118

Most recently, in October 2015, California’s legislature enacted sweeping franchise legislation, which has been described as “the toughest franchise-protection law in the nation.” 119 Specifically, the California Franchise Rela-

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116. Oates Article, supra note 7, at 185.


119. See Spandorf, supra note 8.
tions Act (CFRA) was amended to include significant additional protections for franchisees facing termination or nonrenewal without fair compensation for their franchised businesses.\textsuperscript{120} Assembly Bill No. 525 addressed what the California legislature clearly found were inequities in the modern franchise relationship.\textsuperscript{121}

In recent years, bills aimed at protecting franchisees have been introduced in state legislatures across the country, including in Florida, Maine, Massachusetts, and Pennsylvania.\textsuperscript{122} Even though franchisor advocates and lobbyists have successfully opposed these bills and prevented their enactment, testimony in support of these bills underscores the problems that many franchisees continue to face today. Examples include:

- A franchisee wrote a letter in support of franchisee renewal rights, stating: “[p]resently Franchise Owners who adhere to brand standards and honor their obligations can only watch their equity evaporate as the end of their franchise term nears. Without reasonable assurances of renewal, our family businesses essentially become rent-a-businesses and are worthless to anyone except the Franchisor. Franchise Owners are often presented with one of two options: Sign a more draconian new
form franchise agreement or walk away from their life’s work and family’s business equity.”123

• A franchisee testifying as to franchisor abuses explained that, after he had made improvements to both of his franchised stores, his franchisor singled him out and terminated his two franchises based upon a pretext, all so the franchisor could resell his franchises at a profit.124

• A former franchisee, and then attorney, testified that, despite positive changes to a particular franchisor’s franchise agreement, “[t]he fact is there are bad actors. That’s why you need a minimal level of behavior.”125

• A Pennsylvania legislator championing a franchise bill noted to his colleagues: “Pennsylvania is lagging behind the curve when it comes to franchise regulation. The laws in place do not do enough to protect franchisees from unfair practices in the sale and operation of franchised businesses.”126

• Florida franchisees recently testified about the very real, common, and current problems and abuses franchisees face, including franchisors taking franchised businesses (and the franchisees’ established goodwill) without “good cause,” the devastating costs of litigation for franchisees, and the fact that nearly all franchisors require franchisees to bet their personal and family wealth on the success of the franchise venture by requiring a personal guaranty.127

• A representative of several franchisee associations testifying in support of franchisee protection summarized the inherent problem in franchising without state franchise laws, stating: “[franchising is the] perfect symbiotic relationship . . . unless [there is] a bad franchisor,” in which case it turns “into a nightmare” for franchisees.128

Indeed, although certain “pro-franchisee” bills have passed and others have failed, despite any alleged “balance of information in the age of the Internet,” franchisees are telling state legislatures that they rely on statutory protections at least as much today as they did in the past.

123. Id. at 26.
124. Id. This process is known as “churning,” a franchisor ploy to opportunistically terminate a franchise agreement of an otherwise efficient and profitable franchisee in order to resell the franchise at a premium or to operate the profitable franchise as a company-owned outlet. Uri Benoliel & Jenny Buchan, Franchisees’ Optimism Bias and the Inefficiency of the FTC Franchise Rule, 13 DePaul Bus. & Com. L.J. 411, 415–16 (2015).
125. See Franchisees Paint Grim Scenes of Dunkin’, supra note 115.
128. Id.
IV. Extraterritorial Application of State Franchise Laws Does Not Violate the Dormant Commerce Clause

The Oates Article flatly asserts that some state franchise statutes “raise constitutional issues” and that courts have not properly addressed what interest a state may have in regulating the sale or operation of franchises not owned by their residents or operated in their state.129 The authors of this article believe neither assertion is true.

The U.S. Constitution grants Congress the power to “regulate commerce . . . among the several States.”130 Courts recognize “that this affirmative grant of authority also encompasses an implicit or dormant limitation on the authority of states to enact legislation affecting interstate commerce.”131 The Commerce Clause reflects “the Constitution’s special concern both with the maintenance of a national economic union unfettered by state-imposed limitations on interstate commerce and the autonomy of the individual states within their respective spheres.”132

A court analyzing a Commerce Clause challenge applies two tiers of scrutiny: a “discrimination” tier and an “undue burden” tier. Under the discrimination tier, “when a statute clearly discriminates against interstate commerce,” either on its face or in its effect, “it will be struck down unless the discrimination is demonstrably justified by a valid factor unrelated to economic protectionism.”133 Such statutes are per se invalid.134 Under the undue burden tier, the court will uphold statutes that “regulate evenhandedly to effectuate a legitimate local public interest” and have “only incidental effects” on interstate commerce unless the party challenging the statute can show that the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.135

In the franchise arena, courts have unanimously rejected franchisor challenges to state franchise statutes under the discrimination tier.136 Courts have held that franchise statutes are facially neutral in that they regulate both resident franchisors and foreign franchisors, and franchisors have been unable to prove a discriminatory effect on interstate commerce.

A. State Franchise Statutes Are Not Unconstitutionally Extraterritorial

Although state laws that have “the practical effect of regulating commerce occurring wholly outside the state’s borders” are invalid under the Com-

129. Oates Article, supra note 7, at 213.
130. U.S. CONST. art. I § 8, cl.3.
132. Id. at 335–36.
not every law that has some measurable out-of-state impact violates the Commerce Clause. As the court in *Instructional Systems v. Computer Curriculum* noted, “it is inevitable that that a state’s law . . . will have extraterritorial effects.” Courts “never suggested that the Dormant Commerce Clause requires Balkanization, with each state’s laws stopping at the border.” Although some state franchise statutes affect franchise relationships in other states, they do not, as the Oates Article suggests, “raise constitutional issues.”

To determine whether a state’s legislation has an impermissible extraterritorial effect, courts focus on the applicability and effects of the statute as well as the risk of inconsistent legislation between different states. In *Healy v. Beer Institute*, Justice Blackmun summarized the Court’s approach to extraterritoriality: “taken together our cases . . . stand at a minimum for . . . three propositions.” First, the Commerce Clause “precludes the application of a state statute to commerce that takes place wholly outside of the State’s borders.” Second, a statute that “directly controls commerce occurring wholly outside the boundaries of a State exceeds the inherent limits of the enacting State’s authority and is invalid regardless of whether the statute’s extraterritorial reach was intended.” The reviewing court will inquire “whether the practical effect of the regulation is to control conduct beyond the boundaries of the state.” Third, any assessment of the “practical effect” of a statute must consider “how the challenged statute may interact with the regulatory schemes of other states,” including what the effect would be if “many or every State adopted similar legislation.” A statute that violates any of the propositions is *per se* invalid.

1. State Franchise Statutes Do Not Apply to Conduct Wholly Outside State Borders

The Oates Article argues that courts have generally invalidated state franchise statutes that apply to non-resident franchisees operating in other states as violations of the Commerce Clause because they require “non-residents to obtain the approval of the regulating state before they can implement spe-
specific business practices elsewhere.”146 This analysis ignores the fact that even the “broadest” of state franchise statutes apply “only when an important aspect of the franchise transaction,” such as an offer to sell or buy, acceptance of the offer, or the actual sale occurs in the regulating state.147,148

Under Justice Blackmun’s analysis in *Healy*, a statute’s extraterritorial reach is void only if it applies to conduct that occurs wholly outside the enacting state’s borders. *Healy*, for example, struck down a liquor pricing statute that attempted to regulate the price of alcohol in other states.149 Similarly in *Edgar v. MITE Corp.*, the U.S. Supreme Court struck down a statute that required state regulators to approve corporate takeover offers, even if such offers would affect no Illinois shareholders.150

However, a statute that applies to conduct that occurs both inside and outside of the state is permissible. Thus, in *Instructional Systems v. Computer Curriculum Corp.*, the court rejected a challenge to the extraterritorial application of the New Jersey Franchise Practices Act, holding that a franchisee who was a party to a multi-state franchise agreement could assert claims under the Act (even though several of the franchise outlets were located outside of New Jersey) because the franchisee had a location in New Jersey.151 Similarly, in *Mon-shore Management, Inc. v. Family Media Inc.*, the court held that the New York Franchise Sales Act did not violate the Dormant Commerce Clause by regulating the sales of franchises in circumstances “where the offer originates, is extended or is accepted in New York.”152 In that case, the court explained that “while the primary thrust of the [Franchise] Act was full disclosure,” it also attempted to “forge a comprehensive legal structure to thwart, combat, and rectify franchise sales abuses.”153 The court pointed to the legislative finding of the Act stating that “New York has a valid interest in protecting franchisees from unscrupulous franchisors” and noted that by extending the Act’s protection to franchisees in other states, as long as the offer or acceptance took place in New York State, the legislature was acting not only to protect franchisees but also to “protect

148. The Oates Article relies on a parade of horribles to bolster its claim that state franchise statutes pose a risk of extraterritorial application, noting that that it is “troubling . . . that courts in New York and Florida are willing to impose their state’s franchise statutes even when there have been no contacts with the state other than a choice of law provision.” Oates, *supra* note 7, at 213. The Oates Article fails to cite any cases to support its concern. In fact, courts have repeatedly held that a franchisee may not make claims under a state’s franchise statute when the franchisee had no contact with the state even when the parties agree that law of the state applies. See *Taylor v. 1-800-Got-Junk?, LLC*, 632 F. Supp. 2d 1048 (W.D. Wash. 2009); *Cromeens Hollo-

149. *Healy*, 491 U.S. at 337.
151. *Instructional Sys.*, 35 F.3d at 826.
153. Id. at 189.
and enhance the reputation of the State, which is in and of itself, a legitimate
and substantial state interest.”

Indeed, it would be nonsensical, for example, for Minnesota to discourage
franchise sales abuses by enacting a law that protected Minnesota residents
from all unscrupulous franchisors, but allowed franchisors, Minnesota-
based or foreign, to engage freely in franchise sales abuses in Minnesota as
long as their victims are non-residents.

The Oates Article argues that the decision in *Mon-Shore* “contradict[s] the
more sound reasoning of the U.S. Supreme Court in *Edgar v. MITE
Corp.*” This is not true. The *Mon-Shore* court extensively discussed and
distinguished *Edgar*, noting that “while superficially appealing,” the “analogy
between [the statute at issue in *Edgar*]” and New York’s Franchise Sales Act
“is inapposite.” In *Edgar*, the Supreme Court held that the statute violated
the Dormant Commerce Clause because the challenged statute could have
“permanently thwarted” a nationwide tender offer from a non-resident
actor even if none of its resident shareholders were affected by the offer,
and that the State of Illinois has no legitimate interest in protecting non-
resident shareholders in out-of-state transactions. Conversely, in *Mon-
shore*, the regulated transaction, the sale of a franchise, occurred within the
boundaries of the regulating state. *Mon-Shore* and later courts have repeatedly
held that state franchise laws generally do not regulate extraterritorially be-
cause each statute “only becomes operative when an important aspect of the
franchise relationship” occurs within the state. The authors believe the
Oates Article unreasonably narrows the meaning of the word “commerce”
by focusing exclusively on the residence of the franchisee or the location of
the franchise, removing the entire franchise sales process from the equation.

In addition to ignoring key differences between the challenged statute in
*Edgar* and state franchise laws, the Oates Article fails to mention a distinc-
guishing factor—that the challenged Illinois statute was preempted by fed-
eral legislation and that the state statute conflicted with federal law. The
same is not true with franchise law. Under the FTC Rule, states are
not only explicitly empowered to enact statutes that provide greater protec-
tion, they are encouraged to do so. The Oates Article’s comparison be-
tween the statute in *Edgar* and state franchise statutes would be valid only
if the FTC removed the FTC Franchise Rule language empowering states
to enact broader franchise legislation, and if state franchises statutes applied
to all franchise transactions irrespective of the residence of the franchisor,
the franchisee, the franchise outlet, and the location(s) of the transaction.

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154. *Id.* at 191–92.
160. 16 C.F.R. § 436, n.2.
A state franchise statute in Kentucky regulating sales made in Nevada by a Georgia franchisor would probably violate the Dormant Commerce Clause.

2. State Franchise Statutes Do Not Affect Commerce Wholly Outside State Borders

Franchisors have also argued that franchise statutes are unconstitutional because they have extraterritorial effects. Again, this misrepresents the actual legal standard. A statute that regulates extraterritorially is per se invalid only if it “directly controls commerce occurring wholly outside the boundaries of a State.” Thus, in Volvo Trademark Holding Aktiebolaget v. AIS Construction Equipment, the court held that the Arkansas Unfair Trade Practices Act was not per se invalid because “at least one end [of the transaction] must be in Arkansas” and therefore the statute could not regulate “commerce occurring wholly outside Arkansas.”

The Oates Article argues that “courts have not properly addressed what interest, if any, states have in regulating franchises” that are not located in or operated by residents of the regulating states. A cursory review of the case law demonstrates this is not true. Several courts have discussed why legislatures may choose to regulate franchises that are sold but not located in their state. In Mon-Shore Management, discussed earlier, the court noted that the New York legislature “did not attempt to protect only the residents of this State,” but by extending the protections of the Act to franchisees who received or accepted an offer in New York, the legislature acted to “protect and enhance the commercial reputation of the State itself.” Similarly, in Red Lion Hotels Franchising, Inc., v. MAK, LLC, the court noted that “it was easy to see why the Washington legislature might have wanted to apply” the Washington franchise statute’s relationship provisions to non-resident franchisees of a Washington franchisor: “the legislature might have wanted to reassure potential out-of-state franchisees that they would be treated fairly by, and thereby encourage them to do business with, Washington franchisors.”

Several franchise statutes expressly apply to a franchise “offered” or “sold” “in this state.” It is difficult to imagine that, despite this plain language,
state legislators would permit fraudulent activity by in-state franchisors merely because the franchisee victims are out-of-state.168

3. State Franchise Statutes Do Not Pose a Risk of Inconsistent Legislation

Finally, franchisors have argued that the state franchise statutes violate the Dormant Commerce Clause because they subject franchisors to inconsistent state regulations. However, “state laws which merely create additional, but not irreconcilable, obligations” are not considered to be “inconsistent” for the purpose of a Dormant Commerce Clause challenge.169 The party challenging the law bears the burden of demonstrating that the challenged statute creates “actual conflict amongst state regulations.”170 Thus, in Instructional Systems, Inc., v. Computer Curriculum Corp., the court concluded that the New Jersey Franchise Protection Act’s limitations on terminations were not per se invalid because “while the laws of other states might permit [the franchisor] to conduct its franchise relationship with [the franchisee] under a different framework than the one required by NJFPA, that difference in approach by different states is not sufficient to require per se invalidation.”171 The court explained that state franchise statutes that require the franchisor to register prior to selling franchises or which require additional disclosures would also not be per se violations.172

Applying the principle that a state law is not per se invalid unless it would create “actual conflict among state regulations,” it is clear that state franchise registration statutes are not unconstitutionally extraterritorial. The mere fact that something may be subject to stricter sale requirements in one state than in another does not violate the Dormant Commerce Clause. For example, the fact that a gun seller may have to comply with stricter regulations to sell a gun in the state of Washington than in Texas (regardless of which state the gun purchaser resides in) does not violate the Dormant Commerce Clause. If states were to enact legislation that imposed no more regulations than the least restrictive state, states would cease to be “laboratories of democracy” and would instead become participants in a race to the bottom in which the state with the least regulations would set the standard for the nation.

If state franchise statutes truly burdened interstate commerce, one would expect to see some impact on the franchise economy in the states with the

168. See, e.g., Dollar Sys., Inc. v. Avcar Leasing Sys., Inc., 890 F.2d 165, 171 (9th Cir. 1989) (correctly holding that the California Franchise Investment Law applied to a franchise agreement negotiated and executed in California, even though franchise was purchased by nonresidents and operated in the Virginia–Maryland–D.C. area).
169. Instructional Sys., 35 F.3d at 826 (quoting Buzzard v. Roadrunner Trucking, 966 F.2d 777, 784 n.9 (3d Cir. 1992)).
170. Id. (quoting Old Bridge Chems., Inc. v. New Jersey Dep’t of Envt’l Prot., 965 F.2d 1287, 1293 (3d Cir. 1992)).
171. Id. at 826.
172. Id.
broadest regulations. The data does not support this conclusion. Florida and New York have franchise statutes specifically criticized by the Oates Article. Their franchise economies are booming. In New York, there are more than 29,000 franchise outlets and the International Franchise Association predicts that number will grow by 1.3 percent in 2018.173 Similarly, in Florida there are more than 48,000 franchise outlets and the IFA predicts that number will grow by almost 3 percent in 2018.174 The IFA also ranked Florida as one of the top five states for franchise employment growth in 2017.175

B. State Franchise Laws Do Not Pose an Undue Burden on Interstate Commerce

State franchise statutes have not only survived decades of judicial scrutiny under the “anti-discrimination” tier of Dormant Commerce Clause litigation, they have also withstood challenges to their constitutionality under the “undue burden” tier. With one exception, state franchise statutes have passed the balancing test enunciated in *Pike v. Bruce Church*, in which the U.S. Supreme Court explained that, when a statute addresses a “legitimate local public interest, and its effects on interstate commerce are only incidental, it will be upheld unless the burden imposed on such commerce is clearly excessive in relation to the putative local benefits.”176 Every court evaluating state franchise statutes has held that states have a legitimate interest in (1) “encouraging full disclosure . . . and prohibiting fraud,”177 (2) curbing “franchise sales abuses and unfair competitive practices,”178 and (3) “addressing the disparity in bargaining power”179 between franchisors and their franchisees.

Courts have broadly rejected franchisor claims that state statutes which require registration or which regulate aspects of the franchise relationship (1) “impose a straightjacket on” a franchisor’s operations, (2) “ultimately harm the consumers by prohibiting the creation of an efficient distribution system,” or (3) place an “onerous” burden on franchisors by imposing detailed disclosure and record keeping requirements.180 As the court noted in *Instructional Systems*, “even assuming this to be true,” a statute may be invalidated under *Pike* only if it “imposes a discriminatory burden on interstate commerce.”181 A statute that evenhandedly imposes a burden on all com-

180. *Instructional Sys.*, 35 F.3d at 827.
181. Id.
merce is generally constitutional. In the single case where a court has invalided a portion of a franchise statute under the *Pike* test, the court noted the challenged portion “had no parallel in the law of any other state” and imposed “heavy burdens on out of state interest” and that the challenged section offered no benefits to a state interest beyond those offered by other sections of the statute.182

VI. Conclusion

To borrow from Mark Twain, the Oates Article’s report about the death of the need for state franchise regulation is an exaggeration. State franchise laws that protect the interests of franchisees and discourage unscrupulous franchisors remain necessary. Franchisees are still significantly less experienced and sophisticated than franchisors. The vast majority of franchisees have never operated their own business and do not have independent counsel advising them. Franchise agreements are frequently presented as “take it or leave it” propositions, and the franchisor retains significantly more power than the franchisee in managing the relationship.183 Accordingly, more than a dozen states have enacted specific statutes regulating both franchise sales and the franchise relationship. Rather than being the relic of a dark time, many states have either amended their statutes to broaden their protection or have considered doing so.

Finally, the differences between these statutes and their extraterritorial application are not unconstitutional. Rather, these statutes are the embodiment of the federalist system in which each state acts to protect its residents from unscrupulous businesses and prohibit its businesses from behaving unscrupulously. The Oates Article implies that these states should instead surrender that decision-making authority to the federal government by relying exclusively on the FTC Rule, which does not even allow for private right of action. This conclusion not only contracts the FTC Rule itself, but it is antithetical to our entire system of government. State legislatures should be encouraged to continue looking for better ways to protect franchisees and encourage fair and equitable franchise practices through franchise legislation.

182. *Id.* at 570–71.

183. The implied theory in the Oates Article that franchisees have become so sophisticated that they have “outgrown” the need for state statutory protection is questionable. Even if true, however, the franchisor’s viewpoint is moot because there are exemptions at the state and federal levels that exclude large, sophisticated franchisees from statutory protection. See 16 C.F.R. § 436.8(a)(5)(i) (“large investment” exemption for franchise investments totaling more than $1,143,100); 16 C.F.R. § 436.8(a)(6) (“large franchisee” exemption for franchisees in business for at least five years and a net worth of at least $5,715,500). Certain states have crafted similar exemptions to their franchise laws. See, e.g., Ill. Admin. Code tit.14, § 200.201(c) (“large investment” exemption); Md. Code Regs. 02.02.08.10(E)(1) (same); S.D. Franchise Investment Act § 13(1) (same); Wis. Stat. § 553.235(1)(a) (same); Cal. Corp. Code § 31109 (“large franchisee” exemption); 815 Ill. Comp. Stat. 705/8(a)(2) (same); R.I. Gen. Laws § 19-28.1-6(4) (same); S.D. Codified Laws § 37-5B-13(2) (same); Wash. Rev. Code § 19.100.030(5) (same); Wis. Stat. § 553.235 (same).
Appendix A
Results of Franchisee Survey (253 Respondents)

Table 1
An attorney reviewed my franchise agreement, franchise disclosure document (FDD), and/or Uniform Franchise Offering Circular (UFOC) before I purchased my first franchise.

Table 2
During the franchise sales process, my franchisor’s salesperson told me that I could hire an attorney to review my franchise agreement.
Table 3
During the franchise sales process, my franchisor’s salesperson told me that my franchisor would not make any changes to the franchise agreement.

27% Yes
73% No

Table 4
Number of franchise units owned by franchisee respondents.

47% 1
21% 2
21% 3-5
6% 6-10
5% 10+
Table 5
The franchise disclosure document (FDD) (or Uniform Franchise Offering Circular (UFOC)) I received was an accurate and complete description on my franchise investment.

![Pie chart showing responses to Table 5]

Table 6
During the franchise sales process, my franchisor’s salesperson made statements related to sales, costs, and profits that were not included in the FDD or UFOC.

![Pie chart showing responses to Table 6]
Try Poking It with a Stick:  
Post-Term Noncompetes in California  
Certainly Look Dead

Theo S. Arnold

California is the largest economic power within the United States. Its dominance extends to the franchise industry, where California boasts the largest overall market for franchised businesses, dwarfing other states in number of franchise units and industry GDP. Access to this market comes with a price. California franchisees have the protections of California’s idiosyncratic laws, among them the state’s minority view on covenants not to compete after the completion of the franchise term.

California broadly prohibits covenants not to compete, subject to limited exceptions. Case law has not always reflected the almost outright ban spelled out by the California legislature, creating tension between recent California state court decisions and those from federal courts or earlier California authority.

The first part of this article traces the recent development of California noncompete law. It highlights the dissonance between recent California decisions, prior California decisions, and federal court decisions involving California litigants and distills them into a current statement of California law most supported by applicable authority. The second part of the article applies this distillation to franchise law, discussing ways in which franchisors have attempted or may attempt to enforce covenants not to compete against California franchisees. It concludes that post-termination noncompete clauses in franchise agreements with California franchisees are unlikely to

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1. California produces fourteen percent of total U.S. GDP and is the sixth largest economy in the world.

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be enforced because franchise terminations generally cannot meet California’s statutory exceptions.

I. California Noncompete Law and Its History

A. RTFS: Business and Professions Code Section 16600 and Its Statutory Exceptions

Except as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.4 California’s antipathy toward covenants not to compete is longstanding. Although noncompetes are traditionally valid under common law if subject to reasonable time and place restrictions, California banned noncompetes almost in their entirety in 1872.5 This antipathy has seldom wavered since. Other than a 1945 amendment allowing noncompetes following the entire sale of a stock interest in a company, the statutes prohibiting noncompete agreements have remained functionally identical since their inception.6

The statutory scheme works as follows: Business and Professions Code Section 16600 voids “every” contract to the extent it restrains participation in a lawful profession, trade, or business, “except as provided [by the statutory exceptions] in this chapter.”7 Such exceptions allow business owners exiting a business entirely to agree not to compete with the purchaser afterwards. Section 16601 allows noncompetes when a departing corporate owner sells the goodwill of a business, or the entirety of his or her stock or ownership interest in the business. Sections 16602 and 16602.5 extend similar exceptions to owners of partnerships and LLCs, respectively.8 Noncompetes under these statutory exceptions are enforceable only to the extent they are “reasonable and necessary in terms of time, activity and territory to protect the buyer’s interest.”9

Parties may not attempt to game these statutory exceptions by setting up minor or sham transactions for the purpose of yielding an enforceable noncompete. In *Bosley Medical Group v. Abramson*, the defendant’s employment contract required him to buy a small stake in the plaintiff corporation upon his hiring and to resell the stock back to the company upon termination. The company argued this was a stock sale that allowed enforcement of a noncompete under Section 16601. The California Court of Appeal dis-

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3. On the first day of law school, my Legal Practice professor gave our section the following practical advice: “R. T. F. S. [dramatic pause.] Read. The. F***ing. Statute.”
4. CAL. BUS. & PROF. CODE § 16600.
7. CAL. BUS. & PROF. CODE § 16600.
8. Id. §§ 16601–16602.5.
agreed, pointing out that the purpose of the statute was “to permit the owner of a small corporation to agree not to compete in connection with selling his entire interest in that corporation,” and was applicable only when a “transfer of ‘all’ of the owner’s shares involves a substantial interest in the corporation so that the owner, in transferring ‘all’ of his shares, can be said to transfer the goodwill of the corporation.”

In summary, every noncompete clause in California is invalid by default. The only exceptions to this ban are in the statutes immediately following Section 16600. Through these exceptions, a noncompete may be enforceable as a condition to a business sale, but only when the selling party transfers a substantial enough interest in the business to constitute the transfer of the goodwill of the company, and then only as reasonable and necessary in terms of time and scope.

B. The Ninth Circuit’s Alchemy: Broadening Noncompetes Through Narrow Restraint

In 1987, the Ninth Circuit broadened the applicability of noncompetes by reading a “narrow restraint” exception into the law. In *Campbell v. Board of Trustees of Leland Stanford Junior University*, the court held that “[e]ven though the California Legislature rejected the common-law rule that “reasonable” restraints of trade are generally enforceable, it did not make all restrictions unenforceable.” In *Campbell*, a psychologist and vocational test developer, formerly under contract with Stanford, had promised “to refrain from preparing or causing to publish in his name or otherwise, without the consent in writing of [Stanford], any similar work or anything that may injure the sale of [the Strong-Campbell Interest Inventory (SCII test)].” Stanford argued that Campbell was a psychologist and that the noncompete did not prevent him from practicing psychology, but only restricted him from a limited part of his profession. Campbell, on the other hand, contended that his entire life’s work was dedicated to the research, development, and preparation of vocational tests, and the covenant precluded him from pursuing that specific business. *Campbell*’s ensuing analysis concluded that California meant to ban only those noncompetes that entirely precluded a signatory’s participation in a profession, trade, or business, and those that barred “only a small or limited part of the business, trade or profession” remained enforceable. *Campbell* was followed by other Ninth Circuit cases,
General Commercial Packaging v. TPS Package\textsuperscript{16} and International Business Machines Corp. v. Bajorek,\textsuperscript{17} each of which upheld noncompete provisions on the grounds that they did not entirely preclude the litigants from pursuing their trade or business.

C. “Every” Is “Unambiguous”: The California Supreme Court Kills the Narrow Restraint Exception

The narrow restraint exception was short-lived. In 2008, the California Supreme Court disapproved the exception and reaffirmed the ban on non-competes in Edwards v. Arthur Andersen LLP.\textsuperscript{18} Edwards arose from a non-compete in Arthur Andersen LLP’s employment contract that precluded managers at the company from working for or soliciting certain Andersen clients for eighteen months following their termination from the company. In an odd twist, Edwards’ lawsuit did not arise directly from his termination. Instead, Arthur Andersen LLP sold off its tax practice and accounting groups after being indicted in connection with the Enron investigation.\textsuperscript{19} Edwards’ group was sold to HSBC Bank, which tried to force Edwards to sign a “Termination of Non-Compete” agreement as a condition of employment. This new agreement required Edwards to release any claims against Arthur Andersen LLP, and in exchange, Arthur Andersen would release him from the noncompete, accept his resignation, and agree to his employment by HSBC. When Edwards refused to sign the Termination of Non-Compete, HSBC refused to hire Edwards, and Arthur Andersen LLP fired him and withheld severance benefits.\textsuperscript{20}

Edwards sued, claiming Andersen interfered with his prospective economic relations with HSBC by demanding Edwards give Andersen consider-

\textsuperscript{16} 126 F.3d 1131 (9th Cir. 1997) (General Commercial Packaging packaged materials for transport to EuroDisney and contracted a portion of the job to TPS Package. As part of the contract, TPS agreed not to solicit or directly deal with Disney. TPS won summary judgment at the district court level on the grounds that the contract violated Section 16600. The Ninth Circuit reversed, holding that the contract was valid unless it completely restrained TPS from engaging in the packing and crating business.).

\textsuperscript{17} 191 F.3d 1033 (9th Cir. 1999) (While an employee at IBM, Bajorek signed a stock option agreement requiring him to return his options if he went to work for a competitor within six months after receiving the options grant. The Ninth Circuit held that the six-month restriction was enforceable because it did not entirely preclude Bajorek from working in the business, trade, or profession.).

\textsuperscript{18} 44 Cal. 4th 937 (2008).

\textsuperscript{19} Enron was a natural gas company that took advantage of energy deregulation to game energy markets in the 1990s and early 2000s. The company also manipulated its own stock price. Enron massively overstated estimates of revenues, created special purpose entities to keep liabilities or losses off its balance sheets, and “diversified” investments by hedging risk with itself. In 2001, the house of cards collapsed, and Enron stock went from nearly $90 per share to $0.12. The Securities and Exchange Commission opened an investigation, which led to the criminal convictions of several Enron executives. Arthur Andersen, which was Enron’s auditor, was found guilty on federal criminal charges in 2002 for illegally destroying documents relevant to the SEC investigation. Although the U.S. Supreme Court overturned the conviction in 2005, the scandal destroyed Arthur Andersen’s reputation and business.

\textsuperscript{20} Edwards, 44 Cal. 4th at 943.
ation (release of claims) to release him from an illegal noncompete agreement. The California Supreme Court agreed, holding that the “plain meaning” of Section 16600 prevented an employer from restraining “a former employee from engaging in his or her profession, trade, or business unless the agreement falls within one of the exceptions to the rule.”21 Adopting the fundamental premise that the statutory scheme is dispositive and “unambiguous,” such that no exceptions may be created by “judicial fiat,” Edwards concluded that Section 16600 was to be interpreted broadly.22 Merely restraining competition is enough to violate Section 16600.23

To forestall any clever parsing or claims of ambiguity in the decision, Edwards specifically rejected Campbell and the Ninth Circuit’s narrow restraint exception:

California courts have not embraced the Ninth Circuit’s narrow restraint exception. Indeed, no reported California state court decision has endorsed the Ninth Circuit’s reasoning, and we are of the view that California courts “have been clear in their expression that Section 16600 represents a strong public policy of the state which should not be diluted by judicial fiat.” Section 16600 is unambiguous, and if the Legislature intended the statute to apply only to restraints that were unreasonable or overbroad, it could have included language to that effect. We reject Andersen’s contention that we should adopt a narrow restraint exception to Section 16600 and leave it to the Legislature, if it chooses, either to relax the statutory restrictions or adopt additional exceptions to the prohibition-against-restraint rule under Section 16600.24

After the Edwards rebuke, the Ninth Circuit now shares the California Supreme Court’s view of the breadth of Section 16600’s ban and has extended its application beyond employment contracts.25 In Golden v. California Emergency Physicians Medical Group,26 a medical doctor sought to back out of a settlement he entered into in open court on the grounds that the settlement agreement required him “to waive any and all rights to employment with [the defendant] or at any facility that [the defendant] may own or with which it may contract in the future.”27 Golden contended that this “no-employment” provision impermissibly restricted his right to practice the profession of medicine, as it prevented him from contracting with other hospitals or facilities that CEP might operate in the future. A divided

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21. Id. at 946–47.
22. Id. at 948–49.
23. Id. at 948.
24. Id. at 949–50.
25. Edwards yields one mystery: it begins by explicitly limiting its review to whether Section 16600 prohibits employee noncompetition agreements, seemingly excluding commercial agreements from its scope. However, its logic makes any limitation of its holding to the employment context impossible. Edwards’ core position is that Section 16600 is a clear legislative dictate that the courts may not dilute. Excluding commercial noncompete agreements from the statutory ban would be an impermissible judicial exception.
26. 782 F.3d 1083 (9th Cir. 2015).
27. Id. at 1085.
panel agreed, invalidating the settlement agreement. The court pointed out that, although the settlement agreement was not an employment agreement,

[the statute does not specifically target covenants not to compete between employees and their employers: the text does not include any form of the word “compete” or “competition,” and does not even implicitly constrain itself to contracts concerning employment. Rather, Section 16600 voids “every contract” that “restrain[s]” someone “from engaging in a lawful profession, trade, or business.”]

Accordingly, the statutory context lends little support to construing Section 16600 much more narrowly—as simply a prohibition of agreements between employers and employees not to compete—than its plain language would otherwise suggest.28

Edwards remains good law. It states a bright-line rule about post-term noncompete covenants in California: they are void, unless they fit into the limited statutory exceptions passed by the California legislature.

D. But Wait, “Every” Might Be Ambiguous: The Trade Secret Exception

This bright-line rule is immediately muddied by the “trade secret exception,” which purports to allow covenants not to compete when necessary to protect a party’s trade secrets.

The “trade secret exception” has a longstanding but uneasy presence in noncompete law. It came of age in nonsolicitation cases in the 1950s, in which courts prevented departing employees from taking customer lists to new employers or businesses. These cases upheld nonsolicitation clauses on the grounds that they did not “prevent” or “prohibit” the defendants from carrying on the specified business, but merely restricted each from using information belonging to the plaintiffs.29

By 1965, the California Supreme Court was confident enough in the existence of a trade secret exception to make offhand mention of it without further explanation in Muggill v. Reuben H. Donnelley Corp: “[Section 16600] invalidates provisions in employment contracts prohibiting an employee from working for a competitor after completion of his employment or imposing a penalty if he does so [citations omitted] unless [the provisions] are necessary to protect the employer’s trade secrets.”30

If the trade secret exception sounds suspiciously similar to the narrow restraint exception, that’s because it is. Like the narrow restraint exception, the trade secret exception makes an allowance for a provision that does not entirely preclude participation in the business or profession, but limits only a part thereof—competition involving improper use of protected information.

28. Id. at 1090.
Consequently, courts have justified carving out an exception to Section 16600 to allow noncompete provisions that protect trade secrets.\(^{31}\)

This poses a glaring problem in light of \textit{Edwards}. The trade secret exception is not a statutory exception to Section 16600. It is nothing more than a specific narrow restraint exception created by judicial fiat. \textit{Edwards} explicitly bans this practice.\(^{32}\)

One would therefore expect \textit{Edwards} to disapprove the trade secret exception. Curiously, it does not. \textit{Edwards} offhandedly quotes \textit{Muggill} verbatim in its introductory exposition on the history of Section 16600 jurisprudence and then simply ducks the issue via an enigmatic footnote: “We do not here address the applicability of the so-called trade secret exception to Section 16600, as \textit{Edwards} does not dispute that portion of his agreement or contend that the provision of the noncompetition agreement prohibiting him from recruiting Andersen’s employees violated Section 16600.”\(^{33}\)

Post-\textit{Edwards} decisions on the trade secret exception have been similarly muddled. Federal courts in California have largely continued to assume the trade secret exception is still valid.\(^{34}\) Most have followed the same “narrow restraint” reasoning for trade secret exception cases as they did in \textit{Campbell}, ignoring \textit{Edwards}’ disapproval of that analysis. The Ninth Circuit, in \textit{Asset Marketing Systems, Inc. v. Gagnon},\(^{35}\) even cites \textit{Edwards} as authority for the validity of the trade secret exception, a reading of \textit{Edwards} at odds with both its holding and its express disclaimer of any holding on that issue.\(^{36}\)

\textit{Golden}, the Ninth Circuit decision largely affirming \textit{Edwards}’ reasoning, points out that California “state courts uphold restrictive contracts to protect trade secrets[,] otherwise California does not make exceptions for narrow or reasonable restraints.”\(^{37}\) Again, this is an uncertain conclusion given \textit{Edwards}’ holding. \textit{Edwards} does not “otherwise” ban exceptions for narrow or reasonable restraints. It bans them all, calling the statute “unambiguous”


\(^{32}\) \textit{Edwards}, 44 Cal. 4th at 949.

\(^{33}\) Id. at 946, 946 n.4.


\(^{35}\) 542 F.3d 748 (9th Cir. 2008).

\(^{36}\) Id. at 758.

\(^{37}\) \textit{Golden}, 782 F.3d at 1091 n.4 (citations omitted).
and deferring solely to the legislature to create exceptions.\(^\text{38}\) Yet, Edwards refrains from addressing the trade secret exception head-on.

Published state court cases post-Edwards, meanwhile, have cast doubt on the existence of the trade secret exception. The Fourth District of the California Court of Appeal’s 2009 decision in Retirement Group v. Galante\(^\text{39}\) is perhaps the most negative. In Galante, an investment advisor (Galante) left his former employer (TRG) to work for a competitor. While employed at TRG, Galante had signed a nonsolicitation agreement “substantively indistinguishable” from the one at issue in Edwards.\(^\text{40}\) This nonsolicitation agreement prohibited Galante from using TRG’s customer information, which TRG maintained in a secure database. When Galante left, TRG sued and obtained an injunction preventing him from directly or indirectly soliciting TRG’s customers, which TRG argued was necessary to protect its trade secrets.\(^\text{41}\)

The court vacated the injunction and invalidated the nonsolicitation provision on Section 16600 grounds. Examining Edwards in depth, Galante concluded that Edwards’ total ban on non-statutory exceptions to Section 16600 left no room for the trade secret exception.\(^\text{42}\) Galante specifically disavowed upholding the trade secret exception as a “narrow restraint,” holding that “Edwards rejected the claim that [trade secret exceptions were] exempt from Section 16600 if the conduct covered by such clauses fell within the “narrow restraint” exception[.]”\(^\text{43}\)

However, Galante did not entirely doom post-term trade secret injunctions. Instead, the court carefully explained that the proper basis for enjoining the unauthorized use of trade secrets lies not in contract, but in tort under the California Uniform Trade Secret Act (CUTSA):\(^\text{44}\)

> We distill from the foregoing cases that Section 16600 bars a court from specifically enforcing (by way of injunctive relief) a contractual clause purporting to ban a former employee from soliciting former customers to transfer their business away from the former employer to the employee’s new business, but a court may enjoin tortious conduct (as violative of either the Uniform Trade Secrets Act and/or the Unfair Competition Law) by banning the former employee from using trade secret information to identify existing customers, to facilitate the solicitation of such customers, or to otherwise unfairly compete with the former employer. Viewed in this light, therefore, the conduct is enjoinable not because it falls within a judicially created “exception” to Section 16600’s ban on contractual nonsolicitation clauses, but is instead enjoinable because it is wrongful independent of any contractual undertaking.\(^\text{45}\)

\(^\text{38}\) Edwards, 44 Cal. 4th at 949–50.
\(^\text{40}\) Id. at 1234.
\(^\text{41}\) Id. at 1231–34.
\(^\text{42}\) Id. at 1234–38.
\(^\text{43}\) Id. at 1241.
\(^\text{44}\) CAL. CIV. CODE §§ 3426 et. seq.
\(^\text{45}\) Galante, 176 Cal. App. 4th at 1238.
It is crucial to note that a franchisor seeking to enjoin a franchisee through CUTSA must show actual or threatened misappropriation, complete with actual damages or imminent harm. California does not recognize the “inevitable disclosure” doctrine, in which “a plaintiff may prove a claim of trade secret misappropriation by demonstrating that defendant’s new employment will inevitably lead him to rely on the plaintiff’s trade secrets.”\textsuperscript{46} In California, the inevitable disclosure doctrine is treated as an impermissible attempt to enforce a de facto noncompete clause, and “speculation that a departing employee may misappropriate and use a trade secret in a startup business will not support an injunction.”\textsuperscript{47} Instead, “[a] trade secrets plaintiff must show an actual use or an actual threat.”\textsuperscript{48} “Threatened misappropriation” means “a threat by a defendant to misuse trade secrets, manifested by words or conduct, where the evidence indicates imminent misuse.”\textsuperscript{49} Loosely pleading threatened misappropriation is a bad idea, however, because the CUTSA allows defendants to recover attorney fees and costs from plaintiffs who allege misappropriation in bad faith,\textsuperscript{50} and courts do not hesitate to award them.\textsuperscript{51}

The next California state appellate court to address the trade secret exception was in the Second District.\textsuperscript{52} In \textit{Dowell v. Biosense Webster, Inc.},\textsuperscript{53} a group of plaintiffs sued their former employer, seeking to invalidate post-term noncompete and nonsolicitation clauses in their employment agreements. The noncompete prohibited the plaintiffs from rendering services to a competitor by using the employer’s confidential information for eighteen months after termination of employment, while the nonsolicitation clause prohibited the plaintiffs from soliciting customers of the employer for the same time period.\textsuperscript{54} After the trial court granted summary adjudication in favor of the plaintiffs on the grounds that both clauses were void, the employer appealed.\textsuperscript{55} On appeal, the plaintiffs directly raised the argument that “in light of [\textit{Edwards}], a common-law trade secret exception no longer exists.”\textsuperscript{56} After an exposition on the “tension between Section 16600 and trade secrets” that included a discussion of \textit{Galante}, the court in \textit{Dowell} declined to resolve

\textsuperscript{46} \textit{Whyte}, 101 Cal. App. 4th at 1458, citing \textit{PepsiCo, Inc. v. Redmond}, 54 F.3d 1262, 1269 (7th Cir. 1995).
\textsuperscript{48} Id.
\textsuperscript{49} Id. at 1279.
\textsuperscript{50} CAL. CIV. CODE § 3426.4.
\textsuperscript{52} The Second District includes Los Angeles, Ventura, Santa Barbara, and San Luis Obispo Counties.
\textsuperscript{54} Id. at 567–70.
\textsuperscript{55} Id. at 570.
\textsuperscript{56} Id. at 576.
the issue, choosing instead to invalidate the noncompete on the grounds that it was not narrowly tailored to protect trade secrets.\textsuperscript{57} However, the court stated in passing that “we doubt the continued viability of the common law trade secret exception to covenants not to compete.”\textsuperscript{58}

No other state appellate courts have directly addressed the trade secret exception post-\textit{Edwards}, although at least one other court has expressed similar doubts as to its vitality. In \textit{FLF, Inc. v. Barney & Barney, LLC},\textsuperscript{59} the First District approvingly referenced \textit{Galante} at length and agreed with \textit{Dowell} that the trade secret exception “rests on shaky legal grounds.”\textsuperscript{60} However, as in \textit{Dowell}, the \textit{FLF} court determined the clauses at issue were not narrowly tailored enough to address trade secrets and invalidated the clauses on more general Section 16600 grounds.

\textit{Galante}, \textit{Dowell}, and \textit{FLF} should warn federal courts that their persistence in recognizing the trade secret exception cannot survive continued scrutiny. Federal courts are obligated to defer to the Supreme Court of California on questions of California law.\textsuperscript{61} “In the absence of convincing evidence that the highest court of the state would decide differently,” the federal courts must defer to decisions published by California’s intermediate courts as well.\textsuperscript{62} Before \textit{Edwards}, cases like \textit{Muggill} provided ample evidence of the California Supreme Court’s recognition of the trade secret exception. After \textit{Edwards}, that line of jurisprudence has lost considerable logical value. Without convincing evidence post-\textit{Edwards} that the California Supreme Court would reaffirm the trade secret exception, federal courts must follow \textit{Galante}, which effectively denies its existence.

As a practical matter, the federal courts’ reluctance or unwillingness to follow \textit{Galante}—or simply their misreading of it\textsuperscript{63}—leaves the trade secret exception open as a potential argument for enforcement of a noncompete. Franchisors should be extremely cautious, however, in attempting to rely on the remnants of California’s trade secret exception. An unsuccessful attempt to enforce a noncompete clause by characterizing it as a “trade secret exception” could render a franchisor liable for malicious prosecution and unfair competition. In \textit{Robinson v. U-Haul Company of California},\textsuperscript{64} U-Haul Company of California sued one of its dealers in an attempt to enforce a noncompete clause. The dealer won the underlying action, then sued

\textsuperscript{57} Id. at 577.
\textsuperscript{58} Id.
\textsuperscript{60} Id. at *9.
\textsuperscript{61} West v. Am. Tel. & Tel. Co., 311 U.S. 223, 236–37 (1940).
\textsuperscript{63} See, e.g., \textit{Keating}, 2016 WL 5338072, at *4, which cited \textit{Galante} for the proposition that “restraints on former employees’ use of their employer’s trade secrets is one of the exceptions to Section 16600.” This is the opposite of \textit{Galante’s} holding and clearly misses \textit{Galante’s} analysis of the difference between trade secret injunctions in contract and those in tort.
\textsuperscript{64} 4 Cal. App. 5th 304 (Cal. Ct. App. 2016).
U-Haul for malicious prosecution and unfair competition. Despite U-Haul’s protestations in both actions that the noncompete was valid under the trade secret exception, a jury found U-Haul did not reasonably believe Robinson was misusing trade secrets or confidential information when it filed the original action.65 The parties tried the unfair competition claim to the court, which slammed U-Haul in its ruling:

First off, the clause is void and unenforceable as a matter of law. [Section] 16600 was—the law predated these events herein by many, many years. Their only reason to put a void contract clause in a contract is to mislead people. U–Haul knew when it put that in its contract that [section] 16600 of the [Business and Professions] [C]ode was in existence. That statute was clear. Why would you possibly put something in a contract where the law says it’s void? You do that so you can cause somebody to think that that clause is, in fact, valid when it isn’t.”66

Robinson was awarded compensatory damages and attorney fees in the action, but it could have been worse for U-Haul: the jury declined to award punitive damages, and Robinson had originally sought class certification, which was denied.

In short, the most precise statement of California’s noncompete law, as it applies to franchises, is likely the following: franchisors may not seek to enforce a contractual post-term noncompete on the grounds that the franchisee will use the franchisor’s trade secrets. However, franchisors may enjoin a franchisee under the CUTSA against use of their trade secrets when and if there is “actual use” or an “actual threat” of infringement.67

II. Application: California Noncompete Law in Franchise Litigation

A. Statutory Exceptions: Triggering Exceptions Through the Franchise Agreement?

For a post-term noncompete in a franchise agreement to be unquestionably enforceable under California law, it must fall into one of the statutory exceptions to Section 16600. Again, these statutory exceptions allow enforcement of a noncompete only where the departing business owner exits the enterprise.

Section 16601, for instance, reads:

Any person who sells the goodwill of a business, or any owner of a business entity selling or otherwise disposing of all of his or her ownership interest in the business entity, or any owner of a business entity that sells (a) all or substantially all of its operating assets together with the goodwill of the business entity, (b) all or substantially all of the operating assets of a division or a subsidiary of the business entity together with the goodwill of that division or subsidiary, or (c) all of the ownership interest of any subsidiary, may agree with the buyer to refrain from carrying

65. Id. at 312.
66. Id., quoting J. Kinnicut (trial court).
on a similar business within a specified geographic area in which the business so sold, or that of the business entity, division, or subsidiary has been carried on, so long as the buyer, or any person deriving title to the goodwill or ownership interest from the buyer, carries on a like business therein.68

At first glance, it may appear easy to draft a franchise agreement that complies with an exception by building the sale into the termination provisions. Many franchise agreements require turnover of the franchise to the franchisor upon termination or grant the franchisor purchase rights upon nonrenewal. Either appears to be a sale of at least a “division” of the franchised business and thus appears to satisfy the exception.

1. California is not buying the goodwill reclamation defense.

The lone California court decision on point suggests that a franchisor’s reclamation of a franchisee’s business upon termination does not trigger the Section 16601 exception, because there is no transfer of goodwill from the franchisee to the franchisor in the “sale.” In Scott v. Snelling & Snelling, Inc.,69 the parties entered a franchise agreement that contained a post-term noncompete provision. The noncompete provided that, for a period of two years after termination of the franchise, the franchisees could not operate a competing business within ten miles of any other Snelling franchise location. In addition, it required the franchisees to give Snelling a list of customers and employees before competing outside the ten-mile radius.70 After the relationship disintegrated, the franchisees sued. Both parties filed cross-motions for summary judgment hinging on the enforceability of the noncompete. The franchisor argued that the noncompete was enforceable because the franchisor provided the franchisee “the goodwill which attaches to the franchisor’s name” in the original sale of the franchise.71 The U.S. District Court for the Northern District of California dismissed this argument, holding that a franchise is not a purchase of goodwill, but instead a lease of the franchisor’s goodwill to the franchisee for the term of the franchise agreement, where “the franchisor agrees that the franchisee may benefit from the goodwill for a specified period of time, and for a specified price.”72 Scott further concluded franchise royalties proved the “leased” nature of this goodwill, stating that “the franchisor continues to benefit from its goodwill throughout the franchise relationship, something which would not normally continue after a sale.”73

70. Id. at 1036 n.3.
71. Id. at 1041.
72. Id.
73. Id. The court appears to have parsed Snelling’s argument to mean that Snelling had provided Scott the goodwill associated with the Snelling and Snelling franchise, thus allowing it to enjoin Scott—the buyer of goodwill—from competition. This is the opposite of how Section 16601 operates. Section 16601 allows a buyer of goodwill to enjoin the seller from competition within the geographic area while the buyer continues carrying on a like business therein.
The relevant question is this: if a franchisor exercises contractual rights to reacquire a franchised business after termination or nonrenewal of the franchisee, does it buy the goodwill the franchisee created in the franchised business during the term so that Section 16601 applies, allowing the franchisor to enjoin the former franchisee from competition within the franchise territory? Here, Scott’s lease analysis may prove instructive, because the underlying inquiry requires identifying who owns the goodwill created by a franchisee in the first place.\(^74\)

Franchises are designed for uniformity among franchised units, regardless of the identity of the owner and operator. Franchisees operate under the franchisor’s name, trade dress, and marks, and many customers pay little attention to the fact that a franchise is independently owned and distinct from another franchise within the same system. Consequently, a franchisee seeking to invalidate a noncompete triggered by an on-termination sale has a cogent argument that goodwill in the franchised business inures to the benefit of the franchisor, and the franchisee simply used that goodwill during the term of the franchise—the conclusion reached by Scott’s “lease” analogy. If so, there is no separate goodwill the franchisee can sell to the franchisor upon termination. This poses a significant problem to a franchisor seeking to enforce a post-term covenant not to compete through Section 16601, because the exception requires the exchange of the goodwill of the franchised business as consideration in the sale.\(^75\)

Moreover, a conclusion that part of the goodwill in a franchisee’s business inures to the franchisor during the franchise term suggests a court would simply apply the holding in *Bosley Medical Group v. Abramson* to invalidate a post-term noncompete agreement as a “sham” and an “agreement . . . not to compete with plaintiffs.”\(^76\) *Bosley*, which stands for the proposition that the substance of a transaction will prevail over form in determining the validity of a noncompete agreement, raises at least two hurdles for a noncompete triggered by a post-termination transfer. First, *Bosley* requires the selling franchisee to transfer a “substantial” interest in the business, together with the goodwill therein.\(^77\) If the lion’s share of goodwill in the business already belongs to the franchisor, such that the franchisee lacks substantial goodwill to transfer in an on-termination sale, the noncompete may not qualify as an exception under Section 16601. Second, the court in *Bosley* gave little credence to the stock purchase agreement at issue or its expressly

\(^{74}\) *Bosley*, 161 Cal. App. 3d at 292.

\(^{75}\) The fact that the franchisee also may not receive separate consideration in exchange for the goodwill upon a post-termination takeover likely supports this analysis.

\(^{76}\) *Bosley*, 161 Cal. App. 3d at 292.

\(^{77}\) *Id.* at 290.
stated purpose. It looked right past the language and deemed the agreement a “sham created to avoid the prohibitions of Section 16600.” Thus, a corporation with significantly more bargaining power—i.e., a franchisor—cannot manufacture a sale of business assets and strong-arm a franchisee into agreeing to it, especially if the only result is to avoid Section 16600. If attempted, a franchisor should expect a California court to hold that agreement invalid ab initio.

2. Other states have fared no better in defining who owns a franchise’s goodwill and what happens to it at a termination sale.

Unfortunately, there is no coherent view from other jurisdictions on how to allocate goodwill between a franchisor and franchisee. Commentators have distinguished between “trademark” goodwill and “local” or “customer” goodwill in academic papers, defining the former as the goodwill inherent in the brand owned by the franchisor and the latter as the goodwill in the franchised location built by the franchisee. However, neither these articles nor the cases they draw from point to a unified conclusion as to how to weigh the relative values of trademark goodwill versus local goodwill.

For instance, in his 2013 article Franchise Goodwill: Take A Sad Song and Make It Better, Robert W. Emerson proposed that courts ignore local goodwill entirely and adopt the unified standard that all goodwill in the franchise relationship attaches to the trademark. This proposal stands in stark contrast to the reasoning adopted by Benjamin A. Levin and Richard S. Morrison, who argued in their 1999 article Who Owns Goodwill at the Franchised Location? that local goodwill is a “primary business interest,” even for the franchisor. Adoption of Emerson’s proposal would doom post-termination noncompetes in California—as well as in many other states that require some form of territorial goodwill protection as an element of enforcement—because the franchisee would have no local goodwill to return to the franchisor upon termination.

Relevant case law only reinforces these “inconsistent narratives.” In Lee v. Exxon Co., the U.S. District Court for the District of South Carolina held that the plaintiff franchisee was not entitled to goodwill upon a sale of his business, essentially—as Emerson put it—taking “the position that the franchisee bought only tangible assets and not goodwill.”

79. Emerson, supra note 78, at 409.
80. Levin & Morrison, supra note 78, at 117.
81. Emerson, supra note 78, at 370. The “inconsistent narratives” are franchisor attempts to simultaneously argue that franchisees have no goodwill in their franchises as well as the opposite, depending on the context.
83. Id. at 368.
84. Emerson, supra note 78, at 364.
cuit echoed a similar sentiment in *Pappan Enterprises, Inc. v. Hardee’s Good Systems, Inc.* In *Pappan*, the franchisor terminated the franchisee and sought an injunction against the franchisee continuing to operate under the franchise brand. The court considered only the trademark goodwill held by the franchisor, rejected the franchisee’s argument that he had built up local goodwill in operating as the franchise, and reversed the lower court’s denial of the injunction. Likewise, in *Shell Oil Co. v. A.Z. Services, Inc.*, the U.S. District Court for the Southern District of Florida concluded that trademark goodwill was the relevant driver of patronage to the franchise, finding specifically “that customers are attracted to the Deerfield Beach Shell station primarily by the Shell name and brand and not by AZ [the franchisee].”

Conversely, in *Atlantic Richfield Co. v. Razumic*, the Pennsylvania Supreme Court held that franchisees develop local goodwill in their businesses, which benefits themselves and the franchisor alike:

> An Arco dealer has his own expectations. He knows that his good service will in many instances produce regular customers. He also realizes, however, that much of his trade will be attracted because his station offers the products, services, and promotions of the well-established and well-displayed name “Arco.” Unlike a tenant pursuing his own interests while occupying a landlord’s property, a franchisee such as Razumic builds the goodwill of both his own business and Arco.

Like the Pennsylvania Supreme Court in *Razumic*, many courts appear satisfied that local goodwill does exist for franchised locations. However, these courts do not agree on whether the local goodwill itself ultimately belongs to the franchisee or franchisor. The Texas Supreme Court settled in favor of franchisees owning local goodwill in *Hill v. Mobile Auto Trim, Inc.*, holding:

> However, there exists not only business goodwill but also franchisee goodwill. When people leave a business to work for another or to open a firm of their own, many are capable of taking with them a sizeable number of the clients whom they had served at their previous place of employment. If they were not in possession of some type of personal magnetism or personal goodwill, they would be incapable of retaining those clients or customers. Shrewd employers and franchisors know this and seek to deprive the employee/franchisee of the fruits of his goodwill by requiring that he enter into an agreement containing a restric-

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85. 143 F.3d 800 (3d Cir. 1998).
86. *Id.* at 806.
88. *Id.* at 1417.
89. 390 A.2d 736 (Pa. 1978).
90. *Id.* at 742.
91. See Bray v. QFA Royalties LLC, 486 F. Supp. 2d 1237 (D. Colo. 2007) (distinguishing between trademark and local goodwill and prohibiting franchisor from terminating franchises on the grounds that it would cause irreparable harm to the franchisees’ local goodwill); Arnott v. Am. Oil Co., 609 F.2d 873 (8th Cir. 1979) (franchisee develops local goodwill through operation of franchised business); Hill v. Mobile Auto Trim, Inc., 725 S.W.2d 168, 171 (Tex. 1987), superseded by statute, TEX. BUS. & COM. CODE § 15.50(a) (“there exists not only business goodwill but also franchise goodwill,” referring to both trademark and local goodwill).
tive covenant. The covenant is generally unfair to the employee/franchisee, for when that person is placed in the position of being unable to compete with the former employer/franchisor, his personal goodwill is effectively neutralized.92

Similarly, in *Shakey’s, Inc. v. Martin*,93 the Idaho Supreme Court recognized that franchisees will build up local goodwill “in the minds of the public who patronize the establishment,”94 and in *Bray v. QFA Royalties LLC*, the U.S. District Court for the District of Colorado enjoined Quiznos from terminating franchisees, as the terminations would cause the franchisees to lose the “customer base and community goodwill” the franchisees had built in operating the businesses.95

Other courts have held the franchisor owns local goodwill in franchised businesses. In *Dunkin’ Donuts Inc. v. Dowco, Inc.*,96 the U.S. District Court for the Northern District of New York granted the franchisor’s motion for an injunction to enforce a lease assignment on the grounds that the franchisee’s continued competition under a different brand name harmed Dunkin Donuts’ goodwill in the Dryden, New York, market.97 The Seventh Circuit applied the same analysis in *P.P. & K., Inc. v. McCumber*,98 concluding the franchisor had “developed significant goodwill and good reputation” at the disputed location “in the minds of the consuming public.”99 The U.S. Tax Court has also taken the position that franchisors own local goodwill, having repeatedly ruled against franchisees that seek particular allocations of business sales to goodwill.100

Meanwhile, at least two courts have taken the “lease” approach found in *Scott*. In *Jiffy Lube International, Inc. v. Weiss Bros.*,101 the U.S. District Court for the District of New Jersey held that “good will is, metaphysically, re-conveyed to the franchisor” at the termination of a franchise agreement.102 In *Domino’s Pizza, Inc. v. El-Tan, Inc.*,103 the U.S. District Court for the Northern District of Oklahoma found that “franchise agreements constitute a sale of [the franchisor’s] goodwill for the duration of the franchise agree-

92. *Hill*, 725 S.W.2d at 171–72.
93. 430 P.2d 504 (Idaho 1967).
94. *Id.* at 509.
97. *Id.* at *3*.
98. 46 F.3d 1134 (7th Cir. 1995) (table).
99. *Id.* at *3*.
100. Canterbury v. C. I. R., 99 T.C. 223, 249 (1992) (“We find that petitioners acquired no goodwill that was separate and apart from the goodwill inherent in the McDonald’s franchise.”); Lieb v. C. I. R., 33 T.C.M. (CCH) 1231 (T.C. 1974) (collecting cases and holding “this Court has previously held that where, as here, a business sells brand name products pursuant to a non-transferable franchise which is terminable at will by the franchisor upon sufficient notice, the franchisee can possess no goodwill, for goodwill, if any, is inextricably connected to the franchise and ceases to exist when the franchise terminates”).
102. *Id.* at 691.
ments." Unlike *Scott*, however, both these cases upheld the noncompetes at issue against the franchisees on the grounds that the franchisor had an interest in protecting the leased and returned goodwill. To further muddy the waters, *Domino’s* analyzed the “lease” under an Oklahoma statute allowing for enforcement of a noncompete when ancillary to the sale of goodwill, and explicitly declined to follow *Scott* in reaching the opposite conclusion on functionally identical statutes and facts.

In short, courts and practitioners seeking guidance from other states or commentators will be stymied: there is simply no majority view on how to treat franchise goodwill, let alone any semblance of uniformity.

**B. The California Franchise Relations Act Does Not Preempt Section 16600.**

In *Scott*, the franchisor argued the California Franchise Relations Act (CFRA) preempted Section 16600. Snelling argued the CFRA “manifests legislative intent to exempt franchises from the broad sweep of the language of Section 16600” by banning noncompetes in a nonrenewal, but not a termination. Section 20025 of the CFRA, which governs non-renewals of franchise agreements, directly prohibits enforcement of a post-term noncompete against the former franchisee:

No franchisor may fail to renew a franchise unless such franchisor provides the franchisee at least 180 days prior written notice of its intention not to renew; and . . .

(b)(2) Upon expiration of the franchise, the franchisor agrees not to seek to enforce any covenant of the non-renewed franchisee not to compete with the franchisor or franchisees of the franchisor.

CFRA Sections 20020–20022, however, which govern terminations, contain no such prohibition on noncompete agreements. Based on this distinction, Snelling argued that the CFRA must preempt Section 16600, or the inclusion of a prohibition on noncompetes in CFRA Section 20025 would otherwise be surplusage. Consequently, as CFRA Sections 20020–20022 do not explicitly prohibit post-term noncompetes, a franchisor terminating a franchisee may enforce one.

The district court bluntly rejected this argument, holding that Snelling’s position “by negative implication” was “a contorted interpretation of crystal clear statutory language” and “not an appropriate method of statutory interpretation.” Instead, the court held that it “prefers to follow the more tra-

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104. *Id.* at *1.
112. *Id.*
ditional methodology of statutory interpretation, accepting that the legislature means what it says: Every contract which contains a covenant restraining any person from engaging in a lawful business is to that extent void, including franchise agreements.”

Snelling’s line of argument, however, does give rise to an interesting hypothetical. The CFRA has a non-waiver clause that voids “any condition, stipulation or provision purporting to bind any person to waive compliance with any provision of this law.” Franchise agreements typically obey the CFRA in allowing California franchisees to retain its protections, even though foreign state choice-of-law clauses otherwise apply to disputes. Thus, franchisees facing nonrenewal, as opposed to termination, should get the benefit of the CFRA prohibition on noncompetes in Section 20025 independently of Section 16600. As discussed below, choice of law provisions have the potential to influence the outcome of post-term noncompete enforcement disputes for California franchisees.

C. Circumventing Section 16600 with a Choice-of-Law Clause in the Franchise Agreement Is Not a Likely Solution.

Attempts to avoid Section 16600 through choice-of-law clauses usually fail. The franchise agreement in Scott, for instance, called for Pennsylvania law. The court declined to apply the choice-of-law provision, ruling that “California law will not give force to a choice of law clause where the contract contains a provision which violates a “strong California public policy.”

Although the prohibition on covenants not to compete is a fundamental public policy in California, Scott’s pronouncement is an oversimplification. Like many states, California adopts the Restatement (Second) approach to conflict of laws, which honors a choice-of-law provision unless “application of the law of the chosen state would be contrary to a fundamental policy of a state which has a materially greater interest than the chosen state in the determination of the particular issue and which, under the rule of Sec-

113. Id. at 1040–41.
114. CAL. BUS. & PROF. CODE § 20010.
116. KGB, Inc. v. Giannoulas, 104 Cal. App. 3d 844, 848 (Cal. Ct. App. 1980). Ted Giannoulas was the “San Diego Chicken,” a mascot who became famous for working the stands at San Diego Padres games. KGB, a longtime San Diego classic rock radio station (101.5 FM), created the mascot and hired Giannoulas to play it in 1974. After the Chicken became famous, KGB fired Giannoulas and replaced him with another actor, prompting Padres fans to boo the other mascot out of the stadium. KGB sued in an attempt to prevent Giannoulas from wearing a “competing” chicken suit. See id. at 846–47. Giannoulas prevailed and was still appearing as the Chicken as late as 2016. The suit, however, was not his last brush with the law. He was held liable in 1996 for injuring a Chicago Bulls cheerleader after tackling her at a Bulls game, and he prevailed in a parody-trademark infringement case against Barney the Dinosaur in Lyons Partnership v. Giannoulas, 179 F.3d 384 (5th Cir. 1999).
tion 188, would be the state of the applicable law in the absence of an effective choice of law by the parties.”

Under Section 188 of the Restatement (Second), the state of the applicable law is the state that has “the most significant relationship to the transaction and the parties.” Accordingly, a California franchisee seeking to invalidate a noncompete in the face of a foreign state choice-of-law provision must satisfy three prongs: (1) the noncompete is contrary to fundamental California public policy; (2) California has a materially greater interest than the chosen state regarding noncompetes, and (3) California has the most significant relationship to the transaction and parties.

California litigants have largely been successful in establishing California as the most significant relationship. Although few franchise cases deal with this issue, it surfaces frequently in employment litigation, where out-of-state employers hire California employees under foreign choice-of-law employment agreements. In this line of cases, the California locus of the employee, employment or sales territory and alleged breaches of the disputed noncompete almost always give California a materially greater interest and more significant relationship to the transaction and parties than the contractual choice-of-law state.

Franchise cases with California franchisees are likely to meet similar dispositions, because often the franchised business in question will be located in California, the franchise territory will be located in California, and the disputed breach or anticipated breach of the noncompete will occur in that California territory. Simply put, franchisors should not expect to sustain a post-term noncompete through a foreign state choice-of-law provision against a California franchisee. This is largely true in courts outside California as well. The majority of non-California decisions on point—most of which also use the Restatement (Second) test—apply California law over the forum state choice-of-law provision on fundamental policy and greater interest grounds. Federal district courts in Connecticut, Illinois, Maryland, Massachusetts, New York,

118. Id. at 483, citing RESTATEMENT (2D) CONFLICT OF LAWS § 188.
119. Id. at 464-65, 483; RESTATEMENT (2D) CONFLICT OF LAWS §§ 187-88.
North Carolina,\textsuperscript{126} Ohio,\textsuperscript{127} Texas,\textsuperscript{128} and Utah\textsuperscript{129} have disregarded contractual choice-of-law clauses in the face of a Section 16600 challenge, as have state courts in Delaware\textsuperscript{130} and Texas.\textsuperscript{131}

However, there have been exceptions to this trend. A few non-California federal cases have upheld contractual choice-of-law provisions and declined to invalidate post-term noncompetes on Section 16600 grounds. The major holdout appears to be the U.S. District Court for the Western District of Washington, which has repeatedly ruled in favor of Washington choice-of-law clauses against California employees.\textsuperscript{132}

The most iconoclastic of these cases is \textit{CH2O, Inc. v. Bernier}, which held that California’s interest in voiding noncompete agreements did not materially outweigh Washington’s “strong interest in upholding the justified expectations of the parties to a contract as to their selected governing law,” even though the employee defendants lived and worked in California.\textsuperscript{133} The district court in \textit{CH2O} largely based its decision on the fact that it was applying Washington choice-of-law rules, distinguishing \textit{Scott} on the grounds that the latter “sat in California and therefore applied the choice of law rules of California.”\textsuperscript{134} Other than as a marker of \textit{Scott}'s incomplete analysis, this decision is of questionable logical value, as both states purport to use the Restatement (Second) test.\textsuperscript{135} \textit{CH2O} is otherwise bereft of any reasoning as to why it chose to apply Washington law, and territorialism could have been the overwhelming factor.\textsuperscript{136}

Another string of cases holds that Section 16600 is not fundamental public policy in California—or, more accurately, is an incomplete fundamental public policy—due to the trade secret exception. The U.S. District Court for the District of Massachusetts, in \textit{Shipley Co. v. Kozlowski}, is likely the progenitor of this line. \textit{Shipley} held that the existence of the trade secret exception means that “California law does disfavor non-competition provisions, but

\begin{itemize}
\item \textsuperscript{128} Maxxim Med., Inc. v. Michelson, 51 F. Supp. 2d 773, 781 (S.D. Tex. 1999).
\item \textsuperscript{133} \textit{CH2O, Inc.}, 2011 WL 1485604, at *8.
\item \textsuperscript{134} Id. at *9.
\item \textsuperscript{135} Id. at *8; see Erwin v. Cotter Health Ctrs., 161 Wash. 2d 676, 693–94 (2007).
\item \textsuperscript{136} \textit{CH2O}, 2011 WL 1485604, at *9.
\end{itemize}
California does not have a fundamental policy barring all non-competition clauses.\textsuperscript{137}

\textit{Shipley} predates \textit{Edwards}' cryptic potential disapproval of the trade secret exception, as well as the subsequent \textit{Galante} decision holding that no trade secret exception to Section 16600 exists. Another Massachusetts federal district court case, \textit{Aspect Software, Inc. v. Barnett}, references both \textit{Edwards} and \textit{Galante} and still concludes that, “while California’s policy against non-competition covenants has been characterized as ‘fundamental,’ that fundamental policy does not extend to contractual clauses that are designed to protect an employer’s trade secrets.”\textsuperscript{138} In a footnote, the district court in \textit{Aspect Software} discussed California’s recent antipathy toward the trade secret exception and then promptly ignored it:

More recently, some California courts have questioned the vitality of the \textit{Muggill} line of cases defining the trade secrets exception to Section 16000. See \textit{Edwards v. Arthur Andersen LLP}, 44 Cal.4th 937, 946 n.4, 81 Cal.Rptr.3d 282, 189 P.3d 285 (Cal. 2008) (“[T]his court generally condemns non-competition agreements . . . [but w]e do not here address the applicability of the so-called trade secret exception to Section 16600”); \textit{Dowell v. Biosense Webster, Inc.}, 179 Cal.App.4th 564, 577, 102 Cal.Rptr.3d 1 (Cal.Ct.App.2d Dist., 2009) (“Although we doubt the continued viability of the common law trade secret exception to covenants not to compete, we need not resolve the issue here”); \textit{Retirement Group v. Galante}, 176 Cal. App.4th 1226, 1233–39, 98 Cal.Rptr.3d 585 (Cal. Ct. App. 4th Dist., 2009) (holding that no trade secrets exception exists to Section 16600, and that abuse of trade secrets must be redressed in tort rather than in contract). None of these courts have gone so far as to assert that Section 16600 admits no distinction between non-compete agreements tailored to protect trade secrets and broader non-compete agreements, or that any emergent prohibition on the former is as fundamental to California’s policy as California’s longstanding prohibition on the latter.\textsuperscript{139}

\textit{Aspect Software}’s conclusion that “[n]one of these courts have gone so far as to assert that Section 16600 admits no distinction between non-compete agreements tailored to protect trade secrets and broader non-compete agreements” is particularly curious in light of its immediately preceding recitation that “\textit{Galante} [held] no trade secrets exception exists to Section 16600.”\textsuperscript{140}

Again, the most plausible explanation may be territorial protectionism. If Section 16600 is not truly a fundamental public policy of California, it is much easier to support application of Massachusetts law.

The U.S. District Court for the Eastern District of Michigan also adopted the \textit{Shipley} reasoning in \textit{Lowry Computer Products, Inc. v. Head}.\textsuperscript{141} \textit{Lowry}, which also predates \textit{Edwards}, dismissed the defendant-employee’s argument on two prongs of the Restatement test: (1) Section 16600 was not a fundamental public policy due to the trade secret exception, and (2) Michigan

\textsuperscript{139} Id. at 126 n.6.
\textsuperscript{140} Id.
had a materially greater interest in the dispute in “protecting . . . businesses from breaches of employment agreements and consequent losses of goodwill,” as well promoting “the uniform interpretation of employment contracts.”142

New York, meanwhile, has a pair of outlier cases that analyze the competing interests by relying on the state’s explicit perception of itself as simply more important than California.143 In Estee Lauder Companies Inc. v. Batra, the U.S. District Court for the Southern District of New York recognized Section 16600 as fundamental public policy but concluded that New York’s interest was materially greater than California’s because of “New York’s recognized interest in maintaining and fostering its undisputed status as the preeminent commercial and financial nerve center of the Nation and the world.”144 The court further explained:

That interest naturally embraces a very strong policy of assuring ready access to a forum for redress of injuries arising out of transactions spawned here. Indeed, access to a convenient forum which dispassionately administers a known, stable, and commercially sophisticated body of law may be considered as much an attraction to conducting business in New York as its unique financial and communications resources.145

In Ayco Co., L.P. v. Frisch, the U.S. District Court for the Northern District of New York adopted both the Shipley and Batra lines of reasoning, holding that the trade secret exception undermined the fundamental public policy argument and New York’s commercial importance outweighed California’s interest in protecting employees.146

These decisions hold out a small beacon of hope to franchisors, but they are in the clear minority and require the franchisors to have contacts with Washington, Massachusetts, or New York sufficient for those states to have a material interest in the litigation. Such contacts likely include corporate residency and domicile in those states. The hope also may be short-lived, given the direction California courts have taken regarding the trade secret exception. Assuming California courts continue to be hostile to the trade secret exception—an outcome all but dictated by Edwards’ refusal to consider exceptions to the statute created by “judicial fiat”147—other courts will have less leeway to consider Section 16600 anything except fundamental public policy. New York’s assertion of material interest through self-importance, however, may remain intact.

Other courts have rejected Section 16600 challenges on even shakier foundations. In Baskin-Robbins Inc. v. Patel, the U.S. District Court for the

142. Id.
145. Id.
147. Edwards, 44 Cal. 4th at 949.
Northern District of Illinois errantly followed the narrow restraint exception, holding:

California is not as friendly to non-compete clauses, but would most likely uphold this clause as well. Under California law a contract that restrains someone from engaging in a lawful profession, trade, or business of any kind is void. West's Ann. Cal. Bus. & Prof. Code, § 16600. There is an exception to this provision when the contract only restricts someone from a small or limited part of the business or profession. Boughton v. Socony Mobil Oil Co., 231 Cal.App.2d 188, 41 Cal. Rptr. 714, 716 (1964); IBM v. Bajorek, 191 F.3d 1033, 1040 (9th Cir.1999); General Commercial Packaging v. TPS Package Engineering Inc., 126 F.3d 1131, 1134 (9th Cir. 1997) (one-year covenant to not work for customers introduced in former employment enforceable).148

Another case from the Northern District of Illinois, Budget Rent A Car Corp. v. G & M Truck Rental, also cites Patel for the “narrow restraint” exception.149 These holdings are clearly wrong post-Edwards, which expressly disapproved the three cases Patel cites,150 and franchisors should not rely on another court to err in this manner.151

Finally, arbitration extends the franchise community a sanctioned path to what the author believes is an incorrect outcome. Paul Green School of Rock Music Franchising, LLC v. Smith featured a multi-jurisdictional battle between Paul Green School of Rock Music, a Pennsylvania music instruction franchisor, and Jim Smith, a Los Angeles-area franchisee. Following a dispute over the franchise curriculum, royalties, and practices, School of Rock filed a demand for arbitration against Smith in Pennsylvania. Smith countered by filing suit in the U.S. District Court for the Central District of California, seeking to compel arbitration in California and to stay the Pennsylvania proceedings.152

Smith argued that his franchise agreement “seeks to negate the California Franchise Investment Law (CFIL), an unwaivable statute, via tandem Pennsylvania forum selection and choice of law provisions.”153 The court disagreed, noting that “Smith’s reliance on California Business and Professions

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148. 264 F. Supp. 2d 607, 610 (N.D. Ill. 2003). Patel appears to have used the “narrow restraint” exception to determine that no conflict existed between California law, which the franchisees sought, and Massachusetts law, which Baskin-Robbins demanded. In conflict situations, Illinois follows the Restatement test. See also Morris B. Chapman & Assoc., Ltd. v. Kitzman, 193 Ill. 2d 560, 568 (2000).


150. Edwards, 44 Cal. 4th at 949–50.

151. Oddly, despite the narrow restraint exception, the franchisors lost their bids for injunctions in both Patel and Budget Rent A Car. In Patel, the franchisor was unable to show irreparable harm, while in Budget Rent A Car, the balance of harm favored the franchisee. Patel, 264 F. Supp. 2d at 611–12; Budget Rent A Car, 2003 WL 21501784, at *6.


153. Id. at *4.
Code § 20040.5 in support of this argument is misplaced," but ordered that Smith “must be able to pursue his CFIL rights and remedies during arbitration in the Pennsylvania forum.”

There is no indication from the record that Smith raised Section 16600 to contest the Pennsylvania choice-of-law clause in School of Rock I, and the court states that “[n]o other reason has been identified to deny enforcement of the forum selection and choice-of-law provisions.” In the ensuing arbitration, the franchisor prevailed. The arbitrator issued an award that enforced the post-term noncompete in the franchise agreement, preventing Smith from operating a competing business within ten miles of his territory for two years after termination.

When the franchisor sought confirmation of the award in the U.S. District Court for the Eastern District of Pennsylvania, Smith demanded vacatur on the grounds that the arbitrator “manifestly disregarded” Section 16600 by enforcing the noncompete. Here, Smith was stymied by the narrow argument in School of Rock I. The Pennsylvania federal court determined that School of Rock I had already held the Pennsylvania choice-of-law clause valid, and as “it does not appear that the arbitrator was under any contingency to apply California law in this instance,” it would “not independently presume that California Business & Professions Code should have been applied by the arbitrator.” School of Rock II further held that, because the franchisor had argued for the existence of the trade secret exception in arbitration, the arbitrator could have determined the exception both existed and applied. This, in turn, provided sufficient factual and legal support for the award to overcome vacatur on manifest disregard grounds, whether or not it was correct.

On appeal, the Third Circuit affirmed confirmation of the award, holding that School of Rock I held the Pennsylvania choice-of-law clause valid and enforceable. Moreover, the court held:

The District Court need not have determined that Pennsylvania law applies to the restrictive covenant. Rather, it would have been enough to find that the arbitrator did not willfully flout known, governing law in reading School of Rock I to hold that California law does not apply to the restrictive covenant. Here, the arbitrator plainly did not willfully flout known, governing law, because, as the District Court observed, Section 16600 is not part of the CFIL.

154. Id. at *4 n.7. Either Smith or the court confused two separate California franchise laws. Section 20040.5 is part of the California Franchise Relations Act (CAL. BUS. & PROF. CODE §§ 20000 et. seq.), not the Franchise Investment Law (CAL. CORP. CODE §§ 30000 et. seq.).
156. Id.
159. Id. at *3.
160. Id.
161. School of Rock III, 389 F. App’x at 178.
School of Rock is another outlier case, distinguishable in that an arbitrator determined the noncompete was enforceable. Arbitrators are not bound to the law to the same degree as courts, especially where conflicting precedent may exist, and courts are understandably loathe to vacate arbitration awards in the wake of AT&T Mobility LLC v. Concepcion. Consequently, arbitration is a black box, and cases confirming arbitration awards are a far less predictable metric for assessing the health of Section 16600 than those that originate outside arbitration. The School of Rock cases may have been entirely different had Smith challenged the Pennsylvania choice-of-law clause on Section 16600 grounds in School of Rock I, where a California federal district court would have decided the issue without the hurdle of an arbitration award to vacate.

Conclusion

California law bans post-term covenants not to compete, and California courts have taken overt steps to further restrict their use in the last decade. These have included wholesale disapproval of the narrow restraint exception and clear antagonism towards the trade secret exception.

Although federal and non-California state courts have occasionally enforced post-term noncompetes against California litigants through evasion or unawareness of current California law, franchisors seeking to remain in compliance with the state’s dictates are left with the stark reminder that post-term noncompetes are at best unlikely to be enforced, and at worst may subject them to substantial damages for the attempt. Noncompetes drafted into franchise agreements are unlikely to satisfy the statutory exceptions to Section 16600 required to render them enforceable, because no real transfer of goodwill occurs from departing franchisee to franchisor in relinquishing the business. Franchisors should not rely on the trade secret exception, which is of dubious existence, nor should they attempt to enjoin competition on the grounds that it will lead to the inevitable disclosure of their confidential information. Instead, they are limited to seeking injunctive relief for tortious appropriation of trade secrets, and only after actual misappropriation or an imminent threat of misappropriation has occurred.
Unconscionability in Franchising

David Gurnick and Sam Wolf

In a classic fairy tale, a miller lies to a king, claiming his beautiful daughter can spin straw into gold. The king locks the girl in a room, filled with straw and a spinning wheel. The king offers her marriage if she fills the room with gold, and death if she cannot. Then, a deal-making imp appears. He offers to turn the straw into gold in exchange for her promise to give him her firstborn child. The deal is made. The imp performs. The king performs his promise and marries the girl.

Later, the royal couple’s first child arrives and the imp returns for payment. But the queen resists. The imp agrees to give up his claim if she can guess his name. The queen’s spy overhears the imp utter his name and reports back. When the imp returns again, the queen, pretending to guess, correctly states, “Rumpelstiltskin.” The imp loses his temper and, depending on the version, leaves and is never heard from again, or destroys himself.1

Inherent in this tale is that the girl accepted the deal under threat of death. She would be executed if she did not produce gold, which she had no ability to do. The girl had no real choice. And the deal she was offered, forfeiting her child, was outside the bounds of decency and humanity. One need not be a legal scholar to recognize a key element of this tale by the Brothers Grimm. The agreement was unconscionable.

Yet, some readers and commentators suggest the true victim was the imp. The father lied, claiming falsely that his daughter could spin straw into gold. The king acted unjustly and greedily, locking up the girl and threatening death if she did not perform. The queen reneged on her promise. Rumpelstiltskin

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offered a deal to save the girl’s life and then fully performed his promise, working all night to do the impossible. That is, spin a room full of straw into gold. Thanks to the imp, the girl survived and became queen! Rumpelstiltskin returned to claim only what had been agreed.\(^2\)

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2. See Martin Miller, *Poor Rumpelstiltskin*, PSYCHOANALYTIC Q. (1985) 73, 75 (psychoanalyst recounts patient who “felt sorry for the little man who had struck a bargain but had then been outmaneuvered by this woman.” The patient felt “he made a deal and he was cheated.”); Alicia Hunter Pace (aka Jean Hovey and Stephanie Jones), *Rumpelstiltskin: Villain or Victim* (posted Oct. 22, 2012), http://okaylistenhere.blogspot.com/2012/10/rumpelstiltskin-villain-or-victim.html (last visited Apr. 4, 2018); comment posted by Muckraker in *The Escapist* (posted Apr. 15, 2011), www.escapistmagazine.com/forums/read/18.279509-Poll-Rumpelstiltskin-Villain-or-Victim (last visited Apr. 4, 2018) (“I [propose] that Rumpelstiltskin is the victim in this classic fairy tale”).
Literature and history are filled with various forms of “deals with the devil.” Today, the 1626 Dutch purchase of Manhattan Island from Native Americans for sixty guilders worth of goods is often criticized. The popular concerns are for an unfair price for a large valuable real estate parcel, and sellers who did not understand the transaction. But it is apparently human nature to sometimes make deals that accept present benefits, without calculating fully or appreciating the total cost of a price to be paid in the future.

The Native Americans who sold Manhattan to the Dutch did not seek to undo the deal. But the miller’s daughter, other fairy tale victims of unfair bargains, and in real life many contracting parties have sought relief from grossly unfair, unconscionable agreements. This article discusses the history and contours of the doctrine of unconscionability with particular focus on California because of its importance to the American economy in general and to the franchise industry in particular because of its large population, geographic size, and economy.

I. History of the Unconscionability Doctrine

It is axiomatic that parties who propose contract terms seek to benefit themselves, and lawyers who draft agreements seek to further their clients’ objectives. Our economic system is premised on the principle that self-
interested free exchange benefits everyone. A recent article notes that little in the professional code prohibits lawyers from drafting unfair, oppressive, and one-sided contract provisions and that it is not unethical for lawyers to assist clients in imposing an unconscionable term. This does not mean drafters ignore the interests of the other side. But overreaching is often possible and tempting in drafting agreements.

Nowhere is this more evident than in franchise agreements. Practitioners and others involved in franchising are well aware that franchise agreements are often lengthy pre-printed forms. Their terms typically seek to advance, favor, and protect the interests of the franchisor. As a California court stated, “such contracts are sometimes so one-sided, with all the obligations on the franchisee and none on the franchisor, as not to be legally enforceable.”

Although franchising is a relatively modern business method, the existence of one-sided agreement is nothing new. From time immemorial, laws and courts have been called upon to protect weaker parties against overreaching. Roman law allowed a contracting party to have a sale set aside if the disproportion between the values exchanged was greater than two to one or, stated differently, if the price was less than half the true or proper price.

In the 1600s in England, a defendant agreed to buy a horse for grains of barley corn: one grain for the first nail in the horse’s shoe, two grains for the second nail, and so on. The horse’s shoes had 32 nails, which made the price an astronomical 4,000 bushels of barley. Enforcement was refused.

8. See, e.g., Sumeet H. Chugani & Xingjian Zhao, Making Capitalism More Creative: The Tempestuous Marriage of Sentiment and Self-Interest, 22 PAC. MCGEORGE GLOBAL BUS. & DEV. L.J. 333, 335 (2010) (“Capitalism, as it is understood today, encapsulates Adam Smith’s notion of rational self-interest guided by ‘an invisible hand’ to direct industry in a profit-maximizing manner. Although the selfish individual intends to promote his own gain, by doing so, he frequently dictates an end that benefits society as a whole.” Or, to put it another way, “to promote an end which was no part of [the agent’s] intention . . . by pursuing his own self-interest he frequently promotes that of the society more effectually than when he really intends to promote it.” (citing ADAM SMITH, THE WEALTH OF NATIONS 112, 184 (Penguin Classics 1999) (1776)).

9. Hazel Glenn Beh, Curing the Infirmities of the Unconscionability Doctrine, 66 HASTINGS L.J. 1011, 1025–26 (2015). The author notes that the ABA House of Delegates “rejected the portion of [Model] Rule 1.2(d) that would have prohibited drafting a clearly unconscionable clause in a contract.” And, “in the interest of one’s client, it is permissible to include provisions that test the limits of the law.” Id. at 1028 (citing Christina L. Kunz, The Eshibis of Invalid and “Iffy” Contract Clauses, 40 LOY. L.A. L. REV. 487, 494–95 (2006)).

10. Carrington, supra note 6, at 371 (noting lawyer’s impulse to think of drafting as adversarial, in disregard of rights of other contracting parties who may be illiterate, ignorant, disabled, inattentive, improvident, or weak; the author also describes an incident early in his career in which he succumbed to the temptation to draft an unfair agreement: “I was serving as a tool of deceit and injustice.”).


The court directed the jury to award as damages, the value of the horse, 8 pounds. This decision was looked to in a later case in which an English court stated what has become one of the classic definitions of unconscionability: an agreement “such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other.” In another case, a British court refused to enforce an agreement that a 2,000 pound loan would be repaid at 5,000 pounds if the debtor’s father died, but the loan would be forgiven if the debtor died before his father. The court found this to be an “unconscionable bargain” and ordered the lender to return all monies collected, except the original 2,000 pounds and interest.

In *Hume v United States*, the U.S. Supreme Court invoked the doctrine of unconscionability to protect the U.S. government from being required to pay $1,200 a ton for shucks worth no more than $35 a ton. The Court ruled that the plaintiff could recover only the market value of the shucks. In 1942, Justice Frankfurter wrote in a dissenting opinion in *United States v. Bethlehem Steel Corp.* that courts would not enforce a bargain where one party unconscionably took advantage of the necessities and distress of the other. Justice Frankfurter’s opinion added that this principle had been found in a variety of cases.

By the 1940s, drafters of the Uniform Commercial Code, then known as the Uniform Sales Act, were concerned about the increasing use of form agreements prepared by one party that were signed without having been

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18. “Shuck” refers to an outer covering of a nut or of an ear of corn, or the shell of an oyster or clam. The *Hume* decision does not specify which kind of shucks were involved. *Shuck*, MERRIAM-WEBSTER DICTIONARY, https://www.merriam-webster.com/dictionary/shuck (last visited May 11, 2018).
21. Id. (Justice Frankfurter’s opinion discussed and cited several Supreme Court, English, and state supreme court decisions supporting this proposition); see also Banaghan v. Malaney 85 N.E. 839, 840 (Mass. 1908) (specific performance of contract to convey property denied where contract, though good on its face, was result of plaintiff taking undue advantage of defendant); Chute v. Quincy 30 N.E. 550, 551 (Mass. 1892) (specific performance denied where defendants agreed to sell land for about one-third of the price they supposed they were getting; “specific performance may be refused upon when a contract is hard and unreasonable so that enforcement of it would be oppressive to the defendant”); Hodge v. Mackintosh 143 N.E. 43, 45 (Mass. 1924) (affirming denial of specific performance that would result in unconscionable gain).
II. Modern Development of the Unconscionability Doctrine

The 1960s was a time of increased attention to the interests of consumers. The modern doctrine of unconscionability can be traced to a decision from this era by the District of Columbia Court of Appeals: *Williams v. Walker-Thomas Furniture*. Ms. Williams, who supported 7 children and received government aid, defaulted on her payments for a stereo. The contract let the furniture store, which knew her situation, repossess all items she had bought since 1957. The contracts were structured so that none of the items purchased would ever be fully paid for until Ms. Williams fully paid off every item she had purchased. The court found this to be unconscionable.

California’s entertainment industry generated an important unconscionability decision after the adoption of Section 2-302 of the Uniform Commer-

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22. In 1943, the drafting committee comment to the statute that became Section 2-302 of the Uniform Commercial Code and California Civil Code Section 1670.5 stated: “the situation which gives rise to the section is the increasing use of forms prepared by one party which are not in fact examined by the other at the time of contracting.” Informal Appendix to Revised Uniform Sales Act, Third Draft, 1943, Tentative Sketch of Material for Comments (1943) (quoted in Arthur Leff, Unconscionability and the Code: The Emperor’s New Clause, 115 U. PENN. L. REV. 485, 492 (1967)).

23. H.G. Prince, Unconscionability in California: A Need for Restraint and Consistency, 46 HASTINGS L.J. 459, 469–70 (1995). In one of the cases cited by the early drafters, *Austin Co. v. Tillman Co.*, 209 P. 131 (Or. 1922), the governing contract was not a preprinted form, but was a letter written by the party who ultimately challenged its terms. See discussion of the *Austin Co.* decision in Leff, supra note 22, at 502 and 502 n.56.


25. See, e.g., Philip Kotler, What Consumerism Means for Marketers, HARV. BUS. REVIEW 48 (May–June 1972) (describing distinct consumer movements in the early 1900s, 1930s, and mid-1960s, and noting the movement of the 1960s “resulted from a complex combination of circumstances,” including “increasingly strained relations between standard business practices and long-run consumer interests”). The 1960s was also the time frame when the California Legislature held hearings leading to enactment in 1970 of the first Franchise Investment Law (SB 647, approved by Governor Ronald Reagan on September 18, 1970).

26. 350 F.2d 445 (D.C. Cir. 1965). This decision has been referred to as seminal on the subject of unconscionability. See, e.g., Fotomat Corp. of Fla. v. Chanda, 464 So. 2d 626, 628 (Fla. Dist. Ct. App. 1985) (also noting that *Williams* concerned a contract entered into before adoption by Congress of the Uniform Commercial Code for the District of Columbia, but decided after its adoption); see also Luna v Household Fin. Corp. III, 236 F. Supp. 2d 1166, 1183 (W.D. Wash. 2002) (noting *Williams* is the “seminal opinion regarding unconscionability”).


cial Code in 1979. The plaintiff was not a consumer, but an experienced concert promoter, Bill Graham. Graham agreed to provide services for concerts featuring a prominent singer. Contracts were prepared on a standard form of the American Federation of Musicians union. The contracts said disputes would be decided by the union’s international executive board or similar board of a union local. When one concert lost money, the parties disputed who was responsible to bear the loss and whether profit from one concert could offset loss from another.

Without a hearing, the union’s international executive board issued an award of $53,000 against Graham. Graham’s counsel was able to get the matter reopened and set for hearing. The hearing took place before a former union officer. The officer refused to allow a court reporter. The officer recommended that Graham be ordered to pay the same amount, $53,000, and the international executive board awarded this amount. A trial court confirmed the award.

The California Supreme Court reversed. The court found the contract was adhesive. Graham, despite being prominent and successful as a concert promoter and having “considerable bargaining strength,” was nonetheless in this venture “reduced to the humble role of adherent.” The union’s rules prohibited members from signing any form of contract other than the union’s form. Graham “was required by the realities” of the business to sign the union’s form contract with any concert artist he wished to promote. Therefore, he had only the “nonnegotiable option of accepting” the union’s terms, “or not at all.”

The court then considered the substance of the arbitration clause. The court found the provision lacked even a “minimum level[] of integrity” because it designated as the decision-maker one “so identified with the party as to be in fact, even though not in name, the party.” The court stated that the “minimum levels of integrity” that are requisite to a contractual arrangement for the non-judicial resolution of disputes “are not achieved by an arrangement which designates the union of one of the parties as the arbitrator of disputes arising out of employment especially when, as here, the arrangement is the product of circumstances indicative of adhesion.”

Another key unconscionability decision from California is A&M Produce Co. v. FMC Corp. FMC manufactured and sold expensive equipment to A&M, which was a farming company. The sale contract, which was sent by mail, contained disclaimers of warranties and of consequential damages.

30. Id. at 813.
31. Id. at 818.
32. Id. at 818–19.
33. Id. at 819.
34. Id. at 825 (A union official was designated to decide a dispute between the promoter and the performers, who were union members).
35. Id. at 827.
The farming company’s owner signed and returned the contract with a down payment. The equipment did not work and caused damage to the farming company’s crop. A&M offered to return it for a refund. FMC declined and demanded full payment. A&M then sued to recover damages based on FMC’s breaches of warranties. The trial court ruled that it would be unconscionable to enforce the disclaimer provisions, added that they were not set out conspicuously, and did not allow the jury to see them. The jury made a substantial award in favor of the farming company, A&M.

The Court of Appeal affirmed. The court stated that unconscionability “is a flexible doctrine designed to allow courts to directly consider numerous factors which may adulterate the contractual process.”37 Quoting from Williams, the court noted that unconscionability “has generally been recognized to include an absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.”38 The court explained that this has both a “procedural” and a “substantive” element.39

The court then explained these elements. The procedural element focuses on oppression and surprise. Oppression arises from an inequality of bargaining power that results in no real negotiation and an absence of meaningful choice. Surprise involves the extent to which contractual terms are hidden in a long printed form drafted by the party seeking to enforce the disputed terms. Typically, although not always, the form contract is drafted by the stronger party.40 The substantive element concerns terms that are overly harsh or generate one-sided results, possibly with an absence of justification for the result, or that allocate risks of a bargain in an objectively unreasonable or unexpected manner. The greater the unfair surprise or inequality of bargaining power, the less unreasonable the risk reallocation that will be permitted.41

The Graham and A&M decisions reflect a leap of the unconscionability doctrine from the consumer context in Williams to commercial relationships. The A&M court noted that the dispute arose in a commercial context and that generally, “courts have not been solicitous of businessmen in the name of unconscionability.”42 In the court’s view, this was because business people have more commercial understanding and economic strength than ordinary consumers; therefore, it was harder for business people to show unfair surprise or unequal bargaining power.43

But, the court added, with “increasing frequency,” courts recognized “that experienced but legally unsophisticated businessmen may be unfairly sur-
prised by unconscionable contract terms . . . and that even large business en-
tities may have relatively little bargaining power, depending on the identity
of the other contracting party and the commercial circumstances surround-
ing the agreement.”44 The court clearly endorsed the use of unconscionabil-
ity in commercial disputes involving unsophisticated victims. Harking to the
Smithian view of the benefits of free exchange, the A&M court added that
“social benefits associated with freedom of contract are severely skewed
where it appears that had the party actually been aware of the term to
which he ‘agreed’ or had he any real choice in the matter, he would never
have assented to inclusion of the term.”45 The appellate court found the dis-
claimers to have been unconscionable and affirmed the trial court’s
decision.46

In a 1990s trial that received wide media attention, humorist Art Buch-
wald sued Paramount Studios. Buchwald claimed the successful Paramount
film Coming to America, starring Eddie Murphy, was based on his idea.47
The Los Angeles County Superior Court ruled in Buchwald’s favor.48 He
thus became eligible to receive a share of the film’s net profits.49 But the stu-
dio claimed the film, though it earned over $160 million in gross revenue at
the time, had no profit, and claimed that under the studio’s accounting, it
had so far lost millions of dollars.50

Art Buchwald challenged the studio’s accounting as unconscionable. But
Buchwald was an experienced, well-known writer and personality. Moreover,
he had been represented by a professional agent. Through their agent, Buch-
wald and his partner had been the ones to propose the term they challenged as
unconscionable.51 However, they had proposed the term knowing the provi-
sion was Paramount’s standard term.52

The trial court found that the agreement had not been freely negotiated;
Buchwald and his partner, despite their prominence, did not have enough

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44. Id. at 489–90.
45. Id. at 490.
46. Id. at 497.
47. Prince, supra note 23, at 524 n.6.
(Statement of Decision–First Phase) (finding that Coming to America was “based upon” Buch-
wald’s screen treatment); Id. (Dec. 21, 1990) (Tentative Decision–Second Phase) (holding cer-
tain provisions of Paramount’s net profits formula unconscionable); Id. (Mar. 16, 1992) (State-
ment of Decision–Third Phase) (setting plaintiffs’ award at $900,000). The trial court opinions
in the three phases of Buchwald v. Paramount Pictures are reprinted as appendices in Pierce
O’Donnell and Dennis McDougal, Fatal Subtraction: The Inside Story of Buchwald v. Paramount
49. See discussion in Adam J. Marcus, Buchwald v. Paramount Pictures Corp. and the Future of Net
50. Id. at 559.
51. Id. at 561–62.
clout to negotiate a better deal. The court found the accounting provisions to be overly harsh and one-sided.

Some words and phrases used by courts in characterizing unconscionable contract terms include “shocks the conscience,” “unreasonably favorable to the other party,” “overly harsh,” “unduly oppressive,” “unfairly one-sided,” “unreasonably favorable to the more powerful party,” “that seek to negate the reasonable expectations of the nondrafting party,” and “unreasonably and unexpectedly harsh having to do with central aspects of the transaction.”

The California Supreme Court recently summarized formulations of substantive unconscionability. The court said “the core concern of the unconscionability doctrine is the absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party.” The doctrine assures that contracts do not impose terms that have been described as “overly harsh,” “unduly oppressive,” “so one-sided as to shock the conscience,” or “unfairly one-sided.” These formulations indicate that unconscionability is concerned with terms that are “unreasonably favorable to the more powerful party, which include provisions that negate the reasonable expectations of the nondrafting party, or unreasonably and unexpectedly harsh terms having to do with ‘central aspects of the transaction’.”

The doctrine has further developed in California as an unexpected consequence of another, unrelated legal development, the Federal Arbitration Act (FAA). The FAA reversed a common law hostility toward arbitration clauses. Since the U.S. Supreme Court’s 1984 decision in Southland Corp. v. Keating, the FAA has been read as embodying a “national policy favoring arbitration.”

53. Id.
56. Sonic-Calabasas, 57 Cal.4th at 1145.
57. Id.
58. Id.
61. See id. at 194.
The FAA severely limits the grounds for rejecting an arbitration clause or arbitration award. The FAA provides that a written agreement to arbitrate in a contract involving interstate commerce is “valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.” The Supreme Court interpreted this provision to mean that state law controls the issue of contract revocation. Therefore, a party seeking to resist an arbitration clause was relegated to state law grounds for challenging an agreement on the bases of fraud, duress, and unconscionability.

Fraud and duress are particularly difficult grounds to prove in a business context, especially in a franchise context, and especially with regard to an arbitration clause. Fraud is a disfavored cause of action. And with the existence of Franchise Disclosure Documents and cooling-off periods, duress is likely difficult to prove because any claim for duress requires proof that the innocent party had no reasonable alternatives to the terms presented by the wrongdoer. The unavailability of fraud and duress left the franchisee with the avenue of unconscionability as a basis to challenge arbitration clauses. Thus, a number of decisions emerged where franchisees invoked the doctrine to challenge arbitration clauses.

Building upon those decisions, the doctrine of unconscionability has been applied to negate other types of provisions. Cases can now be found in California relieving victims from oppressive contract terms relating to arbitration and other matters, such as limitations of liability, indemnification,

62. Id. at 10.
63. Id. at 16.
64. Johnson v. State Bar of Cal., 268 Cal.App.2d 437, 444 (Cal. Ct. App. 1968) (“Fraud actions have been classed as disfavored, and are subject to strict requirements of particularity in pleading.”).
65. Tarpy v. Cty. of San Diego, 110 Cal.App.4th 267, 277 (Cal. Ct. App. 2003) (“Economic duress does not necessarily involve an unlawful act, but may arise from an act that is so coercive as to cause a reasonably prudent person, faced with no reasonable alternative, to agree to an unfavorable contract.”).
66. See, e.g., Bridge Fund Capital Corp. v. Fastbucks Franchise Corp., 622 F.3d 996, 1005 (9th Cir. 2010) (holding a venue clause in arbitration provision was likely unconscionable under California law); Indep. Ass’n of Mailbox Ctr. Owners, Inc. v. Super. Ct., 133 Cal. App.4th 396, 417 (Cal. Ct. App. 2005) (holding a ban on arbitration damage limitations and group arbitration was unconscionable under California law); Nagrampa v. Mailcoups, 469 F.3d 1257, 1282 (9th Cir. 2006) (under California law, forum selection clause in arbitration provision was unconscionable because it required arbitration “only a few miles from [the employer’s] headquarters, but three thousand miles away from Nagrampa’s home”); Bolter v. Super. Court, 87 Cal.App.4th 900, 910 (Cal. Ct. App. 2001) (forum selection clause in arbitration provision was unconscionable under California law).
67. Lhotka v. Geographic Expeditions, Inc., 181 Cal.App.4th 816 (Cal. Ct. App. 2010). A 37-year-old man died of altitude-related illness on a trek to climb Mt. Kilimanjaro. His contract with the tour company provided for a general release of liability and an agreement to mediate any disputes with each party bearing 50% of the costs. If mediation failed, the clause required arbitration under the rules of the American Arbitration Association with the hearings to be held in San Francisco and for California law to govern. Finally, the clause provided for a maximum recovery of the sum of land and air costs paid to the tour company for the trip. The court noted that the contract involved a non-essential recreational activity, but went on to note that it was presented on a take it or leave it basis with no changes allowed and that the terms were one-sided.
forfeiture,\textsuperscript{69} judicial reference,\textsuperscript{70} and the requirement to give notice before filing suit.\textsuperscript{71}

Under California law, an evaluation of potential unconscionability is highly dependent on context. California courts give the parties a reasonable opportunity to present evidence as to the provision’s commercial setting, purpose, and effect, and then examine the context in which the contract was formed and the circumstances of the parties as they existed at the formation of the agreement.\textsuperscript{72}

The case law and statutory authority suggest that unconscionability may be more readily available in California than franchisees are aware. For example, courts in California are often willing to find procedural unconscionability from the existence of a typical standard form contract.\textsuperscript{73} Moreover, California has established a lower burden for demonstrating procedural unconscionability. The procedural component can be established by either “oppression” or “surprise.” The court in \textit{A&M} clearly said “or” in noting “social benefits of freedom of contract are severely skewed where it appears that had the party actually been aware of the term to which he “agreed” [i.e., surprise] or had he any real choice in the matter [i.e., oppression], he would never have assented to inclusion of the term.”\textsuperscript{74} Reviewing the \textit{Graham} decision, the \textit{A&M} court noted that in \textit{Graham} “surprise” was absent, but oppression was present. This was because Graham “was forced to accept the contract without negotiation.”\textsuperscript{75} Thus, oppression (even without surprise) met the procedural aspect of unconscionability. In an employment case, a California Court of Appeal found procedural unconscionability even though the party was represented by a lawyer in negotiations.\textsuperscript{76}

\begin{itemize}
\item \textsuperscript{71} Soltani v. W. & S. Life Ins. Co., 258 F.3d 1058 (9th Cir. 2001).
\item \textsuperscript{72} See Comment 3 of the Legislative Committee Comment to Cal. Civ. Code Section 1670.5(b); Tompkins v. 23andMe, Inc., 840 F.3d 1016, 1023 (9th Cir. 2016) (“California courts give the parties a reasonable opportunity to present evidence as to [the provision’s] commercial setting, purpose, and effect . . . and then examine the context in which the contract was formed and the respective circumstances of the parties as they existed at the formation of the agreement”); Perdue v. Crocker Nat’l Bank, 38 Cal.3d 913, 926 (Cal.1985) (“unconscionability often cannot be determined merely by examining the face of a contract, but will require inquiry into its [commercial] setting, purpose, and effect”).
\item \textsuperscript{73} See, e.g., Postal Instant Press v. Sealy, 43 Cal.App.4th 1704, 1716 (Cal. Ct. App. 1996) (“franchising involves the unequal bargaining power of franchisors and franchisees and therefore carries within itself the seeds of abuse. Before the relationship is established, abuse is threatened by the franchisor’s use of contracts of adhesion presented on a take-it-or-leave-it basis.”); Nagrampa v. Mailcoups, 469 F.3d 1257, 1282 (9th Cir. 2006) (“California courts have long recognized that franchise agreements have some characteristics of contracts of adhesion because of the vastly superior bargaining strength of the franchisor.”).
\item \textsuperscript{74} A & M Produce Co. v. FMC Corp., 135 Cal.App.3d 473, 490 (Cal. Ct. App. 1982).
\item \textsuperscript{75} Id. at 488.
\item \textsuperscript{76} Nyulassy v. Lockheed Martin Corp., 120 Cal.App.4th 1267, 1283–84 (Cal. Ct. App. 2004) (“[W]e are not prepared to say that the mere fact that plaintiff was represented by counsel in the negotiation and execution of the employment agreement prevents him from later asserting that the agreement is unconscionable.”).
\end{itemize}
Court findings of procedural unconscionability have been upheld in situations where the contracting parties engaged in negotiations prior to the time of making the contract. In *Graham*, the California Supreme Court noted,

it is argued . . . that other provisions of the contract—e.g., those relating to the length, time, and date of the concert and the selection of a special guest artist . . . were subject to negotiation and that this consideration operated to mitigate or remove all adhesive characteristics from the contract. We do not agree . . . The terms here asserted to be subject to negotiation . . . were of relatively minor significance in comparison to those imposed by [the stronger party] . . . [W]e cannot conclude that the presence of other assertedly negotiable terms acted to remove the taint of adhesion.”

Likewise, the Ninth Circuit noted the question of negotiation concerns the clause at issue, not other parts of the agreement. In granting a franchisee relief from unconscionability, the court said procedural unconscionability “focuses on the manner in which the disputed clause is presented to the party in the weaker bargaining position. When the weaker party is presented the clause and told to ‘take it or leave it’ without the opportunity for meaningful negotiation, oppression, and therefore procedural unconscionability, are present.”

Perhaps more importantly, California courts do not require “conscience-shocking” unfairness for substantive unconscionability. The Supreme Court recently summarized the above formulations of substantive unconscionability. The court said

the core concern of the unconscionability doctrine is the absence of meaningful choice on the part of one of the parties together with contract terms which are unreasonably favorable to the other party. The unconscionability doctrine ensures that contracts, particularly contracts of adhesion, do not impose terms that have been variously described as “overly harsh,” “unduly oppressive,” “so one-sided as to shock the conscience,” or “unfairly one-sided.” All of these formulations point to the central idea that the unconscionability doctrine is concerned . . . with terms that are “unreasonably favorable to the more powerful party.” These include . . . provisions that seek to negate the reasonable expectations of the non-drafting party, or unreasonably and unexpectedly harsh terms having to do with price or other central aspects of the transaction.

The sliding scale method provides for even greater flexibility.

In California, unconscionability is “a flexible doctrine designed to allow courts to directly consider numerous factors which may adulterate the contractual process.” The sliding scale approach does not require that procedural and substantive unconscionability each be present in any particular de-

77. *Graham*, 28 Cal.3d at 820.
78. *Nagrampa*, 469 F.3d at 1282.
79. Id.
As the California Supreme Court stated in *Armendariz v. Foundation Health Psychcare Services, Inc.*, “the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.”

Finding that procedural unconscionability is established by the mere existence of a form contract could permit the court to turn to the question of substantive unconscionability without becoming mired in details, such as the appearance of the contract or the educational level of the consumer. Under California jurisprudence, courts have broad discretion to refuse enforcement of contracts or provisions in a contract that exact unfair terms as a result of disproportionate bargaining on a case-by-case basis. The California Supreme Court has construed California Civil Code § 1670.5(a) as giving “a trial court some discretion as to whether to sever or restrict the unconscionable provision or whether to refuse to enforce the entire agreement.” In California, the unconscionability doctrine provides a powerful tool for victims of contract terms that may fairly be characterized as unfair, unduly oppressive, shocking, or the like.

**III. Unconscionability Outside of California**

Outside California, the unconscionability doctrine has developed differently. As discussed earlier, the Uniform Commercial Code drafters added unconscionability as Section 2-302. This has ultimately had nationwide impact in that the Code’s unconscionability provision has been adopted in 49 states. The section was first cited (as an alternative holding) in 1964.

The Code’s concept of unconscionability developed in the context of consumer transactions. Courts and commentators focused on the Section 2-302 largely as a matter of consumer protection. Thus, courts have typically re-

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83. 24 Cal.4th 83, 114 (Cal. 2000).
84. See Lonegrass, supra note 82, at 14.
85. *Armendariz*, 24 Cal.4th at 122.
87. Am. Home Improvement Co. v. Maclver, 201 A.2d 886, 888–89 (N.H. 1964) (declining to enforce contract against homeowner for installation of windows, door, and work on sidewalls, due to the goods and services being worth far less than the contract price).
jected unconscionability challenges pursued by a business licensee or business transferee. The cases employing the unconscionability doctrine most often involve consumers challenging contractual arbitration clauses or clauses limiting warranties or liabilities. Likewise, the scholarly literature focuses on these cases of unconscionability.

That no single standard has emerged is not surprising given the flexibility inherent in the unconscionability doctrine. The word “unconscionable” is not defined in the text of Section 2-302. The official comments to Section 2-302 attempt to offer some guidance, stating that “[t]he basic test is whether, in light of the general commercial background and the commercial needs of the particular trade or case, the clauses involved are so one-sided as to be unconscionable under the circumstances existing at the time of making

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89. See Am. Nursery Prods., Inc. v. Indian Wells Orchards, 797 P.2d 477 (Wash. Ct. App. 1990) (clauses limiting incidental and consequential damages in commercial settings are prima facie conscionable); Zapatha v. Dairy Mart, Inc., 408 N.E.2d 1370, 1375 (Mass. 1980) (termination clause which authorized franchisor to terminate the agreement without cause on 90 days’ notice was not “unconscionable” within meaning of the Massachusetts Uniform Commercial Code); Dave’s Cabinets, Inc. v. Komo Mach., Inc., 2006 WL 1877075, at *4–5 (D. Minn. July 6, 2006) (plaintiff was a sophisticated party with comparable bargaining strength so the damages exclusion was not unconscionable); Great W. Cas. Co. v. Volvo Trucks N. Am., Inc., 2013 WL 617068, at *8–10 (N.D. Ill. Feb. 19, 2013) (upholding provision disclaiming consequential and special damages in commercial sales transaction between sophisticated parties).

90. See, e.g., Brown v. Tenn. Title Loans Inc., 216 S.W.3d 780, 787 (Tenn. Ct. App. 2006) (“nonmutual” arbitration clause requiring the consumer to arbitrate all claims but that permit the drafting party the option of proceeding in court was unconscionable); Kinkel v. Cingular Wireless LLC, 857 N.E.2d 250, 267–75 (Ill. 2006) (provision prohibiting class-action or collective-action arbitration was unconscionable); McNulty v. H&R Block, Inc., 843 A.2d 1267, 1273–74 (Pa. Super. Ct.) (arbitration provision specifying allocation over electronic filing fee was unconscionable); Eagle v. Fred Martin Motor Co., 809 N.E.2d 1161, 1180–83 (Ohio Ct. App. 2004) (provision requiring arbitration proceedings and results thereof to be kept confidential was unconscionable); Burch v. Second Judicial Dist. Ct., 49 P.3d 647, 650–51 (Nev. 2002) (provision giving insurer the unilateral and exclusive right to decide the rules that govern the arbitration and to select the arbitrators was unconscionable); Hulett v. Capitol Auto Grp., Inc., 2007 WL 3232283, at *4, *5 (D. Or. Oct. 29, 2007) (provision limiting the extent of discovery to twenty-five interrogatories and requests for admissions in the arbitral proceeding was unconscionable).

91. See Universal Leasing Servs., Inc. v. Flushing Hae Kwan Rest., 565 N.Y.S.2d 199, 200 (N.Y. App. Div. 1991) (lease provision that virtually disclaimed all warranties of the lessor was unconscionable); Unico v. Owen, 232 A.2d 405 (N.J. 1967) (waiver of defense clause was unconscionable); McCarty v. E. J. Korvette, Inc., 347 A.2d 253 (Md. Ct. Spec. App. 1975) (limitation of consequential damages was unconscionable); Covenant Health & Rehabilitation of Picayune, LP v. Est. of Moulds ex rel. Braddock, 14 So. 3d 695 (Miss. 2009) (clause waiving all claims for damages from negligence (except willful) or criminal acts, all claims for punitive damages, while providing for differing judicial remedies between the parties as unconscionable).

the contract." The UCC does not assign any particular evidentiary burden to either party, instead placing equal responsibility on each party to make its case. The UCC provides merely that “[w]hen it is claimed or appears to the court that the contract or any clause thereof may be unconscionable the parties shall be afforded a reasonable opportunity to present evidence . . . to aid the court in making the determination.”

Over time, courts developed a now familiar template in which the unconscionability analysis concentrates on the two branches of unconscionability, procedural and substantive. However, a minority of states, including Arizona, Vermont, Virginia, and Washington do not require both procedural unconscionability and substantive unconscionability to invalidate a contract on grounds of unconscionability.

The two principal infirmities addressed in Section 2-302 are “oppression” and “unfair surprise.” Beyond the basic framework, things get foggy. Despite the fact that courts have dealt with the doctrine in a number of cases and fact patterns, “there is no single description of the concept [of unconscionability] to which all courts subscribe.” Some courts apply unconscionability only if an offending contract or term “shocks the conscience” or is

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93. UCC § 2-302, cmt. 1.
94. UCC § 2-302(2).
96. Glassford v. BrickKicker, 35 A.3d 1044, 1049 (Vt. 2011) (“The superior court was mistaken in assuming that the presence of procedural unconscionability is required to void a contract based on it containing unconscionable terms”).
99. The Illinois Supreme Court held that a finding of unconscionability can be based upon procedural unconscionability, substantive unconscionability, or both. Kinkel v. Cingular Wireless LLC, 857 N.E.2d 250, 263 (Ill. 2006) (“A finding of unconscionability may be based on either procedural or substantive unconscionability, or a combination of both”). Missouri courts also appear to not require both procedural and substantive unconscionability. See Ruhl v. Lee’s Summit Honda, 322 S.W.3d 136, 139 n.2 (Mo. 2010) (“[U]nconscionability can be procedural, substantive, or a combination of both. There is no need in all cases to show both aspects of unconscionability.”). The New Mexico Supreme Court has also suggested that both substantive unconscionability and procedural unconscionability are not required. See Cordova v. World Fin. Corp. of N.M., 208 P.3d 901, 908 (N.M. 2009) (holding that, “while there is a greater likelihood of a contract’s being invalidated for unconscionability if there is a combination of both procedural and substantive unconscionability, there is no absolute requirement in our law that both must be present to the same degree or that they both be present at all”). Oregon appears to not require procedural unconscionability. See Livingston v. Metro. Pediatrics, LLC, 227 P.3d 796 (Or. Ct. App. 2010) (employee did not claim arbitration agreement in employment contract was procedurally unconscionable, but court nevertheless examined whether it would be unenforceable on a finding of substantive unconscionability and ultimately concluded that the agreement was not unconscionable).
100. UCC § 2-302, cmt. 1 (“The principal issue is one of oppression and unfair surprise and not one of disturbance of allocation of risks because of superior bargaining power.”).
such that—in the words of Chancellor Hardwicke in *Earl of Chesterfield v. Jansen*—"no man in his senses and not under delusion would make on the one hand and as no honest and fair man would accept on the other."102 Courts in Connecticut, Florida, Iowa, Kentucky, Massachusetts, Michigan, Minnesota, Missouri, New York, Texas, and Utah have used either or both of these standards, or variations thereof, in assessing claims of unconscionability.103

Because the UCC affirmatively grants courts non-enforcement powers, some courts interpret these powers narrowly, taking the view that unconscionability is only defensive and equitable.104 Over time, most state and federal

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102. (1750) 28 Eng. Rep. 82, 100 (Ch.).
103. See, e.g., Celentano v. Oaks Condo. Ass’n, No. X01CV940159297, 2001 WL 83944, at *12 (Conn. Super. Ct. Jan. 11, 2001) (“A substantively unconscionable bargain is one which ‘no man in his senses and not under delusions would make on one hand, and . . . no honest and fair man would accept on the other.’”) (citation omitted); Frantz v. Shedden, 974 So. 2d 1193, 1196–97 (Fla. Dist. Ct. App. 2008) (defining unconscionability as “shock[ing] the judicial conscience” or being such that “no man in his senses and not under delusion would make on the one hand, and [such that] no honest and fair man would accept on the other” (citation omitted)); Nut-Tech Seed, LLC v. Roup, 212 F. Supp. 3d 783, 794 (S.D. Iowa 2015) (“A bargain is unconscionable if it is ‘such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other’”) (citation omitted)); Frantz v. Shedden, 974 So. 2d 1193, 1196–97 (Fla. Dist. Ct. App. 2008) (defining unconscionability as “shock[ing] the judicial conscience” or being such that “no man in his senses and not under delusion would make on the one hand, and [such that] no honest and fair man would accept on the other” (citation omitted)); Holifield v. Beverly Health & Rehab. Servs., Inc., Civil Action No. 3:08CV–147–H, 2008 WL 2548104, at *4–5 (W.D. Ky. June 20, 2008) (holding alternative dispute resolution agreement not unconscionable because it was not such that “no man in his senses, not under delusion, would make, on the one hand, and which no fair and honest man would accept, on the other” (citation omitted)); Bekele v. Lyft, Inc., 199 F. Supp. 3d 284, 299 (D. Mass. 2016) (“An unconscionable contract is one ‘such as no man in his senses and not under delusion would make on the one hand, and no honest and fair man would accept on the other’”) (citation omitted)); HRL Land or Sea Yachts v. Travel Supreme, Inc., No. 1:07–cv–945, 2009 WL 125845, at *7–8 (W.D. Mich. Jan. 16, 2009) (holding that arbitration provision was not unconscionable because it did not “shock the conscience” (citation omitted) (internal quotation marks omitted)); Weller v. Time Ins. Co., Civil No. 08–416 (DWE/RLE), 2008 WL 2952033, at *2 (D. Minn. July 28, 2008) (“A contract provision is unconscionable if it is ‘such as no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other.’”) (citation omitted)); Pleasants v. Am. Express Co., 541 F.3d 853, 857 (8th Cir. 2008) (“Missouri courts have described an unconscionable agreement as one in which ‘no man in his senses and not under delusion would make, on the one hand, and as no honest and fair man would accept on the other, or one where there is ‘an inequality so strong, gross, and manifest that it must be impossible to state it to one with common sense without producing an exclamation at the inequality of it’” (citation omitted)); Schultz v. Schultz, 871 N.Y.S.2d 636, 637 (N.Y. App. Div. 2009) (holding that postnuptial agreement was not an unconscionable bargain, a bargain that the court described as “one which no person in his or her senses and not under delusion would make on the one hand, and no honest and fair person would accept on the other, the inequality being so strong and manifest as to shock the conscience” (citation omitted)); Whataburger Rests. LLC v. Cardwell, No. 08–13–00280–CV, 2017 WL 3167487, at *4 (Tex. App. July 26 2017) (“The unconscionability defense has a long history at common law; an early decision described an unconscionable contract as one that ‘no man in his senses and not under delusion would make on the one hand, and as no honest and fair man would accept on the other.’” (citation omitted)); Goodwin v. Hole No. 4, LLC, No. 2:06–cv–00679, 2007 WL 2221066, at *10 (D. Utah July 31, 2007) (defining unconscionable contract as one whose “terms are so one-sided as to oppress an innocent party,” “conscience-shocking,” or such that “no decent, fair minded person would view the results [of enforcement] without being possessed of a profound sense of injustice”) (citation omitted)).
104. Camp v. Ala. Telco Credit Union, No. 2:12–cv–2237–LSC, 2013 WL 2106727, at *5 (N.D. Ala. May 13, 2013) (Alabama law) (refusing to recognize a cause of action for declaratory relief “because unconscionability is merely an affirmative defense, there is no controversy be-
courts have adopted a less constrained position, following the general rubric of affirmative defenses, including that unconscionability can be raised through declaratory relief\textsuperscript{105} and that restitution\textsuperscript{106} may be sought. As one court explained in a case involving a home loan, if declaratory relief, restitution, and reformation are unavailable, the result could constitute its own form of unconscionability.\textsuperscript{107}

IV. Implications for Franchising

Some California decisions have held that in franchising, one of the elements of unconscionability—the procedural element—is almost inherently present.\textsuperscript{108} Franchise agreements are typically long, preprinted form contracts and often presented on a take-it-or-leave-it basis.\textsuperscript{109} Some franchisors may be unwilling to modify terms or willing to modify only very little. With the procedural element often satisfied,\textsuperscript{110} or believed to be satisfied, the unconscionability issue in the franchise context is whether a provision was substantively unfair or generates a surprising or unexpected result.

Franchise agreements drafted by franchisors have many provisions that franchisees sometimes consider to be unfair, unbalanced, or outside their ex-
pectations, including provisions regarding arbitration in distant venues,\textsuperscript{111} delegation of the arbitrability determination,\textsuperscript{112} choice of law,\textsuperscript{113} limitations of warranties,\textsuperscript{114} and limitations of liabilities.\textsuperscript{115} But other clauses have not been tested in published appellate opinions. These include provisions purporting to disclaim any exclusive territory for a franchisee, and which permit a franchisor to place outlets anywhere, even adjacent to a franchisee’s location. For example, in \textit{Cohn v. Taco Bell Corp.}, the plaintiffs sued Taco Bell for breach of the implied covenant of good faith and fair dealing, claiming Taco Bell implemented a strategy to cannibalize the sales of the existing

\textsuperscript{111} See, e.g., Swain v. Auto Servs., Inc., 128 S.W.3d 103, 108 (Mo. Ct. App. 2003) (venue provision requiring arbitration in Arkansas was unconscionable under Missouri law); Bridge Fund Capital Corp. v. Fastbucks Franchise Corp., 622 F.3d 996, 1005 (9th Cir. 2010) (venue provision choosing Texas over California was likely unconscionable under California law); Boller v. Super. Ct., 87 Cal.App.4th 900, 910 (Cal. Ct. App. 2001) (out-of-state arbitration forum requirement was unconscionable under California law). On the other hand, the Seventh Circuit has held arbitration clauses requiring out-of-state arbitration are not unconscionable. See Faulk-enberg v. CB Tax Franchise Sys., LP, 637 F.3d 801, 805 (7th Cir. 2011) (venue provision requiring arbitration in Houston, Texas, was conscionable under Illinois law).

\textsuperscript{112} Capelli Enters., Inc. v. Fantastic Sam’s Salons Corp., Case No. 5:16-cv-03401-EJD, 2016 WL 4492588, at *4 (N.D. Cal. Aug. 6, 2016) (holding that arbitrability is generally decided by the court unless the arbitration agreement “clearly and unmistakably” provides otherwise, and that incorporation of AAA rules constitutes “clear and unmistakable” evidence that contracting parties agreed to arbitrate arbitrability); Doctor’s Assocs., Inc. v. Pahwa, 2016 WL 7635748, at *21 (D. Conn. Nov. 3, 2016) (court granted motion to compel arbitration and found that under franchisor’s broad arbitration clause, gateway issues such as unconscionability of arbitration agreement are for the arbitrator’s determination in the first instance); Chaudhry v. Int’l House of Pancakes, LLC, Case No. 15-cv-3504, 2016 WL 1644117, at *2 (N.D. Ill. Jan. 13, 2016) (holding that arbitrator must determine the question of unconscionability and that provisions delegating determination of arbitrability to arbitrators must be enforced, unless the delegation provision was unconscionable, which the franchisee did not specifically argue); see also Buckeye Check Cashing, Inc. v. Cardegna, 546 U.S. 440 (2006) (holding that challenges to the validity of a contract as a whole, not specifically the arbitration provision, must be reviewed by the arbitrator under the FAA). Thus, in ordinary cases, a court considering a motion to compel arbitration cannot consider any claim that the contract as a whole is invalid when the FAA applies.


franchisee’s restaurants.\textsuperscript{116} The court dismissed the claim at the pleading stage, finding that the agreement explicitly allowed Taco Bell to open company stores wherever it wanted.\textsuperscript{117} The Cohn court reasoned that the implied covenant is subject to the exception that “the parties may, by express provisions of the contract, grant the right to engage in the very acts and conduct which would otherwise be forbidden by an implied covenant of good faith and fair dealing.”\textsuperscript{118} The court’s ruling implied that a 27 percent to 40 percent decrease in sales resulting from franchisor encroachment was not beyond the reasonable expectation of the parties.\textsuperscript{119}

The result might have been different had the plaintiffs argued that the adjacent-location provisions were unconscionable. The plaintiffs could have argued that procedural unconscionability was abundantly present. Taco Bell, with hundreds of corporate and franchised Taco Bell locations and hundreds of millions of dollars of revenues,\textsuperscript{120} was the party with superior bargaining power; Cohn was in the weaker position. To obtain the franchise, Cohn was required to sign Taco Bell’s form franchise agreement. Some offering circulars and franchise agreements by their length and small print, arguably tend to obfuscate, not to inform or make harsh terms conspicuous.\textsuperscript{121} The fact that Cohn owned nine Taco Bell franchises would not automatically negate a finding of substantive unconscionability because California courts “recognize that experienced but legally unsophisticated businessmen may be unfairly surprised by unconscionable contract terms.”\textsuperscript{122}

Cohn’s testimony reflected that he was not on notice to look out for his own franchisor cannibalizing his restaurant—or to look for a contractual right for the franchisor to do so. One of Taco Bell’s likely rebuttal arguments—that is, that the provision must be reasonable because it is used industry-wide—was raised and rejected in \textit{Graham v. Scissor Tail}. There, the California Supreme Court also noted that adherence to the adhesive contract took

\textsuperscript{117} Id. at *6–8.
\textsuperscript{118} Id. at *5 (quoting Carma Developer v. Marathon Dev., 826 P.2d 710, 728 (Cal. 1992)).
\textsuperscript{119} Id. at *8.
\textsuperscript{120} The plaintiffs made a request to take judicial notice of the annual revenues of Taco Bell and the plaintiffs. See Cohn v. Taco Bell Corp., 1994 WL 643278, at *3 (N.D. Ill. Nov. 10, 1994) (“Taco Bell is a corporation with annual revenues of $3.5 to $4 billion and [ ] RLC is a corporation with a net worth of only $4.8 million”).
\textsuperscript{121} See Eric H. Karp & Ari N. Stern, \textit{A Proposal for a Mandatory Summary Franchise Disclosure Document}, 35 \textit{FRANCHISE L.J.} 541, 543 n.12 (2016) (noting it is not uncommon in recent times for the entire franchise disclosure document, including all related attachments, to exceed 300 pages. According to the article, the March 21, 2015, franchise disclosure document of Taco Bell Corp. as filed with the Minnesota Department of Commerce on March 30, 2015, contained 545 pages of material).
\textsuperscript{122} See A & M Produce Co. v FMC Corp. 135 Cal.App.3d 473, 489–90 (Cal. Ct. App. 1982) (noting that the California Supreme Court has “recognized that experienced but legally unsophisticated businessmen may be unfairly surprised by unconscionable contract terms”); Stirlen v. Supercuts, 51 Cal.App.4th 1519, 1534 (Cal. Ct. App. 1997) (“the suggestion that a contract or clause cannot be unconscionable if it is accepted by a knowledgeable party has been repudiated by our Supreme Court”).
place industry-wide.\textsuperscript{123} That may explain why the courts in \textit{Postal Instant Press v. Sealy} and \textit{Nagrampa v. Mailcoups} noted that franchising itself “involves the unequal bargaining power of franchisors and franchisees and therefore carries within itself the seeds of abuse.”\textsuperscript{124}

One indicia of substantive unconscionability are terms that are “clearly one-sided” and lacking mutuality.\textsuperscript{125} The adjacent-location clause was clearly a one-sided, non-mutual provision. It said Taco Bell could put corporate restaurants next to Cohn’s franchised restaurant. It is fairly apparent that selling a branded franchise location and then putting a corporate store or multiple corporate stores adjacent to it would benefit Taco Bell at Cohn’s expense.\textsuperscript{126} In the Court of Appeal’s words, it was a “seed of abuse” that lay nascent six years and then after Cohn built up a business and clientele, permitted Taco Bell to put restaurants of the same brand in the immediate vicinity of his restaurants.\textsuperscript{127}

Expressed differently, the adjacent-location clause meets the test of being unfair and oppressive, one-sided—putting all the risk on Cohn because if Cohn builds the business and succeeds, Taco Bell could then cannibalize the business with adjacent restaurants. It was imposed by the stronger party—Taco Bell—on the weaker party—Cohn, who was required to “take-it-or-leave-it” in an adhesive pre-printed, nonnegotiable form franchise agreement. The clause suffers from both procedural and substantive unconscionability.

Because the district court applied California law, Cohn would not have been precluded from raising the unconscionability doctrine for the first time on appeal because California courts have ruled that the doctrine may be raised initially on appeal, even if not raised in the trial court.\textsuperscript{128}

Other provisions that have not been tested in published appellate decisions include terms requiring the franchisee to indemnify the franchisor

\begin{footnotes}
\item[124] In \textit{Postal Instant Press, Inc. v. Sealy}, 43 Cal.App.4th 1704 (Cal. Ct. App. 1996), a California appellate court held that California law prohibits a franchisor from recovering damages for lost future royalties when the franchisor terminates a franchise agreement, even though franchisee’s breach of franchise agreement was proximate cause of franchisor’s loss of future royalty payments, finding an award of lost future profits to franchisor as damages would be unreasonable, unconscionable and oppressive.
\item[125] Nagrampa v. Mailcoups, Inc., 469 F.3d 1257, 1293–94 (9th Cir. 2006).
\item[127] According to Cohn’s declaration, “at a meeting of representatives of franchise and corporate restaurants in the Chicago area on January 11, 1994, a Taco Bell executive announced the development plan for restaurant growth in the Chicago area, specifically in the north Chicago suburbs.” Cohn v. Taco Bell Corp., 1994 WL 174128, at *5 (N.D. Ill. May 5, 1994). The Taco Bell executive allegedly stated that the new development plan will include franchisees that are “approved for growth.” \textit{Id.} at *5. Richard Cohn was not “approved for growth.” Based on his impression of the January 11 meeting, Cohn declared that, given “Taco Bell’s decision regarding the Vernon Hills restaurant, I believe that the new restaurants will be used to cannibalize sales from my restaurants and could be used to destroy my business.” \textit{Id.}
\item[128] Lennar Homes of Cal. v. Stephens, 232 Cal.App.4th 673, 686 (Cal. Ct. App. 2014) (“Moreover, unconscionability is, in the absence of a material factual dispute, a question of law that may be raised for the first time on appeal.”).
\end{footnotes}
V. Conclusion

Although one who executes a written contract is generally presumed to know its contents and to assent to those specified terms, the law pertaining to contracts of adhesion recognizes that in certain circumstances, traditional assumptions associated with contract law are unfounded. The unconscionability doctrine allows the court to grant relief from contracts that appear consensual, but are not in fact the product of real choice. The doctrine may properly pave the way for affirmative relief by eliminating an unconscionable provision in a contract and permitting recovery based on the remainder of the contract.

For franchise practitioners, knowing the intricacies of the unconscionability doctrine is useful. In preparing and reviewing franchise agreements, counsel should reexamine provisions that may be subject to a claim of unconscionability. Familiarity with the rule may help transactional attorneys as well because the terms of the franchise agreement often become a focal point in litigation and the doctrine can help in deciding which provisions may be subject to a claim they are unconscionable.

In the article Poor Rumpelstiltskin, psychoanalyst Martin Miller discusses a patient whose sympathy lay with Rumpelstiltskin.131 The patient considered the victim to be not the entrapped girl who was threatened with death, but the imp who demanded of the girl her future firstborn child as the price to save her. No doubt Antonio in the Merchant of Venice, Paramount Studios in its dispute with Art Buchwald, the American Federation of Musicians in its agreement with Graham, FMC Corp in its agreement with A&M Produce, 129. Weaver v. Am. Oil Co., 276 N.E.2d 144, 148 (Ind. 1971) (application of UCC § 2-302 by analogy to an indemnity contract).


131. Miller, supra note 2.
and the franchisor Mailcoup dis considered their deals to be fair and possibly viewed themselves as victims when the agreements were found to be unconscionable.

Unconscionability has existed since ancient times. It will continue to exist, and will be in dispute. This is because clients seek to benefit themselves, and may view oppressive terms as reasonable and justified, and as shown by Dr. Miller’s patient, some people will agree.
What’s in a Name? State Business Opportunity Statutes as Franchise Disclosure Laws

Stanley M. Dub

Franchising is an American business concept with global reach. Franchise attorneys can be proud of their role in creating and maintaining this economic juggernaut. In 2018, franchising is expected to generate $451 billion in sales in the United States, corresponding to three percent of U.S. GDP. But there are weaknesses in the foundation on which franchising is built, and these can only hold back franchising’s potential for future growth.

It is often said that the integrity of America’s financial markets rests on the foundation of its securities laws, which emphasize disclosure of material information to potential investors. Our system of franchise investment is similar in concept, relying on disclosure of material information to would-be franchise investors. In practice, however, our system of franchise regulation is more paper than tiger. The widespread lack of meaningful franchise disclosure regulation is a weakness that undermines the franchising model and begs for a solution.

The Federal Trade Commission’s Franchise Rule requires sellers of franchises to provide buyers with a lengthy disclosure document (the FDD) at least fourteen days before the buyer signs a contract or pays any money. However, there is no private right of action for violation of the FTC Rule, and the FTC seldom acts to enforce violations of the Rule in—

2. 16 C.F.R. § 436, et seq. (FTC Rule).
3. Id. § 436.2(a).

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individual cases of noncompliance. In practice, enforcement by injured purchasers depends on state legislation.

Fourteen states have franchise registration laws, requiring franchise sellers to submit their FDDs to a state agency for registration before offering or selling franchises in the state. Another eighteen states have no state law requiring a franchise seller to provide a buyer with a disclosure document. This article will review the franchise disclosure requirements in the remaining eighteen states. These states typically have laws referred to as “Business Opportunity Laws,” even though their coverage in some cases includes sale of franchises. This article will also examine their applicability to traditional franchise relationships and offer suggestions to franchisors wishing to improve their chances of avoiding disclosure violation claims in these states. Although several of these laws apply to franchise transactions, most do not.

I. “Franchises” or “Business Opportunities?”

State regulation of franchise disclosures began with the passage of California’s Franchise Investment Law in 1970, and the process received a boost from promulgation of the FTC Rule in 1978. The original FTC Rule distinguished “franchises” from other covered transactions, based on their identification with the seller’s trademark. The rule covered two categories of transactions: (1) franchises and (2) transactions that met the other definitional criteria for a franchise but did not involve use of the seller’s trademark (referred to as “business opportunities”). For both categories, the rule required that a disclosure document be given to the buyer in advance of any sale. This unified treatment of the two categories ended with the amendment of the FTC Rule in 2007 and the subsequent promulgation of 16 C.F.R. § 437 as a separate “Business Opportunity Rule.”

These changes to the FTC Rule clarified the distinction between the two categories, reflecting the FTC’s view that sales of franchises are more prevalent and more commercially significant and therefore deserving of a higher level of required disclosures. However, state franchise disclosure laws have not kept pace with these changes. State laws in non-registration states generally do not distinguish between the two categories. Instead, state laws typically

4. The author has tried without success to persuade FTC staff to bring individual enforcement actions.
6. Alabama, Alaska, Arizona, Connecticut, Florida, Georgia, Iowa, Kentucky, Louisiana, Maine, Nebraska, New Hampshire, North Carolina, Ohio, Oklahoma, South Carolina, Texas, and Utah. Business Opportunity statutes in the franchise registration states have been excluded on the assumption that they do not reach transactions (“franchises”) covered by the state’s franchise law.
7. These laws sometimes go by other names, such as Alabama’s “Seller Assisted Marketing Plan Act.”
refer only to the broader of the two categories—business opportunities—and require pre-sale disclosure in connection with the sale of transactions meeting their statutory definitions. Many of these laws exclude coverage of franchise sales, either in the definition section, or by including an exemption for transactions constituting a “franchise.” Because these state laws are typically named “Business Opportunity Laws,” and because they often specifically exclude coverage of “franchises,” there is a general misconception that these laws do not regulate franchise disclosures. However, that is not true; a few of these laws do permit a franchise purchaser to sue for a seller’s disclosure violations.

The next part of this article will examine the various state laws to determine which are actually franchise disclosure laws by another name. Many of these laws require pre-sale disclosure for business opportunities not constituting a franchise. However, this article will consider only whether these laws regulate pre-sale disclosures in the sale of franchises.

II. State Laws That Exclude “Franchise” Transactions

Among the eighteen states that do not require franchise registration, but have some sort of Business Opportunity statute, 9 two laws seem not to cover franchises but are sufficiently different to defy categorization. 10 Twelve other states have laws that fall into four categories that exclude coverage of “franchises,” either explicitly or by other equivalent language. Two of these laws simply exclude transactions that are subject to 16 C.F.R. § 436 from their definition sections. 11 Another six states have definitional exclusions for transactions involving sale of a marketing plan in conjunction with a registered trademark. 12 In two states, Alaska and Florida, the laws do not exclude franchises from their definitions, but subsequently provide exemptions for sale of franchises. However, the Florida exemption is conditioned on the seller providing a pre-sale notice to the state, indicating the seller “is in substantial compliance” with 16 C.F.R. § 436, and on payment of an annual $100 fee. The final two laws exempt transactions that include use of an FDD “prepared pursuant to 16 C.F.R. § 436.” 13

Language included in certain of these laws begs the question whether franchise buyers might still be permitted to sue for disclosure violations in certain cases. For example, would a franchise buyer in Florida or Utah retain the right to sue if the franchisor failed to file the required pre-sale notice

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9. These states are listed in fn. 6, supra.
10. Alabama has only a brief “Seller Assisted Marketing Plan” law prohibiting certain misrepresentations as “Unlawful Trade Practices,” and New Hampshire’s law seemingly regulates only the sale of distributorships, defined without reference to any marketing plan.
11. Arizona and Utah. The Utah law subsequently describes this definitional exclusion as an “exemption” and conditions its availability upon filing an annual notice of FTC Rule compliance and payment of a $100 fee.
13. Iowa and Oklahoma. These states additionally exclude transactions involving sale of franchises if the franchisor has net worth greater than $1 million.
with the state, or if the franchisor filed the required notice and compliance representation, but it was later determined that the franchisor was not in substantial compliance, despite stating this in its notice? Based on the Iowa or Oklahoma statutes, might an injured franchisee argue the exemption was not satisfied if the franchisor used an FDD that was defective, arguing it was therefore not “prepared pursuant to 16 C.F.R. § 436?” The author has not researched these questions.

The broader question raised by these statutes is why they provide these exclusions or exemptions for sale of franchises. What possible policy goal is achieved by this wholesale exemption of franchise transactions? Conceivably, these exemptions crept into the laws before it became clear that there would be no private right of action for violation of the FTC Rule. Now that the franchise community recognizes that the FTC Rule cannot be enforced in a private action, there is an obvious need to provide state regulation of franchise disclosures, and this could easily be accomplished in some cases by amending the existing laws to eliminate franchise exclusions and exemptions.

The justification for requiring pre-sale franchise disclosures was extensively documented by the FTC before passage of the original FTC Rule. As one prominent franchisor spokesman testified at a congressional hearing on the subject:

This emotional dream, the desire of every American to own his own business, to be his own boss, has many pitfalls. He is easy prey for the hot-shot promoter because the stakes are so high here. These small businessmen very often scrape up every dime they can borrow, beg or steal in a lifetime of earnings, and put it all on one dream and hope of a franchise concept that very likely could have been misleading and misrepresentative and fraudulent. For that reason, I think that the Senate, the Government of this country, should take some positive action to protect the small businessman. After all, he is the one that is going to get hurt, not the franchisor, because the franchisee is the one who puts up all the money and all the labor in order to develop the business concept.14

Those statements are as true today as they were fifty years ago, and they support the need to provide effective regulation of franchise disclosures for the benefit of franchise buyers, regardless of their state of residence.

III. State Laws That Do Not Exclude Franchises

Of the eighteen states that do not require franchise registration, but which have Business Opportunity statutes, four have laws that provide the basis for policing the franchise disclosure process.15 It is this group of Business Op-


15. Kentucky, Nebraska, Ohio, and Texas.
portunity statutes that may perhaps be regarded as “franchise disclosure laws.” All of these laws permit franchise sellers to use the FTC disclosure format in some fashion, so that franchisors that fully comply with the FTC Rule can largely ignore any different disclosure requirements required by the laws. However, they employ different standards for establishing necessary FTC Rule compliance and vary widely in their available remedies and other provisions. Each of these laws is discussed below.

A. Kentucky

Kentucky’s Business Opportunity Law\(^\text{16}\) defines “business opportunity” using terminology broad enough to include most franchise transactions, provided they involve an initial payment of $500 or more, and the seller represents “directly or indirectly, that market demand will enable [the buyer] to earn a profit from the business opportunity.” This sort of definition is common for Business Opportunity Laws, and the required representations regarding profit might seemingly be implied by a court in some circumstances, even where express representations may be lacking.\(^\text{17}\)

Sellers of covered transactions are required to register and file a bond with the Division of Consumer Protection and additionally provide a statement containing certain disclosures with the agency. This disclosure statement, requiring less extensive but somewhat different disclosures than an FDD, must subsequently be provided to any purchaser before the purchase. Sales of covered transactions must also provide the purchaser with a 30-day cancellation right.

Franchise sellers will generally wish to avail themselves of the statute’s FTC Rule compliance exemption,\(^\text{18}\) but satisfying this exemption requires that a seller (1) meet the definition of a franchise in 16 C.F.R. § 436, (2) comply with this regulation, and (3) file a written notice of exemption. It therefore remains possible that a franchise seller that fails to file the notice, or that violates the FTC Rule, might run afoul of this statute. Violations are deemed a Class C felony and may be prosecuted by Kentucky authorities, but the statute does not provide for any private right of action. However, purchasers are given certain rights to cancel the transaction.\(^\text{19}\)

B. Nebraska

Nebraska’s Seller-Assisted Marketing Plan Act\(^\text{20}\) is the functional equivalent of a Business Opportunity Law. Before a “seller-assisted marketing plan” may be offered for sale, a seller must prepare a disclosure document in a state-

\(^{16}\) KY. REV. STAT. § 367.801, et seq. (2018)


\(^{18}\) KY. REV. STAT. § 367.807(1)(a).

\(^{19}\) Id. § 367.819.

specific format, file it with the state, and pay a $100 fee. The disclosure docu-
ment must then be provided to a potential purchaser at the first in-person meet-
ing or in the seller’s first written response to any inquiry from the buyer. The
terms of sale must include a three-day cancellation right.

The terminology used by the statute to describe a covered transaction is
broad enough to include most franchises. The definition requires only that
a transaction involve an initial payment of more than $100 and a representa-
tion by the seller (directly or indirectly, verbally or in writing) that: (1) the pur-
chaser can derive income from the business that exceeds the initial payment;
(2) there is a market for the products or services to be offered by the business;
or (3) the seller or a person the seller recommends will provide advice or train-
ing (including promotional materials or operational assistance).

Like other Business Opportunity Laws, however, there are exclusions and ex-
emptions that generally permit franchise sellers to avoid these state-specific dis-
closure requirements. First, the definition of “seller” is limited to one who sells
or intends to sell at least five transacti ons (including those outside Nebraska)
within a twenty-four month period.21 Additionally, the statute has an FTC
Rule compliance exemption.22 However, to satisfy this exemption, a franchise
seller must have complied with the FTC Rule. Even then, the exemption applies
only if a franchise seller first files a notice with Nebraska and pays a $100 filing
fee.

As with Kentucky, it remains possible that a franchise seller that violates
the FTC Rule, or fails to file the required notice, may lose the benefit of the
FTC Rule exemption, and thereby be deemed to violate the statute. How-
ever, in contrast to the Kentucky statute, the Nebraska law provides for a pri-
vate right of action. Injured purchasers are given five years to file suit to re-
cover their damages.23

C. Ohio

Ohio’s Business Opportunity Purchasers Protection Act24 governs the
sale of “business opportunity plans.” Transactions covered by the Ohio
Act are those involving an agreement by which a buyer obtains the right
to offer or sell goods or services under three conditions:

(a) the goods or services or services are supplied by the seller [of the transaction],
a third person with whom the purchaser is required or advised to do business,
or an affiliated person.25

21. If the seller intends to sell four or less within the 24-month period, the seller must notify
each purchaser of this intention in writing in order to satisfy the exclusion from the definition of
“seller.” NEB. REV. STAT. § 59-1705.
22. Id. § 59-1722.
23. Id. § 59-1758.
25. The Ohio Act has additionally been held to apply to a “package franchise” that did not
meet the literal requirements of this section because it involved placement of third parties
(nurses) who were not provided by the business opportunity seller. Jess Cook v. Emp’rs Over-
(b) the purchaser is required to make an initial payment greater than $500 and less than $100,000.

(c) the seller makes any of the following representations . . .

(iii) that the purchaser can earn a profit in excess of the initial payment,

(iv) that there is a market for the goods or services. . . . 26

Before selling a business opportunity plan, a seller must provide a disclosure document to the buyer using the Ohio-specific format specified, 27 and the agreement and transaction must additionally comply with the requirements of Ohio Revised Code §§ 1334.03–.06 (including offering a five-day cancellation right).

Few franchise sellers actually comply with these state-specific disclosure requirements, choosing instead to satisfy one of the fifteen exemptions provided by the Ohio Act. 28 Among the exemptions, the most commonly relied on are the “big company exemption” 29 and the exemption for FTC Rule compliance. 30 However, to satisfy the FTC Rule exemption, a transaction must comply with the FTC Rule in all material respects. 31 Ohio Revised Code § 1334.14 imposes the burden of proving entitlement to any exemption on the person claiming the exemption.

Franchise sellers that cannot satisfy the “big company” exemption may assume they are nonetheless insulated from liability under the Ohio Act if they prepare an FDD that appears to be FTC Rule-compliant and provide it to a purchaser. However, compliance with the FTC Rule requires more than simply providing a document, even in cases where the same document may have previously been registered in one or more states. The seller may be unable to prove the exemption was satisfied if the FDD was not provided to the purchaser sufficiently in advance of the purchase, or if the FDD contains material defects, such as faulty or outdated financial statements; omits reference to significant litigation; violates Item 19 requirements for preparation of financial performance representations; or significantly underestimates the buyer’s required investment. Because a seller in such circumstances will not have complied with the Ohio-specific disclosure requirements (including, notably, the five-day cancellation right), the seller’s inability to satisfy the FTC Rule compliance exemption would effectively leave the seller liable to the purchaser for violation of the Ohio Act.

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28. Id. §§ 1334.12–.13.
29. Ohio Revised Code § 1334.12(L) exempts transactions where the seller has net worth of more than $15 million (or $1 million, if the seller is eighty percent owned by an entity with net worth greater than $15 million), has had at least twenty-five franchises in operation at all times in the previous five years, or has itself conducted the business continuously for the previous five years.
30. Id. § 1334.13.
31. Before the Ohio Act was amended in 2012, this exemption required that a transaction “fully comply” with the FTC Rule.
In cases of violation of the Ohio Act, purchasers are given a private right of action and may rescind the transaction (subject to a three-year statute of limitations) or recover the greater of $10,000 or three times their actual damages (subject to a five-year statute of limitations) plus attorney fees.\textsuperscript{32}

In practical effect, the Ohio Act functions as a franchise disclosure law, providing purchasers with a right of recovery for violation of the FTC Rule where a transaction is not otherwise exempt. Approximately 100 decisions have been reported under the Ohio Act since its passage in 1979, and many more have been decided without publication of an opinion or have been filed and subsequently settled before decision. However, relatively few cases have been reported under the Ohio Act since it was amended in 2012.

D. Texas

Under the Texas Business Opportunity Act, “business opportunity” is defined to mean a sale or lease of more than $500 of products, equipment, supplies, or services that will be used to start a business, where a seller represents that

(i) the purchaser will earn or is likely to earn a profit in excess of the initial consideration, and
(ii) the seller will . . . prepare a sales, production or marketing program.\textsuperscript{33}

Although some franchise transactions might escape the first part of this definition by not involving the sale of products, equipment, or supplies directly by the franchisor, the Texas Act’s definition of “services” is broad enough to ensure that a transaction would be covered even if the seller only provided an initial training program.\textsuperscript{34}

The statutory definition excludes eight categories of transactions, including a “big company”\textsuperscript{35} exemption and an FTC Rule compliance exemption.\textsuperscript{36} To satisfy the FTC Rule compliance exemption, the transaction must comply in all material respects with the FTC Rule and the seller must file a notice with the secretary of state before offering for sale or selling a franchise in Texas.

Although this FTC Rule exemption employs the same qualifying language as the Ohio statute, other differences between the Ohio and Texas statutes lead to different results. The Ohio and Texas statutes each have language prescribing the required content of a state-specific disclosure format, but only Ohio requires a five-day cancellation right as an element of its state-specific format. Both statutes include FTC Rule compliance exemptions that

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  \item \textsuperscript{32} \textit{O HIO REV. CODE} § 1334.09.
  \item \textsuperscript{33} \textit{TEX. BUS. \& COM. CODE} § 51.003(a).
  \item \textsuperscript{34} \textit{Id.} § 51.002(9).
  \item \textsuperscript{35} This excludes transactions where the seller has $25 million net worth, or is eighty percent or more owned by an entity with more than $25 million in net worth, and the parent entity guarantees the seller’s performance. \textit{TEX. BUS. \& COM. CODE} § 51.003(b)(7).
  \item \textsuperscript{36} \textit{Id.} § 51.003(b)(8).
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require a seller to comply in all material respects. However, a franchisor pro-
viding an FDD to a purchaser could frequently comply with the Texas state-
specific disclosure requirements without having to rely on the FTC Rule ex-
emption, although use of the same FDD in Ohio would run afoul of the five-
day cancellation right if the transaction could not satisfy the FTC Rule compliance exemption.

A recent decision involving the Texas Act seems to turn on this principle, though without directly articulating it. In Yumilicious Franchise, LLC v. Bar-
rie, the Fifth Circuit addressed allegations made by a disgruntled South Ca-
rolina franchisee against a Texas franchisor. A frozen yogurt franchisor 
headquartered in Texas sued its franchisee based in South Carolina after 
the franchisee closed one of its stores and stopped paying royalties. The fran-
chisee counterclaimed on numerous grounds, including violation of the 
Texas Business Opportunity Act. Among other claims, the franchisee 
claimed that the FDD had been out of date when received, and that this vi-
olated the FTC Rule and therefore violated the Texas Act. In deciding 
against the franchisee, the court noted that “no provision of Texas law di-
rectly incorporates the requirements of the FTC Rule,” and the franchisee 
failed to plead the elements required for a claim under the Texas Act. The 
case suggests that the franchisee’s mistake was arguing in its pleadings that 
the franchisor could not satisfy an affirmative defense, when it should instead 
have included allegations that would require the franchisor to assert this af-
firmative defense. Readers of the case are left wondering how the court 
would have decided if the franchisee had stated in its counterclaim that 
the seller violated the Texas Act by failing to register in Texas as a “business 
opportunity seller.” If, in fact, the seller did not register as a business oppor-
tunity seller in the belief that it satisfied the FTC Rule exemption, it presum-
ably would have so stated as an affirmative defense, thus raising the issue of 
its FTC Rule compliance for evaluation by the court.

IV. Choice of Law

Choice of law has generated dozens of conflicting decisions over the 
years, and many observers have come to regard it as unpredictable, depend-
ing more on the whims of a particular judge or court than on astute legal rea-
soning. However, the recent federal court decision in Zounds Hearing Fran-
chising, LLC v. Bower may bring a cogent set of guiding principles to future 
cases, at least those attempting to invoke a franchise purchaser protection 
statute. In Zounds, a group of Ohio franchisees sued an Arizona franchisor 
for violation of the Ohio Business Opportunity Act. The franchise agree-

37. The Texas Act permits use of an alternative form of disclosure document, including the 
FDD.
38. 819 F.3d 170 (5th Cir. 2016).
ment selected Arizona law, but the plaintiffs’ complaint relied on application of the Ohio statute and did not allege any claim recognizable under Arizona law. The defendants moved to dismiss on numerous grounds and moved the court alternatively to transfer the case from Ohio to Arizona. The Ohio court declined to make any dispositive rulings, but ordered the case transferred to Arizona. The Arizona court subsequently decided the dispositive motions in favor of the franchisees and transferred the case back to Ohio. In deciding that Ohio law governed the dispute, the court stated as follows:

The question posed in this case is . . . whether an out-of-state franchisor can avoid local investor protection statutes by getting an investor to agree that local law does not apply and the law of some other state applies instead . . . The answer is clearly no. . . . Investor protection franchise laws reflect a fundamental policy of a state as to what contract terms are permitted and legal for investments and businesses in the state. Franchisors may not exempt themselves from such laws merely by entering into the forbidden contract terms and adding that the law of some other state will substitute.

Based on the reasoning in Zounds, the author believes that courts will henceforth generally apply the law of the franchisee’s state, rather than the contractually selected law of the franchisor’s state, in cases where the acts complained of would be covered by a statute in the franchisee’s state.

A related question concerns application of a state’s business opportunity statute to an out-of-state franchisee, where the franchisor is located in the state of the statute, and the franchise agreement selects the franchisor’s state law to govern the agreement. Some statutes include express language limiting the law’s application to purchasers residing in the state, or perhaps to offers or sales deemed to have been made in the state. However, if a statute is silent on this point, case law must be consulted to make this determination.

None of the statutes discussed in Part III of this article includes language limiting its application to in-state purchasers. A number of cases decided under the Ohio Act have involved out-of-state purchasers. These cases were all litigated for several years without mentioning this issue, and all were decided on other grounds. The Yumilicious case decided under the

40. E.g., the franchise agreement prohibited joint suits, specified Arizona as the exclusive venue, and required mediation in Arizona as a precondition to any lawsuit.
42. Two registration states with such language in their statutes are Illinois and Virginia.
43. The Nebraska Act contains a section defining which offers or sales are deemed to occur in Nebraska. Neb. Rev. Stat. § 59-1723. The language of this definition seems broad enough to include most out-of-state franchisees. In any case, the statute does not seem to include operative language limiting its application to transactions defined by this section.
45. See fn. 33 and accompanying discussion.
Texas Act involved a South Carolina franchisee and alluded to this issue, but did not discuss it.

In the absence of case law directly addressing this issue under the Ohio Act, the issue should be governed by the Sixth Circuit’s decision in *Boatland, Inc. v. Brunswick Corp.* In *Boatland*, a Tennessee marine engine dealer attempted to invoke the Wisconsin Fair Dealership Law in its dispute with a Wisconsin manufacturer, where the dealership contract selected Wisconsin law. Rejecting the manufacturer’s argument that the Wisconsin legislature never intended that the statute have extraterritorial effect, the court stated:

There is no evidence that the Wisconsin legislature intended to restrict the territorial application of the statute, or to prevent anyone, particularly a Wisconsin resident, from making Wisconsin law applicable to this contract.

*Boatland* is entitled to equal protection of the same law which applies to dealers located in Wisconsin, because its contract was made and entered into in that state and it contains an express provision that Wisconsin law is to be applied.

The Wisconsin legislature subsequently amended the statute to limit it to Wisconsin residents, but the case nonetheless remains good law as to interpretation of such statutes when they are silent on this issue. This analysis is supported by language in the *Zounds* decision:

it is hard to imagine that any [franchise protection] statute will ever be less than fundamental policy of the state. . . . Under this view, it would not matter either that the franchisee is out of state. As a matter of statutory construction, a state’s declaration of protection of business and investment integrity within its boundaries is not silently limited to protecting its own residents. . . .

The author believes that the four laws can be said to apply to out of state franchisees, based on (1) the absence of contrary language in the four state laws under discussion; (2) the fact that claims have previously been brought and contested under some of these laws by out of state franchisees, without any discussion of their extraterritorial application; and (3) the language cited from the *Boatland* and *Zounds* cases.

**V. Strategies for Avoiding Liability Under the Business Opportunity Acts**

**A. State Specific Amendments**

As noted, four states with Business Opportunity (or equivalent) statutes can seemingly create potential liability for franchisors, based on circum---
stances that might be regarded as FTC Rule violations: Kentucky, Nebraska, Ohio, and Texas. All of these statutes include state-specific disclosure requirements, and all include exemptions for transactions that comply with the FTC Rule. Three of the states require a cancellation period of either three days (Nebraska), five days (Ohio), or thirty days (Kentucky), but in other respects the state-specific disclosure requirements of all four states could probably be satisfied by use of an FDD, with perhaps only minimal additions.

Franchisors selling in many states already include state-specific amendments in their documents for a number of registration states. Nothing prevents a franchisor from including a state-specific amendment in its agreement for a non-registration state such as Ohio. If such an amendment provided the cancellation period required by the respective state-specific disclosure format, and otherwise addressed any other state-specific requirements, including such an amendment in the franchise agreement would provide an added layer of protection against subsequent lawsuits claiming disclosure violations. If a franchisee later attempted to allege FTC Rule violations, the franchisor might be able to establish compliance with the statute’s state-specific disclosure requirements without resorting to its FTC Rule exemption. Under these circumstances, there would be no available cause of action under the statute based solely on FTC Rule violations.

B. Choosing a Different Law

The author assumes that the law of the state where a franchisee operates will typically govern disputes arising under a Business Opportunity statute, regardless of any contrary choice of law provision in the franchise agreement. As additionally discussed in Part IV of this article, the law of the franchisor’s state will typically apply when a franchise is sold to an out-of-state purchaser residing in a state with no applicable franchise statute of its own. But this result could seemingly be avoided by selecting a different law in the franchise agreement. In this way, for example, an Ohio franchisor could avoid application of Ohio’s franchisee-friendly statute to its out-of-state purchasers. To avoid the need to draft individualized language for each franchisee, the franchise agreement could simply state that the applicable law would be the law of the state where the franchisee operates the business.

VI. Conclusion

The author’s law school course on franchise law emphasizes the centrality of the FTC’s Franchise Rule to regulation of franchising. However, of the

51. This might include the need to register the business opportunity with state officials in Kentucky and Texas.
52. See discussion of this point in Part IV.
53. The discussion of this point is here limited to the four states discussed in Part III, namely Kentucky, Nebraska, Ohio, and Texas.
eighteen Business Opportunity Acts considered, only four provide a basis for enforcing faulty presale franchise disclosures. The other fourteen Business Opportunity Acts give sellers a free pass if their transactions meet the definition of a “franchise.” As a result, franchise purchasers in fully thirty-two states are not protected by any state franchise disclosure requirement. Why this state of affairs exists forty years after passage of the FTC Rule is an open question, worthy of consideration by the Forum’s membership.

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54. Business Opportunity statutes were excluded from consideration if the state also had a franchise registration law.
Leegin, Ten Years Later: Did Vertical Agreements Remain Unlawful Per Se Where Adopted to Facilitate a Price-Fixing Horizontal Scheme?

James Mulcahy and Filemon Carrillo

I. Introduction

In June 2007, in its Leegin Creative Leather Products, Inc. v. PSKS, Inc. decision, the U.S. Supreme Court overruled its century-old rule applying per se illegality to vertical agreements to fix minimum resale prices. They are now subject to the rule of reason analysis.

Some anticipated that the Leegin decision would catalyze the proliferation of resale price maintenance (RPM) agreements nationwide. However, because some states still consider RPM agreements as per se violations of their respective antitrust statutes, this phenomenon has been largely unseen. For instance, California courts continue to uphold per se condemnation under the Cartwright Act, the California antitrust statute; this is unlikely to change soon. Also, Maryland rejected the Leegin holding by statute. And although New York state appellate courts have not addressed the


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issue, New York’s attorney general has challenged RPM agreements.6 This suggests a willingness to continue to file such cases, leaving companies unsure about whether they should enter into RPM agreements. With this in mind, it is no surprise that companies have been unwilling to test the waters.

Still, following the Leegin decision, the federal courts have been asked to address the potential anticompetitive effects of vertical agreements that have horizontal effects in that they reduce competition among competitors. Leegin, of course dealt only with a purely vertical price restriction that existed to increase interbrand competition. Nevertheless, the Leegin Court recognized that RPM might harm consumers if it has a horizontal effect by facilitating cartels that reduce interbrand competition.7 According to the Court:

A horizontal cartel among competing manufacturers or competing retailers that decreases output or reduces competition in order to increase price is, and ought to be, per se unlawful. [Citations]. To the extent a vertical agreement setting minimum resale prices is entered upon to facilitate either type of cartel, it, too, would need to be held unlawful under the rule of reason. This type of agreement may also be useful evidence for a plaintiff attempting to prove the existence of a horizontal cartel.8

But what exactly does this language mean? Section I of the Sherman Act bars unreasonable restraints, and the rule of reason typically applies to vertical agreements between entities at different levels. But what is the test for price restraints that do not fit neatly into the standard taxonomy because, while vertical in nature, they restrict competition between horizontal entities (vertical/horizontal hybrid restrictions)?9 Are these vertical agreements still subject to the rule of reason under Leegin? Consider the following hypotheticals:

One: A retailer—call it Retailer A—wants to enter the eBook market. But Retailer A cannot compete at the below-cost prices offered by another retailer, Retailer B, which holds over 90 percent of the eBook market. To combat the below-cost price, the Retailer A approaches all of the eBook publishers to orchestrate a horizontal price-fixing agreement among them. Retailer A devises an elegant vertical agreement whereby the publishers convert their eBook retailers to an agency model. Through this new model, the publishers set the retail price of the eBooks, and Retailer A is guaranteed a 30 percent commission. The vertical agreements also include a provision that allows Retailer A to match the lowest price on the market for these books. In effect, this provision requires the publishers to enter into the same agency model with Retailer B, which the publishers accomplish in short order. Is Retailer A’s conduct of entering into vertical agreements to

8. Id. at 893 (emphasis added).
9. For clarity, the term “vertical/horizontal hybrid restrictions” is used to refer to cases where the allegedly anticompetitive scheme includes vertical agreements with horizontal effects—i.e., hub and spoke cases and group boycott cases.
organize a horizontal price-fixing cartel subject to per se condemnation or will it be judged under the rule of reason?

Two: A franchisor-manufacturer of heavy-duty trucks grants franchises with non-exclusive territories. To assist its franchisees in competing with other brands, the franchisor offers transaction-specific discounts. One franchisee is selling the trucks with an additional discount in the non-exclusive territories of other franchisees. In response, the non-discounting franchisees pressure the franchisor to adopt a policy that denies the franchisor’s transaction-specific discounts to sales within other franchisees’ territories. This policy effectively stops the discounted sales into their territories. Are the franchisor’s vertical agreements with the non-discounting franchisees that facilitated a horizontal price-fixing cartel per se unlawful?

These hypotheticals represent the facts under which the Second Circuit and the Third Circuit decided this question. And they arrived at opposite conclusions. The Second Circuit in United States v. Apple, Inc. held that the vertical agreements were entered into as a part of the horizontal scheme, and thus the vertical participant must suffer the same per se fate as the horizontal colluders.10 The Third Circuit in Toledo Mack Sales & Service, Inc. v. Mack Trucks, Inc. held that, under Leegin, the vertical agreements are subject to the rule of reason even when they are entered into to enforce a horizontal price-fixing cartel.11 Which is correct?

This conflict presents an important question, the outcome of which will have a tremendous impact. If vertical participants in a scheme designed to fix prices or decrease output are subject to rule of reason analysis, it is possible that the very sine qua non of the price-fixing cartel gets off scot-free. In fact, this was the very outcome of the Third Circuit decision—the vertical participant was found not liable by the jury in a rule of reason trial. With these conflicting decisions, the antitrust plaintiff now faces a heightened standard to plead and prove a case alleging vertical/horizontal hybrid restrictions.

This article analyzes whether Leegin overruled a series of cases holding that where a vertical participant joins in the unlawful horizontal cartel, the vertical participant is also per se liable for a violation of Section 1 of the Sherman Act. The article also analyzes the standard that the antitrust plaintiff must now satisfy to plead and prove that a vertical participant should be liable per se in a case alleging vertical/horizontal hybrid restrictions. First, it will lay out the statutory scheme and historical trend toward the elimination of per se condemnation of vertical restraints. Second, this article outlines the Supreme Court’s case law in cases alleging vertical/horizontal hybrid restrictions. Third, it will set forth the facts and holdings of the conflicting decisions of the Third Circuit and the Second Circuit. Fourth, the article presents the argument for upholding the Supreme Court’s long history of treating both vertical and horizontal participants equally in a case alleging

10. 791 F.3d 290, 323 (2d Cir. 2015).
11. 530 F.3d 204, 225 (3d Cir. 2008).
vertical/horizontal hybrid restrictions. Fifth, the article analyses recent decisions to articulate the burden that antitrust plaintiffs now have to meet to subject a vertical participant to per se liability.

II. The Sherman Act—Per Se v. Rule of Reason Analysis

To successfully plead a claim under Section 1 of the Sherman Act, a plaintiff must plead evidentiary facts to show:

(1) a contract, combination or conspiracy among two or more persons or distinct business entities; (2) by which the persons or entities intended to harm or restrain trade or commerce among the several States, or with foreign nations; (3) which actually injures competition.\(^\text{12}\)

It is now a legal axiom that a bare assertion of the existence of an unlawful agreement is not entitled to the presumption of truth.\(^\text{13}\) Requiring proof of a potential agreement is essential to the claim.

In limited circumstances, certain conduct may be per se unlawful. Per se condemnation under the Sherman Act is reserved for “conduct that is manifestly anticompetitive . . . that is, conduct that would always or almost always tend to restrict competition and decrease output.”\(^\text{14}\) Consequently, where a plaintiff proves facts that establish a business practice that has been declared per se unlawful, liability is established as a matter of law.

Because of the severity of per se condemnation, “most antitrust claims are analyzed under the rule of reason.”\(^\text{15}\) Under this framework, “the finder of fact must decide whether the questioned practice imposes an unreasonable restraint on competition, taking into account a variety of factors, including specific information about the relevant business, its condition before and after the restraint was imposed, and the restraint’s history, nature, and effect.”\(^\text{16}\) Although the rule of reason has been synthesized from several past decisions, the contemporary rule of reason analysis has been “cast[] in terms of shifting burdens of proof.”\(^\text{17}\) Under the rule of reason:

The plaintiff bears the initial burden of showing that an agreement had a substantially adverse effect on competition. If the plaintiff meets this burden, the burden shifts to the defendant to come forward with evidence of the procompetitive virtues of the alleged wrongful conduct. If the defendant is able to demonstrate procompetitive effects, the plaintiff then must prove that the challenged conduct is not reasonably necessary to achieve the legitimate objectives or that those objectives can be achieved in a substantially less restrictive manner. Ultimately, if


\(^\text{13}\) Twombly, 550 U.S. at 555.


\(^\text{15}\) See State Oil Co. v. Khan, 522 U.S. 3, 10 (1997).


\(^\text{17}\) Law v. Nat’l Collegiate Athletic Ass’n, 134 F.3d 1010, 1019 (10th Cir. 1988).
these steps are met, the harms and benefits must be weighed against each other in order to judge whether the challenged behavior is, on balance, reasonable.\textsuperscript{18}

Needless to say, as a practical matter, it is far more cumbersome (and costly) to litigate an antitrust action judged under the rule of reason than under the per se rule. In the per se realm, a plaintiff need only establish that the conduct occurred—i.e., horizontal price-fixing cartel. Once the conduct is established, so is liability.

In the rule of reason realm, establishing that the underlying agreement existed is only step one. The plaintiff would be required to satisfy the burden shifting set forth above and show that the conduct is an unreasonable restraint of trade. From a purely practical standpoint, “it is very difficult for a plaintiff (whether the government or a private party) to win a rule of reason case.”\textsuperscript{19} Indeed, one academic survey found that from 1977–2009, plaintiffs won very few rule of reason cases to reach a judgment.\textsuperscript{20} For this reason, where a court decides that alleged anticompetitive conduct is judged under the rule of reason, it is tantamount to handing the defendants a “get out of jail free” card.

III. The Court Slowly Chips Away at the Per Se Treatment of Vertical Restraints

A. A Brief History of the Court’s Treatment of Vertical Non-Price Restraints

The Supreme Court was hostile toward non-price restraints for a long time but did not condemn them per se until its 1967 decision in \textit{United States v. Arnold Schwinn & Co.}\textsuperscript{21} In \textit{Schwinn}, the United States challenged Arnold Schwinn & Company’s distribution policy that (1) restricted distributors to selling to franchised retailers in a restricted territory and (2) restricted franchised retailers to selling to consumers and not to non-franchised retailers.\textsuperscript{22} The Court held that “[u]nder the Sherman Act, it is unreasonable without more for a manufacturer to seek to restrict and confine areas or persons with whom an article may be traded after the manufacturer has parted with dominion over it.”\textsuperscript{23} Thereafter, vertical non-price restrictions were a

\textsuperscript{18} Buccaneer Energy (USA) Inc. v. Gunnison Energy Corp., 846 F.3d 1297, 1310 (10th Cir. 2017).
\textsuperscript{21} 388 U.S. 365 (1967)
\textsuperscript{22} \textit{Id.} at 371–72.
\textsuperscript{23} \textit{Id.} at 379 (emphasis added).
per se violation if the products were sold to retailers, but subject to the rule of reason if the products were sent on consignment.\footnote{Id. at 382.}

Of course, this is a distinction without difference and is economically irrational. The intent and competitive impact of the policy is the same whether or not distributors and franchisees take title to the products. The goal of geographic restrictions and of disallowing sales to non-franchised retailers is to eliminate intrabrand competition among franchisees in a given market. This, in turn, promotes interbrand competition because retailers of the same brand will not need to compete with one another. Instead, the consumer’s choice will be between brands and/or ancillary services that retailers may offer. The transaction between a manufacturer and the distributor or retailer has no bearing on the competitive effects of the underlying policy. After all, the aim of antitrust law is to protect competition for the good of the consumer.\footnote{Cf. Brunswick Corp. v. Pueblo Bowl-O-Mat, Inc., 429 U.S. 477, 488 (1977) ("The antitrust laws, however, were enacted for "the protection of competition, not competitors." (citing Brown Shoe Co. v. United States, 370 U.S. 294, 320 (1962))).}

The Court recognized that its decision in \textit{Schwinn} was untenable and overruled it ten years later in \textit{Continental T.V., Inc. v. GTE Sylvania Inc.}\footnote{433 U.S. 36 (1977).} There, GTE Sylvania Inc. found its market share declining to one to two percent of national television sales.\footnote{Id. at 38.} To combat its falling market share, Sylvania adopted a franchise system. Its purpose was to decrease intrabrand competition to attract successful retailers and incentivize investment into the franchisee’s business. To achieve this, “Sylvania limited the number of franchises granted for any given area and required each franchisee to sell his Sylvania products only from the location or locations at which he was franchised.”\footnote{Id. at 38–39.} A discontented franchisee challenged this geographic restriction as a violation of the Sherman Act under \textit{Schwinn}.\footnote{Id. at 40.}

In overruling its \textit{Schwinn} decision, the Court recognized that “the distinction drawn in Schwinn between sale and nonsale transactions is not sufficient to justify the application of a per se rule in one situation and a rule of reason in the other.”\footnote{Id. at 57.} The Court also recognized that scholarly and judicial authority supported the “economic utility” of vertical non-price restrictions.\footnote{Id. at 57–58.}

\section*{B. A Brief History of the Court’s Treatment of Vertical Price Restraints}

In 1911, the U.S. Supreme Court issued its decision in \textit{Dr. Miles Medical Co. v. John D. Park \& Sons Co.},\footnote{220 U.S. 373 (1911).} in which the Court held that RPM agree-
ments were a violation of the antitrust laws.\textsuperscript{33} While the Court did not use the “per se” label in its decision, the Court and lower courts interpreted \textit{Dr. Miles} as holding that vertical price restraints are unlawful per se.

Notably, the Court’s decision in \textit{Dr. Miles} was not based on an economic analysis of RPMs generally. Instead, the Court’s holding was based on the common law belief that the “right of alienation is one of the essential incidents of a right of general property” and that “restraints upon alienation have been generally regarded as obnoxious to public policy.”\textsuperscript{34} Nevertheless, this decision sparked the Court’s analysis of vertical restraints, both price and non-price.

It did not take long before the Court reined in its per se condemnation of RPM in \textit{Dr. Miles}. In 1919, the Court in \textit{United States v. Colgate}\textsuperscript{35} announced that the Sherman Act “does not restrict the long recognized right of . . . [the] manufacturer . . . freely to exercise his own independent discretion as to parties with whom he will deal.”\textsuperscript{36} Distinguishing \textit{Colgate} from \textit{Dr. Miles}, the Court noted that in \textit{Dr. Miles} “the unlawful combination was effected through contracts which undertook to prevent dealers from freely exercising the right to sell.”\textsuperscript{37} Consequently, under \textit{Colgate}, even anticompetitive conduct with no redeeming value escapes Section 1 liability if there is no “contract, combination or conspiracy.”\textsuperscript{38} The so-called \textit{Colgate} doctrine continues to apply today.\textsuperscript{39}

After \textit{Colgate}, the central question was whether a plaintiff could plead and prove an agreement. In the 1980s, the Supreme Court reaffirmed the importance of establishing an agreement as opposed to unilateral conduct. In \textit{Monsanto Co. v. Spray-Rite Service Corp.},\textsuperscript{40} a discounter-distributor brought an action alleging that Monsanto (the manufacturer) conspired with its distributors to fix the resale prices and terminated the discounter-distributor in furtherance of the conspiracy.\textsuperscript{41} The Court held that “[t]here must be evidence that tends to exclude the possibility” of independent action.\textsuperscript{42} “[T]he antitrust plaintiff should present direct or circumstantial evidence that reasonably tends to prove that the manufacturer and others had a conscious commitment to a common scheme designed to achieve an unlawful objec-

\begin{thebibliography}{99}

\bibitem{33} \textit{Id.} at 408–09.
\bibitem{34} \textit{Id.} at 404.
\bibitem{35} \textit{250 U.S. 300} (1919).
\bibitem{36} \textit{Id.} at 307.
\bibitem{37} \textit{Id.} (emphasis added).
\bibitem{40} \textit{465 U.S. 752} (1984).
\bibitem{41} \textit{Id.} at 757.
\bibitem{42} \textit{Id.} at 764.
\end{thebibliography}
The plaintiff in Monsanto satisfied this standard. Moreover, the Court declined the United States’ and amicus curiae’s request that the court overrule *Dr. Miles*.

Fast forward to 2007. In *Leegin*, a leather belt manufacturer instituted an RPM policy and offered compliant retailers various incentives. PSKS, a retailer, refused to comply and insisted upon selling belts below the mandatory minimum resale price. The manufacturer refused to continue providing incentives to PSKS and litigation ensued. The case made it to the Supreme Court, which overruled *Dr. Miles* and announced that RPM agreements are subject to the rule of reason analysis. Procompetitive justifications, such as stimulating *interbrand* competition, incentivizing investment by retailers, and diversifying products available to consumers were the economic bases for applying the rule of reason. The Court overruled *Dr. Miles*, stating that the “reasons upon which *Dr. Miles* relied do not justify a per se rule.” From that point on, RPM agreements were to be analyzed under the rule of reason, at least under federal law.

By overruling the century-old law, the Supreme Court brought its decades-long contraction of the per se condemnation of vertical restraints to full circle. Yet, although the Court conclusively stated that RPM agreements are subject to the rule of reason, it by no means established a framework of analysis going forward. Delegating this task to the lower courts, the Court stated: “As courts gain experience considering the effects of these restraints by applying the rule of reason over the course of decisions, they can establish the litigation structure to ensure the rule operates to eliminate anticompetitive restraints from the market and to provide more guidance to businesses.”

Now, ten years later, one may ask: have the lower courts taken steps to establish such a “litigation structure” designed to efficiently apply the rule of reason so as to eliminate anticompetitive vertical price restraints? Unfortunately, the answer is “no.”

### IV. The Court’s Historical Treatment of Vertical/Horizontal Hybrid Restrictions

It goes without saying that the antitrust laws reach both horizontal and vertical agreements. “Horizontal restraints are agreements between competitors at the same level of market structure, whereas vertical restraints are

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43. *Id.* (internal quotations and citations omitted).
44. *Id.* at 765.
45. *Id.* at 769 (Brennan, J. concurring).
46. 551 U.S. 877.
47. *Id.* at 883.
48. *Id.* at 884.
49. *Id.* at 907.
50. *Id.* at 889–90.
51. *Id.* at 889.
52. *Id.* at 898.
combinations of persons at different levels of market structure such as manufacturers and distributors.”53

Much of the antitrust case law has centered on this distinction. However, although these categories seem dichotomous, they are not. As the Seventh Circuit noted, “[s]ometimes . . . it can be hard as a matter of fact to be sure what kind of agreement is at issue” because many cases have been brought alleging both vertical and horizontal components to the collusive scheme.54 The cases summarized below illustrate the Supreme Court’s treatment of vertical/horizontal hybrid restrictions.

A. Interstate Circuit v. United States (1939)

In Interstate Circuit, Inc. v. United States,55 theater chain companies operated motion picture theaters at which they showed movies they obtained from distributors. Both the theater chain companies and the distributors were defendants. The theater chain defendants wrote a letter to each of eight movie distributors asking them to meet certain conditions in exchange for the theater company’s “continued exhibition of the distributors’ films in its . . . first-run theatres” at a prescribed price of admission.56 The effect of the conditions was to restrict the pricing terms under which the distributors could license their films to the theater chain’s competitors. Because the letter listed all eight distributors as addressees, the court found that “from the beginning each of the distributors knew that the proposals were under consideration by the others.”57 The distributors accepted the theater chain company’s proposed terms. The district court found this evidence proved concerted action by the distributors (horizontal agreement) and the theater chain (vertical agreements) in violation of Section 1 of the Sherman Act, and the Supreme Court affirmed.58

B. Klor’s, Inc. v. Broadway-Hale Stores, Inc. (1959)

In Klor’s, Inc. v. Broadway-Hale Stores, Inc.,59 a retailer brought a Section 1 claim against a competing retailer and against manufacturers and their distributors alleging a group boycott. Klor’s, Inc. alleged that the colluders conspired to prevent it from purchasing the merchandise it sold to the public. The Supreme Court characterized the collusion as a “wide combination con-

54. See Toys “R” Us, Inc. v. Fed. Trade Comm’n, 221 F.3d 928, 930 (7th Cir. 2000).
55. 306 U.S. 208 (1939).
56. Id. at 216–17.
57. Id. at 222.
58. It bears mentioning that, in truth, Interstate Circuit was not a per se case. See Interstate Circuit, 306 U.S. at 230–32; see also Royal Drug Co. v. Grp. Life & Health Ins. Co., 737 F.2d 1433, 1437 (5th Cir. 1984) (“the Supreme Court’s analysis [in Interstate Circuit] was predicated upon the rule of reason”).
sisting of manufacturers, distributors and a retailer.”60 The Court held that if the combination between the competing retailer, several manufacturers, and their distributors could be proved,61 it would be subject to the per se ban of group boycotts.62 Whether the members of the boycott were vertical or horizontal components did not affect the analysis of the Court.

C. United States v. General Motors Corp. (1966)

United States v. General Motors Corp.63 involved a car manufacturer-franchisor coordinating with its franchisee-dealers and franchisee associations to prevent a small group of franchisees from selling cars at discount prices.64 Franchisees complained of the discounting practices to General Motors Corp. (GM). In response, GM gave notice to all franchisees that selling to discounting outlets was a violation of their franchise agreement. After this notice was announced, GM personnel called and met with the discounting franchisees, after which the franchisees abandoned the discounting practices. The policy against the discounting practices was enforced by GM, the franchisees association, and select individual franchisees. The Supreme Court held that this violated Section 1. In holding the vertical and horizontal participants liable per se, the court noted:

And once the agreements were secured, [GM] both solicited and employed the assistance of its alleged co-conspirators in helping to police them. What resulted was a fabric interwoven by many strands of joint action to eliminate the discounters from participation in the market, to inhibit free choice of franchised dealers to select their own methods of trade and to provide multilateral surveillance and enforcement.65

As the above cases illustrate, although the Supreme Court has long distinguished between vertical and horizontal agreements in analyzing the competitive effect, the vertical/horizontal hybrid restrictions presented in Interstate Circuit, Inc., Klor’s Inc., and General Motors were analyzed holistically. The horizontal agreements were not analyzed separately from the vertical agreements. According to the Court, “if the action of a manufacturer . . . is taken at the direction of its customer, the restraint becomes primarily horizontal in nature that one customer is seeking to suppress its competition by utilizing the power of a common supplier. Therefore, although there is . . . a vertical restraint, the desired impact is horizontal and on the dealer, not the manufacturer, level.”66 This further underscores the aim of the antitrust

60. Id. at 212–13.
61. The combination alleged in Klor’s consists of vertical agreements between the retailer and the manufacturers and distributors and of horizontal agreements among the manufacturers.
62. Id. at 212–14.
64. Id. at 130–33.
65. Id. at 144 (emphasis added); see also Toys “R” Us, Inc., 221 F.3d 928 (holding Toys “R” Us per se liable where it “supervised” a horizontal agreement among manufacturers to reduce output by entering into exclusive dealing arrangements with each manufacturer).
laws to hold accountable all those co-conspirators with a “conscious commit-
ment to a common scheme designed to achieve an unlawful objective.”67 In
other words, the antitrust laws seek to prevent anticompetitive effects.

V. After Leegin Are Price Restraints That Are Vertical in Nature,
But Have Horizontal Effects in That They Reduce Competition,
Subject to Per Se Treatment?

As it turns out, lower courts have not interpreted Leegin’s language con-
sistently when deciding cases alleging vertical/horizontal hybrid restrictions.
Notably, the Interstate Circuit, Inc., Klor’s Inc., and General Motors decisions
were not mentioned in the Leegin decision. Consequently, courts are left
to decide whether the Supreme Court tacitly overruled these precedents
by stating: “To the extent a vertical agreement setting minimum resale prices
is entered upon to facilitate either type of cartel, it, too, would need to be
held unlawful under the rule of reason.”68 So assuming that the horizontal
agreement is unlawful per se, does the vertical participant in the unlawful
scheme escape per se liability under Leegin? As illustrated by the two com-
peting cases below, the answer is unclear.

A. Toledo Mack Sales & Service, Inc. v. Mack Trucks, Inc.

One year after the Leegin decision, the Third Circuit decided Toledo Mack
Sales & Service, Inc. v. Mack Trucks, Inc.69 There, Mack Trucks, Inc., a man-
ufacturer of heavy-duty trucks and franchisor of Mack dealerships, granted
franchises with nonexclusive geographic regions.70 The conduct discussed
below formed the basis of the Section 1 claim by franchisee Toledo Mack
Sales & Service, Inc.

Mack trucks are “made to order” from the potential consumer’s specifications.
After the potential customer gives its specifications to the Mack
franchisee-dealer, the dealer goes to Mack to obtain a price at which Mack
is willing to sell the truck to the dealer. To assist its dealers in competing
with other brands, Mack offers a “transaction-specific discount known as
'sales assistance.'”71 The dealer then gives a quote to the consumer. If the
consumer accepts the quote from the dealer, the dealer orders the truck to
deliver to the consumer.72

Potential consumers will solicit bids from multiple Mack dealers and from
Mack’s competitors. Given that the “sales assistance” is transaction-specific,
Mack gives its quote to each dealer. Consequently, Mack dealers competing

68. Leegin, 551 U.S. at 893. See e.g., Apple, 791 F.3d at 324 (stating that the Supreme Court
had not overturned General Motors or Klor’s).
69. 530 F.3d 204 (3d Cir. 2008).
70. Id. at 209.
71. Id.
72. Id. at 209–10.
for the same consumer may submit bids that differ based, in part, on the sales assistance offered to it by Mack.73 Toledo’s business strategy “focused on offering the lowest possible price to his consumers [and] aggressively pursued its low-price sales strategy throughout the country, competing on price against other Mack dealers for sales in other dealers’ [nonexclusive geographic regions].”74

After other dealers complained, Mack adopted a policy that declined sales assistance on sales into another dealer’s territory.75 Toledo submitted evidence that Mack executives were aware of Toledo’s discounting practices and that “[they] are not going to let this happen.”76 In fact, Mack executives and dealer representatives drafted the policy that denied sales assistance to sales into another dealer’s territory.77 The Third Circuit concluded that “Toledo presented direct evidence that Mack agreed with its dealers to support their anti-competitive agreements and that it did so by, among other things, refusing to offer sales assistance to dealers who sought to sell outside their [non-exclusive territories].”

Toledo filed a lawsuit asserting, inter alia, claims for violation of Section 1 of the Sherman Act. It alleged that Mack and the Mack dealers had developed an unlawful conspiracy “to keep prices on Mack products artificially high.”78 The conspiracy had two parts:

First, Toledo claims that, beginning in the mid-1980s, individual Mack dealers entered into “gentlemen’s agreements” not to compete with each other on price. Second, Toledo alleges that, beginning in 1989, Mack entered into an agreement with its dealers that it would delay or deny sales assistance to any dealer who sought to make an out-of-[territory] sale, thereby protecting dealers that sell within their own [nonexclusive territories].79

After trial, the district court granted judgment as a matter of law in favor of Mack on Toledo’s Section 1 claim. Toledo appealed. The issue before the Third Circuit was whether the evidence that Toledo presented at trial was “sufficient to allow a rational jury to conclude that Mack and its dealers committed . . . acts in furtherance of an illegal conspiracy or conspiracies.”80

The court split its analysis of Toledo’s Section 1 claim into two “purported agreements—the horizontal agreement among the dealers, and the vertical

73. Id.
74. Id.
75. Id. at 212.
76. Id. at 221.
77. Id. at 222.
78. Id. at 210.
79. Id. (emphasis added).
80. Id. at 218. The Third Circuit also addressed (1) whether Toledo was required to prove its case using evidence restricted to the statute of limitations period; (2) whether the district court erred in granting summary judgment in favor of Mack on its Robinson-Patman Act claim; and (3) whether Mack’s misappropriation of trade secrets counterclaim was barred by Pennsylvania’s “gist of the action” doctrine. Id. at 217. Relevant here, the Third Circuit held that “Toledo was not required to prove an illegal conspiracy with evidence restricted to the limitations period.” Id.
agreement between Mack and the dealers.81 First, the court found that direct evidence supported the existence of agreements among Mack dealers not to compete with one another.82 Citing the Leegin Court’s language, the court noted that horizontal price-fixing was per se unlawful.83 The court found that, if such agreement exists, “it involved horizontal competitors colluding to control prices and, therefore, would be per se unlawful.”84

Second, the court found that “Toledo’s evidence was sufficient to allow a jury to conclude that Mack entered into a competition-restricting agreement with its dealers.”85 Finding that evidence supported the existence of an agreement, the court moved on to deciding whether that agreement was an unreasonable restraint of trade.

Here lies the point of distinction between this case and the Apple holding, discussed below. The court held that Mack only entered into the vertical agreements to facilitate the horizontal agreement among the competing dealers.86 Citing Leegin, the court stated: “The rule of reason analysis applies even when, as in this case, the plaintiff alleges that the purpose of the vertical agreement between a manufacturer and its dealers is to support illegal horizontal agreements between multiple dealers.”87

The court analyzed the evidence at trial and found that, under the rule of reason, a jury could find that Mack entered into an illegal agreement with its dealers. The case was remanded to the district court for further proceedings.88

B. United States v. Apple, Inc.

In June 2015, the Second Circuit issued its decision in United States v. Apple, Inc.89 There, the United States filed a civil suit against Apple, Inc. and five of the six largest publishers of trade books (the Publishers).90 The government alleged that Apple and the Publishers conspired to raise and fix prices of new releases and New York Times bestselling books in violation of Section 1 of the Sherman Act, among other state law claims.91 The facts giving rise to this suit are summarized below:

81. Id. at 219. Before beginning its analysis, the Third Circuit noted that “special rules govern [its] analysis of Toledo’s evidence for the existence of the agreements and their legality.” Id.
82. Id. at 220.
83. Id. at 221 (“A horizontal cartel among . . . competing retailers that . . . reduces competition in order to increase price is, and ought to be, per se unlawful.” (quoting Leegin, 551 U.S. at 893)).
84. Id.
85. Id. at 224–25.
86. Id. at 225.
87. Id.
88. Id. at 226.
89. 791 F.3d 290 (2nd Cir. 2015).
90. Id. at 311. The publisher defendants were Simon & Schuster, Inc., Hachette Book Group, Inc., HarperCollins Publishers L.L.C., Macmillan, and The Penguin Group. Id. at 296. The publisher defendants signed consent decrees to settle the claims with the Department of Justice. Id. at 311–12. Apple was the only defendant to go to trial. Id. at 312.
91. Id. at 311.
The sale of new releases and bestseller books was fairly consistent among the Publishers. The Publishers sold hardcover copies to retailers at a wholesale price, suggesting a retail list price. In November 2007, Amazon.com, Inc. began to offer eBooks on its Kindle device. Although it followed the traditional wholesale business model on most books, Amazon sold eBook versions of new releases and New York Times bestsellers at a price of $9.99. This price was equal to or slightly below the wholesale price that it paid to the publishers. Notably the hardcover version of these releases was “often priced . . . at thirty dollars or more.”

The Publishers saw Amazon’s pricing policy as a threat to their business model. Their fear was the $9.99 price point for these eBooks would become engrained in the minds of the consumers and would drive down the price of print books. Although the Publishers made some attempts to negotiate with Amazon, their efforts proved futile.

Enter their white knight—Apple. Looking to enter the eBook market, Apple approached the Publishers as its first step to creating its eBook store. Apple recognized that it could not compete with Amazon’s below-cost price point. To combat Amazon’s price, Apple suggested that the Publishers enter into an agency relationship where the publisher sets the retail price of each book and pays the retailer a commission from those sales. This did not solve the other problem Apple and the Publishers faced—Amazon’s price. Apple needed to figure out a way to eliminate retail price competition. To that end, Apple devised the most-favored nation clause (the MFN clause). The MFN clause required that, if the price the publisher set for a particular book in Apple’s iBookstore was higher than the price offered at another retailer, Apple would be allowed to match the lower price. The MFN clause set price caps on eBooks at $12.99, $14.99, $16.99, and $19.99, depending on the price of the hardcover book. Of the proceeds, the Publishers would keep 70 percent and Apple would receive a commission of 30 percent of the price.

Ostensibly, the MFN clause required the Publishers to match the iBookstore price to the price that Amazon offered. This meant that, in practice, the Publishers would need to move Amazon into the agency model, whereby they could set the price offered to consumers. Moreover, the court found that the Publishers all agreed that in order for this model to work, every Publisher would have to participate. And the court found that “[u]nder Apple’s proposed agency model, the publishers stood to make less money per sale

92. Id. at 298.
93. Id. at 299.
94. Id. at 299–300 (internal quotations and citations omitted).
95. Id. at 300–01.
96. Id. at 304.
97. Id. at 304–07.
98. Id. at 304–05.
than under their wholesale agreements with Amazon, but the Publisher Defendants were willing to stomach this loss because the model allowed them to sell new releases and bestsellers for more than $9.99."99 But it would only work if the Publishers successfully moved Amazon to the same agency model. In short order, Amazon capitulated to the Publishers’ agency model.100

Their plan worked, but at a steep price. The trial court found that Apple violated Section 1 of the Sherman Act by “orchestrat[ing] a conspiracy among the Publisher Defendants to eliminate retail price competition in the e-book market in order to raise the retail prices of e-books.”101 The trial court also found that “[b]ecause this conspiracy consisted of a group of competitors . . . assembled by Apple to increase prices, it constituted a ‘horizontal price-fixing conspiracy’ and was a per se violation of the Sherman Act.”102

On appeal, Apple argued that its conduct should not be subject to per se condemnation, even if it orchestrated the horizontal conspiracy.103 The Second Circuit found that the record supported that Apple had “conspired with the Publisher Defendants to eliminate retail price competition and to raise e-book prices.”104

Next, the Second Circuit decided that the per se condemnation of the horizontal price-fixing agreement applied to Apple’s conduct.105 The court analyzed Apple’s conduct in the aggregate rather than focusing on its posture as a vertical participant. It found that “the relevant ‘agreement in restraint of trade’ in this case is not Apple’s vertical contracts with the Publisher Defendants (which might well, if challenged, have to be evaluated under the rule of reason); it is the horizontal agreement that Apple organized among the Publisher Defendants to raise e-book prices.”106 As far as the Second Circuit was concerned, the fact that Apple was a vertical participant did not mean that it had not participated in the horizontal agreement; in fact, it found that Apple orchestrated the whole thing. In support of its holding, the court cited the long line of “hub and spoke” cases and held that the Leegin Court had not overruled this precedent.107

99. Id. at 316.
100. Id. at 309.
101. Id. at 312.
102. Id.
103. Id. at 314.
104. Id. at 320.
105. Id. at 321–22.
106. Id. at 323.
107. Id. at 323–25. The court conclusively found that Apple’s agreement was per se unlawful. However, beginning on page 329 of the decision, the majority also analyzed Apple’s horizontal agreement under the rule of reason.
VI. Mack Trucks v. Apple: Which Court Correctly Interpreted Leegin?

The antitrust plaintiff is now left with uncertainty as to whether courts will impose per se liability on a vertical participant in a vertical/horizontal hybrid restraint. On the one hand, Mack Trucks held that where a horizontal agreement is found and is per se unlawful, the vertical agreements established to facilitate the illegal horizontal agreement are analyzed under the rule of reason. The Third Circuit separates the antitrust scrutiny of the horizontal from the vertical components of the collective scheme. On the other hand, Apple held that where a vertical participant orchestrates a horizontal agreement to fix prices and to that end adopts a series of vertical agreements, the vertical participant has joined the horizontal scheme. Apple follows the long-standing trend to analyze vertical/horizontal hybrid restraints by focusing on the intended goal of the co-conspirators rather than the posture of the participants.

As a practical matter, there is little doubt that the objective of both schemes was to stop discounting practices by agreement among competitors. The Mack Trucks and Apple courts both found that the horizontal agreements among competitors were subject to per se condemnation. So under Leegin what fate should the vertical participants face?

Some may argue that because the Court announced in Leegin that RPM agreements entered upon to facilitate a horizontal cartel “would need to be held unlawful under the rule of reason,” the end result would be the same under either standard. But that was not the outcome of the Mack Trucks decision. And therein lies the danger.

After remand, a jury returned a verdict for Mack, the franchisor. Although the Third Circuit had found that there was sufficient evidence to establish an unlawful horizontal agreement to control prices, the vertical participant in that price-fixing scheme escaped liability altogether. This result is anomalous to the century-old caselaw holding that all parties in a case challenging vertical/horizontal hybrid restraints are as liable as their co-conspirators. It is also contrary to the Leegin decision, which stated that this very type of vertical conduct should be unlawful.

A vertical/horizontal hybrid restraint most likely will be horizontal if it was “the product of a horizontal agreement” among the competing entities. Participation by a party vertically related to the conspiring competitors does not lessen the anticompetitive dangers inherent in a horizontal restraint.

108. Apple, 791 F.3d at 327; Mack Trucks, 530 F.3d at 221.
109. Leegin, 551 U.S. at 893.
110. See Toledo Mack Sales & Serv., Inc. v. Mack Trucks, Inc., 386 F. App’x 214 (3d Cir. 2010).
111. Mack Trucks, 530 F.3d at 221.
price-fixing conspiracy.\textsuperscript{113} Nor does that participation transform the horizontal conspiracy into a series of vertical restraints subject to the rule for reason.\textsuperscript{114} Indeed, a vertically related party can “induc[e] the [competitors] to collude, rather than to compete independently.”\textsuperscript{115}

Although there are some points of distinction in the facts in \textit{Mack Trucks} from the facts in \textit{Apple}, these distinctions do not merit Mack escaping liability. Although Apple orchestrated and joined the price-fixing scheme, Mack agreed to facilitate it. Based on this, some may argue that a vertical participant that merely acquiesces to the conspiracy of its downstream or upstream co-conspirators does not deserve the same treatment as the vertical participant that orchestrates the whole scheme. However, the antitrust fate of a competitive scheme is judged by its consequences on the market. Under \textit{Monsanto}, a plaintiff must show that the defendants “had a conscious commitment to a common scheme designed to achieve an unlawful objective.”\textsuperscript{116} A defendant cannot escape antitrust liability by waving its hands in the air and saying: “It was not my idea.” After all, “parties who knowingly join an antitrust conspiracy, like any conspiracy, are liable to the same extent as other conspirators.”\textsuperscript{117}

And \textit{Leegin} is not to the contrary. No horizontal price-fixing conspiracy was alleged in \textit{Leegin}. While the Supreme Court held that vertical minimum price agreements were subject to the rule of reason, it recognized that a “horizontal cartel among compet[i tors] . . . that decreases output or reduces competition in order to increase price is, and ought to be, per se unlawful.”\textsuperscript{118}

The \textit{Leegin} Court also observed that “[t]o the extent a vertical agreement setting minimum resale prices is entered upon to facilitate [such a] cartel, it, too, would need to be held unlawful under the rule of reason.”\textsuperscript{119} Read in context, that statement is best understood to mean that a party who enters into a vertical agreement that facilitates a horizontal conspiracy, but does not join the horizontal conspiracy itself, would be subject to liability under the rule of reason. The Court in \textit{Leegin} did not suggest that a horizontal price-fixing conspiracy escapes per se condemnation simply because it is facilitated by a vertical agreement. Nor did it suggest that the parties who did

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\textsuperscript{113} \textit{In re Insurance Brokerage Antitrust Litig.}, 618 F.3d 300, 338 (3d Cir. 2010).
\textsuperscript{114} \textit{Denny's Marina, Inc.}, 8 F.3d at 1220.
\textsuperscript{115} \textit{Toys “R” Us, Inc.}, 221 F.3d at 936.
\textsuperscript{116} \textit{Monsanto}, 465 U.S. at 764.
\textsuperscript{117} MM Steel, L.P. v. JSW Steel (USA) Inc., 806 F.3d 835, 844 (2015) (citing United States v. All Star Indus., 962 F.2d 465 478 (5th Cir. 1992), and Spectators’ Commc’n Network Inc. v. Colonial Country Club, 253 F.3d 215, 220–21 (5th Cir. 2001)) (holding that a vertical participant joined a horizontal conspiracy among distributors to exclude the plaintiff-distributor); see also \textit{In re Insurance Brokerage, Antitrust Litig.}, 618 F.3d at 337 (defendant insurance broker orchestrated bid-rigging conspiracy with competing insurers); \textit{Toys “R” Us, Inc.}, 221 F.3d at 936 (defendant toy store orchestrated group boycott with competing toy manufacturers); \textit{Denny's Marina}, 8 F.3d at 1221–22 (defendant boat show operators joined price-fixing conspiracy with competing boat dealers).
\textsuperscript{118} \textit{Leegin}, 551 U.S. at 893.
\textsuperscript{119} Id. at 893; see also \textit{Mack Trucks}, 530 F.3d at 225.
join the horizontal conspiracy can escape per se liability simply because they do not compete with their co-conspirators or because the party is only vertically related.

Though monumental, the *Leegin* decision only overruled the per se condemnation of vertical pricing agreements. It did not provide a safe harbor for a vertical participant in a vertical/horizontal hybrid restraint. This is because a “hub and spoke” and group boycott scheme is not the practical equivalent of a purely RPM agreement. The procompetitive effects that removed per se condemnation from RPM agreements\(^{120}\) are not present where the RPM agreement is adopted for the purpose of enforcing or facilitating an unlawful objective. For this reason, the Supreme Court did not tacitly overrule the doctrine espoused in *Interstate Circuit, Inc., Klor’s Inc.*, and *General Motors*. In those cases, the Court held that where a vertical participant joins an unlawful horizontal cartel by adopting vertical agreements, the vertical participant is as liable as its horizontal co-conspirators. This is still the law of the land.

The Supreme Court has established that both price and non-price vertical restraints are to be analyzed under the rule of reason, while agreements among competitors to fix prices or reduce output continue to be unlawful per se.\(^{121}\) Courts can now formulate a new proof structure that should apply to the antitrust liability of vertical/horizontal hybrid restraints.

First, courts should establish whether there has been (1) an agreement among competitors to fix prices or reduce output. Once the court finds such an agreement, then the scheme falls into the per se side of the dichotomy. Second, courts should decide whether the vertical participant(s) had a conscious commitment to the common scheme designed to achieve the unlawful objective of the colluding competitors. If so, the vertical participants should suffer the same fate as their co-conspirators. In fact, the Supreme Court so stated in *Leegin*.\(^{122}\)

By doing this, courts will subject schemes designed to result in price-fixing cartels or group boycotts to the per se treatment, consistent with current Supreme Court law. And courts will allow cases that are purely vertical in nature—or where the horizontal agreement cannot be proved—to be judged under the rule of reason.

**VII. The Antitrust Plaintiff’s Burden Going Forward**

Given the conflicting decisions in *Mack Trucks* and *Apple*, the antitrust plaintiff is left to persuade the court that its case merits the same treatment as in *Apple*. To do this, it is not enough to plead that a vertical participant

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121. *Id.* at 893.
122. *Id.* (“To the extent a vertical agreement setting minimum resale prices is entered upon to facilitate either type of cartel, it, too, would need to be held unlawful under the rule of reason.” (emphasis added)).
entered into vertical agreements to facilitate an unlawful horizontal cartel. Such a strategy could end in the same result as in *Mack Trucks*—a win for the vertical participant in a rule of reason trial. So what must the antitrust plaintiff prove to avoid this?

The burden on the antitrust plaintiff is to plead and prove that the vertical participant *joined* in the unlawful horizontal cartel. That is, the plaintiff must convince a court that despite the vertical posture of the defendant, the end goal of the vertical agreements was to enter into the horizontal cartel. As the following cases illustrate, this can make or break a challenge to a vertical/horizontal hybrid restraint.

A. **MM Steel, L.P. v. JSW Steel (USA) Inc.**

In November 2015, the Fifth Circuit decided *MM Steel, L.P. v. JSW Steel (USA) Inc.* There, MM Steel, L.P., a steel distributor, brought a Section 1 case against competing distributors and two steel manufacturers. MM's sole theory of liability was that the conspirators were per se liable for joining a horizontal group boycott. MM offered evidence at trial that the manufacturer defendants refused to sell them steel as a result of pressure from other steel distributors. MM won at the jury trial and was awarded $6 million in damages.

The two manufacturers, Nucor Corp. and JSW Steel (USA) Inc., appealed, arguing, *inter alia*, that as vertical participants, they were not subject to per se treatment under *Leegin*. The Fifth Circuit responded by noting:

> [T]he crux of the group boycotts at issue in the cases in which per se liability has always applied is that members of a horizontal conspiracy *use vertical agreements anticompetitively to foreclose a competitor from the market*. . . . In these cases, the vertical participants, the manufacturers, actually join the horizontal conspiracy.

The court “decline[d] to hold that the Supreme Court silently overruled this line of cases by stating that vertical agreements to *regulate prices* that facilitate horizontal agreements to *regulate prices* ‘too, would need to be held unlawful under the rule of reason.’”

Next, the court moved to deciding whether there was sufficient evidence supporting the jury’s conclusion that JSW and Nucor had joined the unlawful group boycott. JSW argued that it did not knowingly join the conspiracy. However, the court found that the evidence showed otherwise. The evidence

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124. *Id.* at 842.
125. SSAB, one of the manufacturers, settled before trial. *Id.*
126. *Id.* at 844.
127. The distributor defendants settled and dismissed their appeal. *Id.* at 842.
128. *Id.* at 848–49.
130. *Id.*
supported that JSW had first agreed to supply steel to MM. However, after receiving threats from MM’s competing distributors, JSW decided not to do business with MM. The court also concluded that, at the time JSW abruptly decided to no longer deal with MM, it already knew of the horizontal conspiracy to exclude MM from the market. Based on this, the Fifth Circuit affirmed JSW’s per se liability for joining the horizontal group boycott scheme.  

The court next held that that MM failed to prove that Nucor had joined the horizontal scheme. Nucor provided testimony that it decided not to deal with MM because it had a policy to remain loyal to its existing supply chain. Moreover, the court found that Nucor decided not to deal with MM long before it learned of the horizontal group boycott. Citing to Monsanto Co., the court held that without knowing of the threats by a distributor or that other manufacturers were refusing to deal with MM, “Nucor could not consciously commit to a common scheme to foreclose MM from the market.”

The MM Steel case perfectly illustrates the proof structure suggested earlier. The court found that the plaintiff proved a horizontal scheme subject to per se liability. Next, it decided whether the vertical participants had joined into the goals of the horizontal scheme. This structure also applies to the pleading stage, as illustrated by the two cases below.

B. Meyer v. Kalanick

In Meyer v. Kalanick, a plaintiff filed a putative antitrust class action against Travis Kalanick, CEO and co-founder of Uber Technologies, Inc. There, the plaintiff alleged that Kalanick orchestrated and facilitated an illegal price-fixing conspiracy between and among Uber and Uber drivers. The agreement was implemented by Uber driver’s agreement to use Uber’s pricing algorithm to set prices for the rides they offer. The complaint also alleged that Kalanick was an occasional Uber driver.

Kalanick moved to dismiss arguing, inter alia, that the agreements are only vertical agreements between each driver and Uber, and that there can be no horizontal agreement among the drivers. The U.S. District Court for the

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131. Id. at 844–45. Accord Laumann v. Nat'l Hockey League, 907 F. Supp. 2d 465, 486–87 (S.D.N.Y. 2012) (“where parties to vertical agreements have knowledge that other market participants are bound by identical agreements, and their participation is contingent upon that knowledge, they may be considered participants in a horizontal agreement in restraint of trade”).

132. MM Steel, 806 F.3d at 845; Am. Steel Erectors v. Local Union No. 7, Int'l Ass'n of Bridge, Structural, Ornamental & Reinforcing Iron Workers, 815 F.3d 43, 64 (1st Cir. 2016) (holding that where vertical agreements failed to “intersect with or give rise to an unlawful horizontal relationship,” per se condemnation did not apply). Cf. Howard Hess Dental Labs. Inc. v. Dentsply Int'l, Inc., 602 F.3d 237, 255 (3d Cir. 2010) (“even assuming the Plaintiffs have adequately identified the hub (Dentsply) as well as the spokes (the Dealers), we conclude that the amended complaint lacks any allegation of a [horizontal] agreement among the Dealers themselves. . . . In other words, the ‘rim’ connecting the various ‘spokes’ is missing.”).

133. MM Steel, 806 F.3d at 845–47.


135. Id.

136. Id. at 824.

137. Id. at 823.
Southern District of New York declined to dismiss the Section 1 conspiracy claim. It held that the plaintiff had plausibly alleged that the drivers sign up for Uber with the understanding that other drivers are subject to the same pricing algorithm, and that the agreements went against the interest of the drivers unless all drivers joined.\footnote{138. Id. at 824.}

The court further dispelled Kalanick’s argument that \textit{Leegin} undermines the claim of an illegal horizontal agreement. Citing to \textit{Interstate Circuit} and \textit{Apple}, the court held that the plaintiff had alleged a plausible horizontal conspiracy that Kalanick had organized and facilitated. The court also held that Kalanick had joined the horizontal conspiracy as an occasional driver.\footnote{139. Id.}

\textbf{C. \textit{Ion v. Pizza Hut, LLC}}

Franchisors are also target of these types of cases. Recently, Kristen Ion filed a putative class action against franchisor Pizza Hut, LLC. The complaint alleges that Pizza Hut “orchestrated, dispersed, and enforced” an agreement between and among it and its franchisees not to recruit or hire each other’s management employees.\footnote{140. Amend. Compl., ¶ 1, Ion v. Pizza Hut, LLC, No. 4:17-cv-00788, D.E. 22 (E.D. Tex. Mar. 1, 2018).} Pizza Hut, as a franchisor of pizza restaurants, includes an express non-solicitation clause in its franchise agreement that forbids franchisees from hiring management employees of other Pizza Hut restaurants.\footnote{141. Id. ¶ 64-66.} Ion alleges that this no-hire clause evidences a horizontal agreement among competing franchisees and Pizza Hut to suppress wages of management employees of Pizza Hut restaurants.

The plaintiff cites to a provision of Pizza Hut’s franchise agreement that states that “[e]ach franchisee has agreed that all other franchisees are ‘intended beneficiaries of [the non-solicitation clause].’”\footnote{142. Id. ¶ 7 (citations omitted).} This clause provides potential direct evidence of a horizontal agreement among the franchisees. If such an agreement is found \textit{and} the courts find it to be per se unlawful, it may establish a strong case for per se treatment of the franchisor’s conduct. However, for this to happen, Ion must convince the courts that these provisions should be treated as per se unlawful—i.e., that they are of the same level of danger as group boycotts or price fixing agreements. To espouse this theory, the plaintiff cites Joseph Harrington, Wharton professor of business economics and public policy. Mr. Harrington claims: “In terms of suppressing competition, companies agreeing not to compete for each other’s employees is the same as companies agreeing not to compete for each other’s customers.”\footnote{143. Id. ¶ 29.}

\textit{Ion v. Pizza Hut LLC} is still in the pleading stages. Pizza Hut has filed a motion to dismiss, arguing, \textit{inter alia}, that per se liability does not apply to
no-hire agreements.144 If the case survives a motion to dismiss, the court will eventually decide whether to follow Mack Trucks or Apple.

VIII. Conclusion

So, post-Leegin, in evaluating vertical/horizontal hybrid restrictions, when is it appropriate for courts to apply the per se rule rather than the rule of reason? It stands to reason that talismanic labels that parrot “fickle and uncertain”145 conclusions describing the vertical participant’s conduct—such as is set forth below—is neither helpful nor sufficient:

The vertical participant:

• “orchestrated” the horizontal conspiracy
• “knowingly orchestrated and facilitated” the horizontal conspiracy
• “facilitated and implemented”
• “masterminded and directed”
• “participated” in the horizontal conspiracy

Instead, courts must engage in a fact intensive evaluation of the vertical restraint after reviewing the totality of the evidence. Where the totality of the factual evidence reveals that the vertical participant was knowingly an integral part of a horizontal price fixing conspiracy that has for its purpose and effect of raising prices, then the per se rule is properly applied to the vertical restriction. And, Leegin does not dictate otherwise.

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IQ Dental Supply (IQ) sued Henry Schein, Inc. (Schein) and others alleging that Schein and other dental supply distributors engaged in an antitrust conspiracy by boycotting and attempting to destroy an online distribution platform. The distribution platform was run by nonparty Source One Dental (Source One). IQ used Source One’s platform to sell dental products to dentists. IQ asserted claims against Schein for restraint of trade in violation of the Sherman Act and corresponding state laws, as well as other common law claims. Schein and the other dental distributors moved to dismiss and the U.S. District Court for the Eastern District of New York granted their motion to dismiss.

IQ is a nationwide distributor of dental supplies and equipment and Schein and the other dental supply distributors are major distributors of dental supplies that accounted for 80 percent to 90 percent of the market. Schein and the other supply distributors sold directly to dentists. Distributors have the advantage of being able to serve as the one-stop shop for dentists because they can provide supplies and equipment from any manufacturer.

Source One operated an online distribution platform through various e-commerce websites. IQ and other suppliers sold to dentists through various e-commerce platforms. Source One simply provided a mechanism for suppliers and dentists to interface but did not actually sell products. IQ alleged that Schein and others pres-
sured dental product manufacturers not to sell to IQ or through the Source One platform and that Schein and the others agreed to threaten and implement a boycott of state dental associations that worked with Source One. Finally, IQ alleged that Schein and others boycotted dentists who purchased supplies through Source One websites.

The court first examined antitrust standing and held that an antitrust plaintiff must meet not only the general requirements of constitutional standing, but also demonstrate at the pleading stage that it satisfies antitrust standing. The Second Circuit has held that an antitrust plaintiff must allege: (1) that it suffered a special kind of antitrust injury; and (2) that it was a suitable plaintiff to pursue the alleged antitrust violations and was an efficient enforcer of the antitrust laws. An antitrust injury is an injury attributable to the anticompetitive aspects of the practice under scrutiny. Thus, the first inquiry involves determining whether or not the complaint has sufficiently alleged anticompetitive conduct. The second inquiry involves determining whether the plaintiff has adequately alleged antitrust injury by looking to the ways in which the plaintiff claims to be in a worse position as a consequence of the defendant’s conduct.

The court held that, although IQ may have alleged anticompetitive conduct with respect to the price-fixing scheme, IQ did not assert an injury because it could not claim to be a competitor of Schein and simultaneously claim to have been injured by Schein’s imposition of supracompetitive prices on the market. IQ only stood to benefit from any price increases imposed by Schein and the other distributors. With respect to the alleged boycott schemes, IQ again could not show injury because IQ sought to work with Source One only as a result of Schein’s boycott tactics that resulted in Source One terminating two other distributors. IQ was a replacement seller and therefore was in a better position as a result of the alleged boycott. IQ also could not demonstrate that it would be an efficient enforcer of the antitrust laws. To determine whether a plaintiff is an efficient enforcer, courts look to the directness or indirectness of the asserted injury; the existence of an identifiable class of persons whose self-interest would normally motivate them to vindicate the public interest and antitrust enforcement; the speculative nature of the alleged injury; and the difficulty of identifying damages and apportioning them among direct and indirect victims so as to avoid duplicative recoveries. Here, the court held that Schein and the other distributors’ anticompetitive conduct could have directly injured Source One, but they did not direct such alleged conduct at IQ; instead, Schein and the other distributors directed the conduct at Source One. To the extent IQ suffered harm as a result, it was secondary. Additionally, others had a greater incentive to sue for the alleged anticompetitive conduct, such as the manufacturers that were threatened if they did business with IQ.

IQ alleged that its damages turned on lost business opportunities and such damages were conjectural because there was no reasonable way to re-create the many possible permutations of each alleged lost sale. The speculative nature of its purported damages weighed strongly against holding it to be an
efficient enforcer. Because IQ could not allege standing under the antitrust laws, the court granted the motion to dismiss IQ’s claims.


The U.S. District Court for the District of Delaware found that an acoustic ceiling tile manufacturer with a smaller market share adequately pleaded anticompetitive conduct by a manufacturer with a much larger share through exclusivity agreements with distributors in the relevant market in the United States. The court also found that the smaller manufacturer failed to state claims for anticompetitive conduct in Canada and for tortious interference with contractual relationships.

Plaintiff Roxul USA (Roxul) and Defendant Armstrong World Industries (Armstrong) manufacture and sell ceiling tiles in the United States and Canada. Armstrong holds at least a 55 percent share of the ceiling tile market in both countries. Three firms, including Roxul, compete against Armstrong. In the ceiling tile industry, manufacturers sell 85 percent of their products through distributors. Distributors play an important role in the industry because building contractors, the vast majority of ceiling tile consumers, rely on distributors’ services, resources, and networks. Market forces have resulted in only a limited number of distributors capable of servicing Roxul and Armstrong.

Armstrong took action to protect its market share by executing exclusivity agreements with distributors. Armstrong’s exclusive distributors cannot carry Roxul or other competing firms’ tiles. Armstrong actively polices these agreements and retaliates against violators. Some of the agreements extend the exclusivity nationally or throughout the United States and Canada. Roxul alleged that these actions allowed Armstrong to increase prices and to charge 5 percent above competitive prices, despite an overall decline in ceiling tile sales since 2011. Roxul brought suit alleging that Armstrong’s exclusivity agreements with distributors in the United States and Canada violated the Sherman Act and the Clayton Act and amounted to tortious interference with business relations. Armstrong moved to dismiss.

The court found that Roxul adequately stated various claims for anticompetitive conduct in the United States based on monopolization under the Sherman Act. In analyzing whether Armstrong possessed a monopoly in the ceiling tile industry, the court noted that 55 percent market share typically is insufficient to demonstrate monopoly power. But, in the presence of other factors, 55 percent market share may suffice. The court found that other factors did show that Armstrong possessed monopoly power. Specifically, the court noted that Armstrong has only three competitors, that only a few distributors can service those competitors, and that Armstrong has raised its prices above competitive prices despite an overall market decline. The court found that by alleging these facts and the 55 percent market share, Roxul sufficiently alleged monopoly power.
The district court also found that Roxul sufficiently alleged Armstrong willfully acquired this monopoly power through anticompetitive conduct. In determining that the exclusivity agreements resulted in anticompetitive conduct, the court again noted the limited number of distributors capable of servicing the competitive ceiling tile firms. This, coupled with Armstrong’s active enforcement of its exclusivity agreements, sufficiently foreclosed competition in the ceiling tile market. Notably, the court determined that Armstrong’s arguments regarding Roxul’s alternative channels of distribution and Armstrong’s own valid business justifications for the agreements were issues best reserved for summary judgment or trial. Finally, the court found that Roxul’s allegations that the exclusivity agreements foreclosed the ceiling tile market to it and other competitors adequately pleaded an antitrust injury.

The Delaware district court applied the same reasoning to find that Roxul pleaded attempted monopolization under the Sherman Act and concerted action in restraint of trade under the Sherman Act and the Clayton Act. The court held Roxul’s allegations of Armstrong pursuing exclusivity agreements and of actively policing those agreements sufficient to allow a reasonable inference that Armstrong acted with the intent to monopolize. Additionally, the relatively few players involved, on both the competitor and distributor sides, allowed these exclusivity agreements to foreclose competitors from a significant portion of the market.

The court dismissed Roxul’s two other claims. First, Roxul failed to state a claim for antitrust violations based on Armstrong’s use of the exclusivity agreements with distributors in Canada. The court found that Roxul’s challenge to Armstrong’s Canadian conduct was prohibited under the Foreign Trade Antitrust Improvements Act. Although the claim could have proceeded if it fell within that Act’s domestic commerce exception, the court found that it did not. Specifically, the court found that Roxul did not meet the exception’s “direct effects” requirement because it failed to allege how foreclosure from the Canadian market because of Armstrong’s exclusivity agreements directly affects United States commerce. Finally, Roxul failed to state claims for tortious interference with business relationships under Delaware law because Roxul failed to adequately allege interference with an existing contractual relationship with a distributor or interference with a reasonably probable business opportunity.

ARBITRATION

Franchisee Brian Nygaard (Nygaard) sued his franchisor Property Damage Appraisers, Inc. (Property Damage) in the U.S. District Court for the Eastern District of California. In response, Property Damage moved to compel
arbitration pursuant to the parties’ franchise agreement. The court denied Property Damage’s motion to compel arbitration on the grounds that the California addendum to the franchise agreement rendered the arbitration provision unenforceable.

The only question the court had to answer was whether Nygaard and Property Damage entered into a valid agreement to arbitrate. The court first looked to the California addendum attached to the franchise agreement, which provided that the arbitration provision “may not be enforceable under California law.” Property Damage argued that the mere statement that a particular provision may not be enforceable under California law should not necessarily signify that there was no meeting of the minds as to that provision. The court held that although Property Damage may be correct, the California Court of Appeal and the Ninth Circuit have both held that similar provisions to the one in the California addendum show that there was no meeting of the minds as to the respective arbitration provisions. As a result, governing law compelled the court to hold that the parties never entered into an enforceable arbitration agreement and thus deny Property Damage’s motion to compel.

ATTORNEYS’ FEES


The U.S. District Court for the District of Maryland declined to award attorneys’ fees to a franchisor under a franchise agreement without provisions explicitly providing for attorneys’ fees where the franchisee initiates a suit alleging invalidity of the agreement and tort claims. The court noted that the parties were sophisticated businesspersons who knew how to negotiate attorneys’ fees provisions, so it declined to read a provision into the agreement. The court also declined to award attorneys’ fees as sanctions because it found that the plaintiffs’ act of voluntarily dismissing their claim two days after defendants moved to dismiss did not unreasonably and vexatiously multiply the proceedings.

Defendant Essential Brands, Inc., which does business as Kiddie Academy Domestic Franchising, negotiated the sale of a daycare franchise to Plaintiffs Supriya Sumanth and Sumanth Nandagopal. Between 2011 and 2016, the parties engaged in business discussions, the sale and purchase, and the construction of the daycare facility. Throughout this period, the plaintiffs encountered numerous problems, including construction delays, trouble securing loans, and budgeting mistakes. The plaintiffs claimed they acted upon false information provided by the defendants, including false and misleading projections of success and promises of business support.

The plaintiffs filed suit alleging intentional and negligent misrepresentation, fraud in the inducement, and defamation. The defendants moved to
dismiss the plaintiffs’ complaint for failure to state a claim. Two days later, the plaintiffs voluntarily dismissed their action. The franchisor-defendants then moved for attorneys’ fees and costs under two theories. The defendants argued that the franchise agreement provided for attorneys’ fees and that plaintiffs should be sanctioned for a meritless lawsuit. The court declined to award attorneys’ fees under either theory.

In addressing whether the franchise agreement justified attorneys’ fees awards, the court noted that Maryland law strictly construes contractual attorneys’ fees provisions to avoid inferring duties the parties did not intend to create. The franchise agreement here included provisions requiring the franchisee to indemnify the franchisor for attorneys’ fees if the franchisee violated the agreement and the franchisor was forced to pursue an enforcement action. The agreement also covered fees incurred by the franchisor related to a franchisee’s asserted defenses, counterclaims, and crossclaims. However, the agreement did not explicitly cover attorneys’ fees in the event that the franchisee initiated a claim against the franchisor for misrepresentation and fraud. Moreover, because the parties were sophisticated businesspersons and because the agreement contained numerous other sections with attorneys’ fees provisions, the court concluded that the failure to include a provision providing for attorneys’ fees was not an oversight and that the agreement did not provide for attorneys’ fees in this situation.

The court then considered whether to award attorneys’ fees as sanctions against the plaintiffs or their counsel under 28 U.S.C. § 1927 and Federal Rule of Civil Procedure 11. The plaintiffs stated they voluntarily dismissed their case because they wanted to seek advice from counsel in Texas, where they lived. They filed their dismissal two days after the defendants moved to dismiss. The court found that by acting quickly and with reasonable motives, the plaintiffs did not commit the sanctionable conduct of multiplying the proceedings in an unreasonable and vexatious way.

**CLASS ACTIONS**


A customer of a Jackson Hewitt franchisee asserted claims for fraud and negligence, among others, against the franchisee tax preparer and its franchisor Jackson Hewitt, Inc. (JH). JH moved to dismiss on October 19, 2017, and the U.S. District Court for the Central District of California granted that motion but provided Lomeli with leave to amend to comply with Federal Rule of Civil Procedure 9(b)’s heightened pleading standards. Upon Lomeli’s submission of an amended complaint, JH moved to dismiss for failure to comply with the requirements of Rule 9(b) and moved to strike certain class allegations in the amended complaint. The court denied JH’s motion to dis-
miss with respect to Lomeli’s fraud and negligence claims, granted it with respect to Racketeer Influence and Corrupt Organizations Act (RICO) claims, and denied it with respect to JH’s motion to strike class allegations.

Generally, Lomeli alleged that JH was directly liable for fraudulent statements it made to consumers regarding the accuracy of its tax preparation services and that, given its level of control over franchisees, JH was vicariously liable for fraud and other derivative claims for its franchisees’ actions in preparing fraudulent tax returns. The basis for his claims revolved around the fraudulent preparation and submission of his 2014, 2015, and 2016 tax returns that included additional expenses claimed without his approval, resulting in an unwarranted fraudulent tax refund, and his enrollment in an assisted refund program that charged him fees without his approval.

‘Allegations of fraud require a heightened pleading standard pursuant to Federal Rule of Civil Procedure 9(b), which provides that an allegation of fraud must state with particularity the circumstances constituting the fraud. The fraud allegation must set forth the “who, what, when, where, and how” of the fraudulent activity as well as the basis for asserting that the representation was false or misleading and why it was false. When, however, there are several defendants sued in connection with an alleged fraudulent scheme, a plaintiff need not identify false statements made by each and every defendant but it may not simply lump all defendants together without any differentiation as to the defendants’ alleged role in the fraudulent scheme.

With respect to direct allegations of fraud, Lomeli alleged that JH reviewed and approved tax returns that it knew to be fraudulent, and that it wrote a letter to Lomeli telling him that the return he authorized for filing was sent to the IRS Processing Center when, in fact, JH sent a different return to the IRS. JH argued that Lomeli still lumped all defendants together instead of parsing the allegations as to each defendant. The court, however, noted that Lomeli alleged in the amended complaint that JH knew of the fraudulent scheme because on each occasion, the tax preparer prepared two versions of Lomeli’s return using the software and electronic systems that JH controlled. He also alleged that even though a tax return with markedly different information had been submitted for the same tax year just days before, JH approved of the submission of the subsequent fraudulent return and caused it to be transmitted to the IRS using its software. In other words, JH received and approved multiple returns for Lomeli for the same year that contained significantly different amounts of wage-related expenses claimed. Considering that allegation, when paired with JH’s assurances of 100 percent accuracy in its advertising, the court held the circumstances surrounding the submission of his returns were pleaded with sufficient particularity to withstand a motion to dismiss. There was enough in the allegations to allow a court to reasonably infer a fraudulent intent.

Additionally, Lomeli argued that JH committed fraud by advertising a 100 percent guarantee for accurate returns and the “preparers’ pledge” to handle customers’ tax returns like their own. JH argued that Lomeli never
alleged that he relied on the statements or JH knew the statements were false when made. The court disagreed with JH and pointed to allegations in the amended complaint asserting reliance on the alleged fraudulent statements. Additionally, Lomeli alleged that JH knew of the falsity of its 100 percent guarantee because JH had received thousands of complaints that tax returns it prepared were inaccurate. The court held that JH could not convince consumers to use Jackson Hewitt tax preparation services by promoting a 100 percent guarantee on accuracy and then simply turn tail when the consumer actually relies on those statements. Therefore, Lomeli’s fraud claims with respect to JH’s advertising was sufficient to survive JH’s motion to dismiss.

Additionally, Lomeli asserted that he relied on a letter addressed to him dated April 15, 2015, that was on Jackson Hewitt letterhead and stated that Lomeli’s 2014 tax return had been completed and filed electronically with the IRS. He alleged that the statement was false at the time because the return that JH submitted was materially different from the return he had approved and included fake deductions leading to an undeserved tax refund. The court held that although a letter bearing the JH letterhead did not necessarily prove that JH, as opposed to its franchisee, sent the letter the allegation was sufficient at the motion to dismiss stage and denied JH’s motion to dismiss the direct fraud claims against it.

In the previous complaint, Lomeli failed to meet his burden to plead a level of control required to establish vicarious liability of JH. In the amended complaint, he alleged additional controls over the processing and submission of tax returns that were directly related to the fraudulent conduct of which Lomeli complained. For example, he alleged that JH exercised direct control over franchisees’ employees, including hiring, direction, supervision, discipline, or discharge; that it required the tax preparer to report directly to JH’s chief tax compliance officer; that the code of conduct for franchisee employees referred to the reader as an employee of JH, not the specific franchisee; that JH tracked franchisee employees on the returns they worked on through unique identifiers; that it distributed a compliance manual outlining JH’s control over fraud prevention training; that it controlled training related to tax fraud, including fraud by taxpayers; that it required franchisees to certify that their employees complied with JH’s directives, including training regarding fraudulent tax returns; that it required franchisee employees to take a tax preparer readiness test; and that JH set forth grounds wherein franchisees are required to terminate employees and operated a program known as the Red Flag Report that tracked tax return filing trends to identify questionable tax situations. The court held that these facts were sufficient to plead fraud on a vicarious liability theory against JH. The court held that Lomeli sufficiently alleged that JH controlled the instrumentality that caused the harm—the hiring and training of tax preparers who then fraudulently prepared his returns and opened a bank account without his consent. He also alleged that JH reviewed, approved, and submitted tax returns through its mandatory computer systems and the court held that these alle-
gations sufficiently alleged a theory of vicarious liability because JH retained a high level of control over its franchisees and franchisees’ employees' actions. Thus, the court denied JH’s motion with respect to Lomeli’s fraud claim on a vicarious liability theory.

Lomeli also asserted claims under the RICO statute. The court held that to sufficiently allege a RICO claim, a plaintiff must allege (1) conduct (2) of an enterprise (3) through a pattern (4) of racketeering activity. The enterprise must be a distinct entity from the defendant and the common purpose the enterprise pursues must be distinct from the enterprise’s or members’ primary business activities. The court held that Lomeli’s allegations of an enterprise between JH and its franchisees failed to properly and sufficiently allege an enterprise because the allegations of the relationship between JH and its franchisees were to further their primary business of processing tax returns. Thus, the court granted JH’s motion to dismiss Lomeli’s RICO claims.

With respect to Lomeli’s claims for negligence, he alleged that JH failed to implement adequate controls to identify and prevent fraudulent submission of franchisees’ customers’ tax returns. JH argued that the negligence claim was contradictory to the fraud claim and therefore must be dismissed. The court, however, disagreed, noting that Lomeli had the right to plead in the alternative and that contradictory allegations of the pleading stage do not warrant dismissal. JH also argued that Lomeli failed to allege the elements of a negligence claim, but the court held that he had sufficiently alleged: (1) JH owed a general duty of care, supported by its guarantee to consumers of a 100 percent accurate tax return; (2) JH breached that duty by negligently failing to implement controls to detect and prevent the submission of fraudulent tax returns; and (3) JH’s breach proximately caused Lomeli’s harm and damages. Therefore, the court denied JH’s motion to dismiss Lomeli’s negligence claims.

Although JH also moved to strike Lomeli’s class allegations, the court held that it is rare that a court will strike out class allegations prior to the class certification stage. Although the court noted that it could see problems at the class certification stage in light of the individual modes of proof that would likely be required, it declined to address those issues now without the benefit of discovery and briefing on the issue. Therefore, the court also denied JH’s motion to strike the class allegation claims.

In re: Jimmy John’s Overtime Litig., Bus. Franchise Guide (CCH) ¶ 16,105, 877 F.3d 756 (7th Cir. 2017)
The Seventh Circuit, reversing the U.S. District Court for the Northern District of Illinois, held that plaintiffs asserting putative class actions against Jimmy John’s franchisees can proceed independently and apart from the three consolidated class actions against franchisor Jimmy John’s pending in the Northern District of Illinois. Readers may be familiar with this long-running dispute, in which three employees—Emily Brunner, Alexander Whiton, and Scott Watson—have asserted violations of the Fair Labor Stan-
dards Act (FLSA) against Jimmy John’s in several collective and class action
lawsuits on behalf of all assistant store managers nationwide. Their com-
plaints, now consolidated in the Northern District of Illinois, allege that
Jimmy John’s, as a joint employer with their franchisee employers, is liable
for unpaid overtime following the misclassification of assistant managers as
exempt from federal and state wage-and-hour laws.

Approximately 660 individuals opted into the FLSA collective action fol-
lowing notice to the potential class members. The district court then bifur-
cated discovery into two phases, with the first phase focused on issues of joint
employer status, and the second phase focusing on the merits of the dispute.
After the close of joint-employer discovery, three opt-in plaintiffs filed col-
lective actions against their franchisee employers, without naming franchisor
Jimmy John’s, in federal district courts outside the Northern District of Il-
linois. The franchisee plaintiffs argued that the FLSA statute of limitations
compelled them to preserve their claims against the franchisee defendants,
which, operating outside the Northern District of Illinois, could not be
joined in the consolidated Illinois action for lack of personal jurisdiction
and venue.

Jimmy John’s moved for an anti-suit injunction barring the franchisee
plaintiffs from pursuing their claims prior to the resolution of the consolidated
Illinois action. The district court agreed that an injunction would be fair and
economical, given the fact that the plaintiffs’ interests would be protected in
the Illinois action and the “interest of harmony and delaying expense and over-
lapping work for judges doing the same kind of thing.” 877 F.3d at 760. The
franchisee plaintiffs appealed the district court’s grant of the injunction, and
the Seventh Circuit reversed. The Court of Appeals held that the district
court abused its discretion by failing to analyze the injunction under the All
Writs Act and by failing to consider the requirements for a traditional prelim-
inary injunction under Federal Rule of Civil Procedure 65.

The Seventh Circuit first analyzed the district court’s authority to enjoin
actions against the franchisees—not parties to the Illinois action—in other
federal district courts. Jimmy John’s contended that the district court’s inher-
ent powers authorized the injunction against parallel duplicative litiga-
tion. The Seventh Circuit disagreed, concluding that a district court’s inher-
ent powers are limited to parallel federal actions involving the same parties
and issues. Because Jimmy John’s was not a party to the non-Illinois actions,
and the defendant-franchisees in those actions were not parties to the Illinois
action, the lawsuits were not parallel proceedings subject to the district
court’s inherent ant-suit powers.

Nor did the All Writs Act support the district court’s injunction. The All
Writs Act authorizes courts to “issue all writs necessary or appropriate in aid
of their respective jurisdiction and agreeable to the usages and principles of
law.” 28 U.S.C. § 1651(a). As the Seventh Circuit explained, the Act is rarely
invoked by a district court to enjoin another federal court. District courts
more commonly invoke the Act to enjoin a parallel state-court action.
Such federal-state injunctions, however, must meet the narrow standards of the Anti-Injunction Act, which would prohibit the injunction “except as expressly authorized by Act of Congress, or where necessary in aid of its jurisdiction, or to protect or effectuate its judgments.” 28 U.S.C. § 2283. Though the Anti-Injunction Act’s “in aid of jurisdiction” language did not directly apply, the Seventh Circuit nevertheless deemed cases interpreting that language instructive.

Courts, moreover, interpret the “in aid of jurisdiction” clause narrowly. The clause does not authorize an injunction based on the potential effect of one suit on another. Thus, the Seventh Circuit rejected Jimmy John’s argument that the injunction was necessary to prevent conflicting interpretations of written policies that overlap across the different cases—what the Seventh Circuit considered simply a fear that the disparate franchisee litigations would reach final judgment or resolve disputed fact issues before the consolidated Illinois actions. The Seventh Circuit likewise was unconvinced that the injunction was necessary to protect the Northern District of Illinois’ pretrial orders regarding discovery and notice. The court emphasized that the “in aid of jurisdiction” clause applies only to in rem actions, school desegregation cases, and Multi-District Litigations. Thus, the Seventh Circuit refused to apply the “in aid of jurisdiction” clause of the All Writs Act to the three consolidated class actions.

In the second part of its analysis, the Seventh Circuit confirmed that the district court had erred in failing to apply the traditional factors for preliminary injunctions under Rule 65. Although circuits are split on the issue, the Seventh Circuit requires district courts issuing anti-suit injunctions to make findings of fact and conclusions of law sufficient to show that the party seeking the injunction is likely to succeed on the merits; that there is no adequate remedy at law; that the party is likely to suffer irreparable harm absent injunctive relief; that the balance of equities favors the injunction; and that the injunction is in the public interest. The court’s order must state the reasons for issuing the injunction. The district court’s explanation that there were “all kinds of reason[s] that justif[y] the stay as to the parties” in the Illinois action failed to meet those standards. Thus, even if the injunction had been supported by the All Writs Act, the Seventh Circuit reversed for failure to establish the requisite elements of a preliminary injunction.

CONTRACT ISSUES


The U.S. District Court for the Northern District of Georgia found that a nonsignatory may be bound to noncompetition and other post-termination restrictions in an agreement for the operation of a Church’s Chicken franchise. The nonsignatory, who had purchased the franchised restaurant
from the contracting party shortly after the franchise agreement was executed, had operated the restaurant for the ten-year term, receiving the benefits of the franchise agreement, and therefore could be preliminarily enjoined from use of the trademarks and other protected information, as well as from operating a quick-service fried chicken restaurant in violation of the noncompete provisions of the franchise agreement.

Plaintiff Cajun Global, which does business as Church’s Chicken, entered into a franchise agreement in 2007 with defendant Swati Enterprises (SEI) with respect to a franchised Church’s Chicken restaurant in Orange, Texas. The franchise agreement contained post-termination restrictive covenants precluding the franchisee from owning or operating any quick-service fried chicken restaurant within twenty-five miles of any franchised location or any other Church’s restaurant in existence at the time of expiration or termination of the agreement. The agreement also contained personal jurisdiction and forum selection clauses requiring the franchisee to resolve disputes in the Northern District of Georgia.

SEI, consistent with the agreement, could not transfer or sell the franchise without the franchisor’s written knowledge and consent. Nevertheless, only two months after executing the agreement, SEI transferred the franchised restaurant to defendant Rahman without the plaintiff’s knowledge. Rahman contended that he had never seen or signed the franchise agreement, but the defendants conceded that Rahman had thereafter operated the franchised restaurant, used the Church’s Chicken trademarks and other protectable information, received training from Global, and worked with SEI to remit royalties and other fees to plaintiff.

When the franchise agreement expired in 2017, Rahman continued to operate the restaurant, rebranding the same quick-service fried chicken concept as “Orange Fried Chicken.” Rahman continued to use a logo and other identifying marks that the court called confusingly similar to Church’s marks. After sending an unsuccessful cease and desist letter, plaintiffs Cajun Global and Cajun Funding LLC filed suit to enjoin the defendants from infringing on the plaintiffs’ trademarks and violating the noncompete restrictions in the franchise agreement. Relevant to the court’s preliminary injunction order, Rahman contended that, as a nonsignatory, he was not bound by either the substantive provisions or the jurisdictional provisions of the franchise agreement and moved to dismiss on jurisdictional grounds. Rahman did not challenge the enforceability of the noncompete covenants or jurisdictional terms themselves.

The primary issue in deciding to enter a preliminary injunction was whether the court could bind a nonsignatory to the post-termination covenants and jurisdictional terms of the franchise agreement. The court concluded that Rule 65 of the Federal Rules of Civil Procedure contained language broad enough to reach a nonsignatory on these facts. Further, although first noting that contacts generally do not bind nonsignatories, the court cited multiple state law grounds under which a nonparty to a con-
tract might be bound to its terms, including (among other things) assumption and estoppel. Because Rahman performed under the franchise agreement for ten years and received all the benefits thereunder, he was estopped from disclaiming the franchisee’s post-termination obligations on grounds that he did not sign the agreement.

For similar reasons, the court dismissed Rahman’s motion to dismiss for lack of jurisdiction and venue. Just as he was bound to the post-termination restrictions of the agreement, Rahman was bound by the agreement’s jurisdictional and forum selection clauses. In any event, the court found that Rahman had purposefully availed himself of the benefit of doing business with plaintiffs in Georgia sufficient to justify jurisdiction in Georgia.

Ultimately, the court entered a preliminary injunction in the plaintiffs’ favor barring the defendants, including Rahman, from using the Church’s Chicken trademarks, service marks, and trade dress, or any “colorable imitation” thereof; leading customers to believe that the defendants and their restaurant were affiliated with Church’s; and violating the noncompetition and other post-termination restrictions of the agreement. The court further ordered the defendants to return all Church’s signs and marketing materials (or any imitations thereof) to the plaintiffs, return all copies of the Church’s manual to the plaintiffs, and refrain from disclosing any of the plaintiffs’ confidential business information or trade secrets.


BP West Coast Products (BP) moved for partial summary judgment on certain claims against a number of defendants for failure to pay money owed for fuel purchased. Specifically, BP moved for summary judgment with respect to its claim for breach of franchise agreements against defendants Khaja Ansari, NP Petroleum Corp., Sharina Alloosh, Daisie Enterprises, Inc., and Hadaf, Inc. (Dealer Defendants). BP also moved for summary judgment with respect to its claim against Khaja Ansari, Fazilath Ansari, Nader Sahih, Payam Sahih, Rajesh Arora, Anup Patel, Tarun Maitra, and Soma Prasad (Guarantor Defendants) for failing to comply with the terms of the guarantees they entered into. The U.S. District Court for the Southern District of California granted summary judgment with respect to the claims against the Dealer Defendants and granted in part and denied in part the motion for summary judgment against the Guarantor Defendants.

The Dealer Defendants operated gas stations under franchise agreements with BP. BP sold and delivered motor fuel to the Dealer Defendants for them to resell at their respective stations. Pursuant to the parties’ agreements, the Dealer Defendants were required to pay BP for the fuel. BP alleged that it delivered fuel to the Dealer Defendants, but they defaulted on payment in breach of the franchise agreements, and that the Guarantor
Defendants failed to pay BP the amounts owed by the Dealer Defendants and personally guaranteed in breach of the personal guarantees.

The breach of contract claim against the Dealer Defendants was straightforward. BP proved the existence of valid franchise agreements, its performance pursuant to the franchise agreements, the Dealer Defendants’ breach based on their failure to pay for the fuel, and BP’s resulting damages. Therefore, the court granted BP’s motion for summary judgment with respect to its breach of contract claims against the Dealer Defendants.

To meet its burden on the motion for summary judgment with respect to the Guarantor Defendants, BP had to show: (1) there was a valid guarantee; (2) the borrower defaulted; and (3) the guarantor failed to perform under the guarantee. The Guarantor Defendants argued that the guarantees were “sham guarantors” and thus illusory. Under California law, to collect a deficiency from a guarantor, the guarantor must be a true guarantor and not merely the principal debtor under a different name. Thus, where a principal obligor purports to take on additional liability as a guarantor, nothing is added to the primary obligation, and the guarantee must be considered ineffective.

In determining whether a guarantee is a sham, courts must determine whether the guarantor is actually the principal obligor, which occurs when: (1) the guarantor personally executes the underlying loan agreements or deed of trust; or (2) the guarantor is, in reality, the principal obligor under a different name by operation of trust or corporate law or some other applicable legal principle. When there is sufficient legal separation between the borrower and the guarantor, for example, through appropriate use of the corporate form, the sham guarantee defense will not apply.

With respect to Khaja Ansari, BP claimed that Khaja Ansari and Fazilath Ansari entered into a guarantee, thereby personally guaranteeing the obligations with respect to Khaja Ansari’s franchise agreement with BP. BP failed to provide any information as to why the guarantee was effective, despite the fact that Khaja Ansari was guaranteeing his own franchise agreement. Therefore, the court denied BP’s motion for summary judgment with respect to its claim against Guarantor Defendant Khaja Ansari.

Soma Prasad and Tarun Maitra signed agreements guaranteeing the debt of Hadaf, Inc. BP failed to address, however, the issue of whether there was adequate legal separation between Tarun Maitra and the principal debtor Hadaf, Inc. It was not enough that the names on the franchise agreement and guarantee were different because there was still a question of fact as to whether there was adequate legal separation between Tarun Maitra and Hadaf, Inc. to avoid rendering the guarantee a sham guarantee. Thus, the court denied BP’s motion for summary judgment with respect to Guarantor Defendant Tarun Maitra.
In addition to the sham guarantee doctrine, a guarantee must be supported by consideration. When a guarantee is made coincidently with the principal agreement, the guarantee is supported by the same consideration as the principal agreement and is enforceable. If, however, the guarantee is signed at a different time, it must be supported by its own consideration. Therefore, the dates of signatures were particularly relevant as to whether the remaining Guarantor Defendants’ guarantees were enforceable. Fazilath Ansari, for example, executed a guarantee in 2006 but the principal debtor for which Fazilath Ansari was entering into a guarantee did not execute the principal agreement until 2008. BP failed to provide information as to why the guarantor entered into the agreement two years prior to the principal contract and therefore had no support for the existence of consideration with respect to that guarantee. Accordingly, the court denied BP’s motion for summary judgment with respect to Guarantor Defendant Fazilath Ansari.

The same was true of Soma Prasad. Soma Prasad signed the guarantee almost a year before her respective principal debtor executed its franchise agreement. BP failed to provide any information to explain this discrepancy and therefore failed to meet its burden of showing no genuine issue of material fact as to the validity of the guarantee. Thus, the court denied BP’s motion for summary judgment with respect to Guarantor Defendant Soma Prasad.

With respect to Payam Sahih, who entered into a guarantee in 2010 at around the same time as the principal debtor agreement, the court found the underlying consideration to be sufficient to enforce the guarantee although the guarantor entered into a guarantee approximately one week before the franchisee entered into the principal franchise agreement. The court held that this was close enough that consideration for the franchise agreement was sufficient to constitute consideration for the guarantee. The same was true for Anup Patel, who signed the guarantee agreement around the same time as his respective principal debtor. Thus, the court granted BP’s motion for summary judgment with respect to Guarantor Defendants Payam Sahih and Anup Patel but denied BP’s motion for summary judgment with respect to Guarantor Defendants Khaja Ansari, Fazilath Ansari, Tarun Maitra, and Soma Prasad.

Mrs. Fields Franchising, LLC v. MFGPC, Bus. Franchise Guide (CCH) ¶ 16,111, 721 F. App’x 755 (10th Cir. Jan. 8, 2018)
On January 8, 2018, the Tenth Circuit reversed the U.S. District Court for the District of Utah’s dismissal of a licensee’s breach of contract claim. The Tenth Circuit did, however, affirm the district court’s dismissal of the licensee’s account-stated claim. In so holding, the Tenth Circuit demonstrated the importance of the specific allegations in a licensee’s complaint for purposes of a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

In 2003, MFGPC’s predecessor-in-interest entered into a license agreement with Mrs. Fields Franchising, LLC, which gave MFGPC’s predecessor-in-
interest the right to sell popcorn under the brand “Mrs. Fields.” In exchange, Mrs. Fields Original Cookies, a third-party defendant, would receive 5 percent of net sales as “running royalties” and a certain amount of royalty payments for the first five years under the agreement as “guaranteed royalties.” The running royalties could be paid by shipment of licensed popcorn to Mrs. Fields Original Cookies and having the price received for the popcorn reduced by any outstanding running royalties. After the agreement was signed, Mrs. Fields Original Cookies transferred its rights under the agreement to Mrs. Fields Franchising. Though the license agreement had an initial term of five years, it would automatically renew for successive five-year terms unless MFGPC failed to pay the guaranteed royalties. In 2014, Mrs. Fields Franchising terminated the license agreement for MFGPC’s failure to pay guaranteed royalties. Mrs. Fields Franchising filed for a declaratory judgment against MFGPC in federal court in Utah stating that the termination had been proper. In response, MFGPC brought claims against Mrs. Fields Franchising for breach of contract and for an account stated, alleging that MFGPC owed no outstanding royalties and was in fact owed $26,660.43 for popcorn that had been shipped to Famous Brands, another third-party defendant.

The district court dismissed MFGPC’s breach of contract and account-stated claims. In dismissing MFGPC’s breach of contract claim, the district court considered a declaration by MFGPC’s president, which MFGPC had filed earlier in the case when it sought a preliminary injunction. MFGPC appealed, specifically asserting that the district court erred in relying on the president’s declaration without converting Mrs. Fields Franchising’s motion to dismiss into a motion for summary judgment. However, MFGPC did not raise the foregoing argument in the district court.

The Tenth Circuit reversed the dismissal of MFGPC’s breach of contract claim but upheld the district court’s dismissal of MFGPC’s account-stated claim. Though MFGPC waived its argument that the motion to dismiss should have been converted to a motion for summary judgment, the Tenth Circuit nonetheless held that the president’s declaration should not have been considered for two reasons: (1) if the district court relied on the declaration, it was required as a matter of law to convert the motion to dismiss into a motion for summary judgment, and (2) consideration of a motion to dismiss under Federal Rule 12(b)(6) is based solely upon MFGPC’s allegations in its complaint.

The Tenth Circuit concluded that MFGPC clearly stated a plausible breach of contract claim based on the allegations in its complaint—specifically, MFGPC alleged that Mrs. Fields Franchising’s termination of the license agreement and failure to pay for the licensed popcorn amounted to a contractual breach. The court held that the result of Mrs. Fields Franchising’s termination of the agreement was that MFGPC could no longer sell popcorn under the Mrs. Fields brand. Indeed, “[w]hy would MFGPC continue making popcorn and shipping it to a licensor that believed there was no valid license agreement?” Mrs. Fields Franchising argued that MFGPC suffered no
damages because the agreement allowed MFGPC to continue selling Mrs. Fields popcorn for six months after the agreement was terminated. The appeals court, however, was not persuaded because: (1) the agreement allowed MFGPC to sell popcorn that had already been manufactured and packaged, not to continue manufacturing and selling the popcorn as if the agreement was not terminated, and (2) six months of selling popcorn was insufficient to remedy the fact that the agreement would have allowed MFGPC to sell popcorn for an additional two-and-a-half years if the agreement was not terminated. Accordingly, MFGPC adequately alleged a breach of contract claim.

With regard to the account-stated claim, the Tenth Circuit held: “An agreement on the amount owed is an essential element of an account stated, and MFGPC has not alleged such an agreement.” Although MFGPC alleged that it shipped licensed popcorn to Famous Brands, which approved an invoice for $70,222.60, MFGPC only alleged an account stated for $26,600.43, which was the amount invoiced minus the amount of running royalties that MFGPC regarded as due. However, MFGPC did not allege that Famous Brands agreed to such an offset. As such, the court held that “MFGPC has not adequately alleged an account-stated claim.”

The U.S. District Court for the Northern District of Illinois held that a franchisor has the absolute right to control its franchisees’ advertising of the products and services offered under a franchise. The decision is particularly instructive for two reasons: (1) it assures franchisors that language in the franchise agreement can control the advertising for the entire franchise system; and (2) it cautions franchisees to fully understand the franchisor’s ability to control advertising under the franchise agreement before implementing their own advertising initiatives.

Franchisee Afzal Lokhandwala sued franchisor KFC Corporation, alleging that KFC breached the franchise agreement by unreasonably attempting to prevent him from telling customers that his KFC franchises offer Halal chicken (food prepared in accordance with Islamic law and traditions). Lokhandwala brought claims for breach of contract and promissory estoppel and sought declaratory and injunctive relief. In response, KFC moved to dismiss Lokhandwala’s complaint and brought counterclaims for injunctive and declaratory relief and attorney’s fees, asserting that the franchise agreement’s plain language gave KFC the “absolute right” to approve or prohibit any advertising or promotional claims regarding its products.

Lokhandwala opened his first KFC franchise in 2002, at which point he entered into a franchise agreement with KFC. According to Lokhandwala, from 2003 to late 2016 or early 2017, KFC approved the sale of Halal chicken in Lokhandwala’s stores. However, in late 2016 or early 2017, pursuant to a 2009 KFC policy that prohibits franchisees from making religious
dietary claims about KFC products, KFC required Lokhandwala to stop marketing products as Halal. The 2009 policy prohibited KFC franchises from offering Halal or Kosher foods because: (1) there are different interpretations for what satisfies certain processing requirements; and (2) KFC cannot certify that such practices would not lead to cross contamination between Halal and non-Halal, or Kosher and non-Kosher, foods. The franchisee asserted that the 2009 policy contradicts representations made to it by KFC when he negotiated for and opened new stores in 2010 and 2012. Lokhandwala also said the policy was incompatible with KFC’s permission to allow Lokhandwala to continue advertising Halal products after the 2009 policy took effect.

After a detailed review of the franchise agreement, which provided that Kentucky law governs any disputes regarding the agreement, the court held that the agreement was unambiguous and that KFC had every right to bar Lokhandwala from advertising products as Halal, even if KFC had allowed such advertising in the past. Specifically, the franchise agreement required that franchisees “strictly comply” with KFC’s requirements and gave KFC full control over advertising and promotional material. Moreover, the agreement contained waiver provisions that allow KFC to enforce the franchise agreement at any time, regardless of past contradictory practices or past failures to enforce the agreement. Finally, the agreement specifically stated that it constituted a complete agreement that supersedes any other agreements between the parties. The specific foregoing provisions relied upon by the court include the following:

- Section 3.7—“Franchisee will strictly comply with the requirements and instructions of KFC regarding the use of the trademarks, trade names and service marks in connection with the Approved Products and the Outlet.”
- Section 5.3(h)—“Franchisee will take such action and precautions as necessary to assure that: . . . (h) only signs and menuboards, advertising and promotional material, equipment” and other supplies “which meet KFC’s standards and specifications (as established from time to time) are used at the Outlet or in connection with its business.”
- Section 20.4—“No failure, forbearance, neglect or delay of any kind or extent on the part of KFC in connection with” enforcing and exercising rights under the franchise agreement “shall affect or diminish KFC’s right to strictly enforce and take full benefit of each provision of this Agreement at any time . . . No custom, usage, concession or practice with regard to this Agreement, the Franchisee or KFC’s other Franchisees shall preclude at any time the strict enforcement of this Agreement (upon due notice) in accordance with its literal terms . . . No waiver by KFC of any performance of any provision of this agreement shall constitute or be implied as a waiver of KFC’s right to enforce such provisions at any future time.”
Section 20.5—“This Agreement constitutes the [parties’] entire understanding and agreement” and “supersedes all prior and contemporaneous understandings and agreements of the parties.”

Despite Lokhandwala’s argument that the court should consider extrinsic evidence because the franchise agreement was either silent or ambiguous as to whether he may make “truthful disclosures” about Halal products, the court held that such truthful statements made to customers could in fact constitute advertising. Because the franchise agreement was unambiguous, the court declined to consider extrinsic evidence. Lokhandwala also argued that KFC’s refusal to allow him to display signs about his Halal food products would cause him to violate the Illinois Halal Food Act. The court, however, held that if Lokhandwala ceased advertising Halal products, the Illinois Halal Food Act would no longer apply to him. Last, the court held that KFC’s demands were not unreasonable, as the agreement did not impose any specialized or overarching reasonableness requirement to KFC’s decisions regarding advertising.

Finally, the court held that KFC’s counterclaims for injunctive relief, declaratory relief, and attorney’s fees failed under the “mirror image rule” because the counterclaims, like Lokhandwala’s claims, sought to enforce the agreement, thereby making KFC’s counterclaims “repetitious and unnecessary.” Further, KFC was not entitled to attorney’s fees under the agreement because it did not institute the action.


This case is discussed under the topic heading “Attorneys’ Fees.”

_DZ Bank AG Deutsche Zentral-Genossenschaftsbank v. McCranie, Bus. Franchise Guide (CCH) ¶ 16,136, 720 F. App’x 576 (11th Cir. 2018)_

In an unpublished opinion, the Eleventh Circuit affirmed the ruling of the U.S. District Court for the Middle District of Florida, following a bench trial, enforcing a promissory note entered into by an insurance agency franchisee in connection with the financing of its purchase of the franchise. Disagreeing with the district court, the Eleventh Circuit concluded that the note was not a negotiable instrument, but otherwise agreed with the district court that the franchisee’s obligation to pay was not conditioned on the absence of breach by any other party to the franchise agreement, nor was payment conditioned on the commercial success of the franchise endeavor.

Defendant-Debtor McCranie is an insurance agent with substantial experience buying and selling independent insurance agencies. Brooke Corporation (Brooke), prior to its failure, bought independent agencies and sold them as franchises to agents, like McCranie, who financed the purchase through Brooke Credit Corporation (Brooke Credit). McCranie purchased
a Brooke franchise in Florida in 2000. In connection with that purchase, he
signed two promissory notes in favor of Brooke Credit, as well as a Security
Agreement and an Agreement for Advancement of Loan (Advancement
Agreement). In 2002, McCranie executed a new promissory note with
Brooke Credit to refinance the two earlier loans (the Note). The Note stated
that it was separately secured by the already existing Security Agreement and
also stated in a separate section: “ADDITIONAL TERMS: See Agreement
for Advancement of Loan dated October 30, 2000.”

In 2004, Brooke Credit entered a series of agreements with third parties,
ultimately transferring interest in certain loans entered into by Brooke
Credit after 2004 to Brooke Funding. Plaintiff-Creditor DZ Bank took a se-
curity interest in the transferred loans in exchange for providing the funding
for the purchase of the loans. The purchase contracts also allowed Brooke
Credit to offer and Brooke Funding to purchase or reject loans entered
into prior to 2004. As such, although McCranie’s loan was technically
non-qualifying under the purchase agreements, the loan was sold to Brooke
Funding and DZ Bank held a security interest in the loan.

In 2008, relationships among the Brooke entities and related contractual
parties broke down. DZ Bank stopped providing funding to Brooke Fund-
ing. Franchisor Brooke stopped paying McCranie commission payments as
provided in the franchise agreement—payments McCranie needed in order
to meet his obligations under the Note. McCranie therefore terminated
the franchise agreement and demanded that Brooke have insurers transfer
“agent of record” status to McCranie so he could continue to sell policies
with those insurers. Neither Brooke nor Brooke Credit took steps to make
McCranie the agent of record with the insurers, which then pulled their
business from McCranie’s agency.

In October 2008, DZ Bank notified McCranie that payments on the Note
should be directed to DZ Bank rather than Brooke Credit. Brooke filed for
bankruptcy in October 2008, and by the end of the month DZ Bank, Brooke
Credit, and Brook Funding formalized a transfer of ownership of collateral
(including McCranie’s Note) to DZ Bank. DZ Bank then filed suit against
McCranie to recover on the Note.

At a bench trial, the district court found that the Note was a negotiable
instrument, that DZ Bank was a holder in due course, and that holder-in-
due-course status defeated McCranie’s defenses to enforcement. On appeal,
McCranie argued that the Note was not a negotiable instrument and that,
because the Note was part of a single integrated agreement for the franchise
endeavor, Brooke’s breach of the franchise agreement relieved McCranie
from his obligation to pay under the Note.

In the first portion of its discussion, the Eleventh Circuit agreed with
McCranie that the Note was not negotiable. The court explained that a ne-
gotiable instrument must be complete on its face, such that a holder need not
look to any other documents to determine the parties’ rights and obligations.
Although mere references to other documents do not defeat negotiability,
the suggestion that another document contains terms applicable to the instrument renders the instrument non-negotiable. Importantly, whether the ancillary document in fact contains applicable terms is irrelevant—the question was whether the ancillary document must be consulted in the first place. The Note, which stated: “ADDITIONAL TERMS: See Agreement for Advancement of Loan dated October 30, 2000,” could not be considered a self-contained document. Although the Advancement Agreement in fact contained no conditions on McCranie’s obligation to pay, the reference in the Note to “additional terms” defeated negotiability.

A related issue concerned whether title to the Note in fact transferred to DZ Bank. At trial, McCranie had offered evidence of a competing claim to title in the Note. Further, the purchase agreements under which DZ Bank claimed title only referenced loans made by Brooke Credit after 2004. The trial court had ultimately ruled that DZ Bank had shown proof of title as to defeat the competing claim. On appeal, the Eleventh Circuit held that McCranie lacked standing to challenge the transfer of a non-qualifying loan under the terms of the purchase agreements, to which he was not a party.

The court then considered McCranie’s various contractual defenses and concluded that none applied to defeat enforcement of the Note. The court rejected McCranie’s argument that the franchise agreement arose under Article 2 of the U.C.C. and that he was not obligated to pay under the Note because he ultimately did not receive the “goods” under the arrangement. At best, the franchise agreement was a mixed agreement for the sale of goods and services, with its predominant purpose being the establishment of the franchise relationship as a joint service endeavor.

Lastly, the court held that McCranie’s defenses of commercial frustration and impossibility were inapplicable. Those defenses are available only when the event allegedly causing frustration or impossibility of performance was unforeseeable at the time of contracting. The agreements in question, moreover, contained substantial protections for Brooke in the event of various defaults by McCranie. McCranie, however, despite having legal counsel, failed to negotiate for protections in the event of a breach of the franchise agreement by Brooke. The court concluded that if Brooke could anticipate McCranie’s breaches, McCranie could have guarded against Brooke’s breaches.


The Georgia Court of Appeals reversed the ruling of the trial court that purported to grant a temporary restraining order (TRO) in favor of the franchisor. Although the trial court’s order was called a TRO, in effect, the order actually granted a declaratory judgment in favor of franchisor on the issue of whether the franchisee breached the terms of the franchise agreements by filing for bankruptcy. Because the trial court granted such relief without
complying with the procedures of Georgia’s Declaratory Judgments Act, the Court of Appeals reversed the order.

Taylor Investment Partners II and its affiliates (Taylor) operated two Moe’s franchises pursuant to franchise agreements with Moe’s Franchisor (Moe’s). When Taylor filed for bankruptcy, Moe’s alleged the filing violated the terms of the franchise agreements. Moe’s filed suit seeking an interlocutory injunction and a TRO and asserting trademark infringement claims. Taylor then filed its own TRO motion and requested an emergency hearing. Taylor, through counsel, sent an e-mail to trial court staff and opposing counsel stating that its TRO motion was intended to “simply seek to preserve the status quo until the termination dispute is resolved on the merits.”

After the hearing, the trial court granted Taylor’s TRO motion and asked the parties to brief the issue of whether Taylor’s filing of the bankruptcy petition terminated the franchise agreement. The parties filed the briefs. Taylor also filed its answer and counterclaims, which included a declaratory judgment counterclaim seeking a declaration that the bankruptcy termination clauses in the franchise agreements were unenforceable. Then, the trial court issued an order purporting to grant a TRO in favor of Moe’s. The order explicitly found that the termination of the franchise agreements was proper and that the termination-upon-bankruptcy clauses were enforceable. The trial court ordered Taylor to shut down the franchises and to remove all Moe’s identifying marks from the restaurants.

On appeal, the Court of Appeals addressed the trial court’s order in light of the principle that substance, not nomenclature, controls the construction of a document. The Court of Appeals found that because the order directed action giving Moe’s all the relief it sought, it did not merely preserve the status quo. Additionally, the order resolved the ultimate issue of the enforceability of the franchise agreements’ bankruptcy clauses. So, despite calling it a TRO, the substance of the order granted a declaratory judgment in favor of Moe’s.

The Court of Appeals then found that the trial court’s order failed to comply with the required procedures of Georgia’s Declaratory Judgments Act. Specifically, Georgia law requires that a declaratory judgment action may not be tried earlier than 20 days after service is perfected, unless the parties consent in writing to an earlier date. The hearing in the case was held only one day after service. The Court of Appeals rejected Moe’s argument that the e-mail from Taylor’s counsel requesting the emergency hearing operated as consent in writing to an earlier trial date. The Court of Appeals noted that the e-mail indicated that the purpose of the hearing was to preserve the status quo and that Taylor had not even filed its declaratory judgment counterclaim at the time of the e-mail. The Georgia appellate court ultimately held that because the trial court’s order was substantively a declaratory judgment issued after a procedurally improper hearing, the trial court committed reversible error.
This case involved a Dealership Agreement between a manufacturer and dealer that contained certain indemnification provisions in the event of a dispute. On February 2, 2018, the U.S. District Court for the Northern District of Ohio determined the ripeness of such indemnity provisions under a unique set of facts.

In 2006, Rayco Manufacturing, Inc. (Rayco) and Beard Equipment Company (Beard) entered into a Dealership Agreement whereby Rayco allowed Beard to serve as its exclusive dealer in the territory set forth in the agreement. The agreement provided that: (1) Rayco would indemnify and hold harmless Beard from and against all lawsuits and damages arising out of the design and manufacture of the product sold to Beard; (2) Beard would indemnify and hold Rayco harmless from and against all claims and damages arising out of the sale, rental, lease, modification, or servicing of the product by its employees or agents; and (3) if Rayco and Beard were contributory causes to a claim, each party would cover its own expenses and cooperate in the resolution of litigation. Further, the agreement stated that Beard was not Rayco’s agent and could not create any obligation on behalf of Rayco. The agreement had a forum selection clause under which all disputes had to be resolved in the Northern District of Ohio and a choice of law provision under which the agreement would be construed in accordance with Ohio law.

In December 2016, Rayco brought an indemnity action against Beard in an Ohio state court, which was removed to federal court. The timeline and relevant factual background preceding the indemnity action are as follows:

- In 2008, Josh Akridge (Akridge), individually and d/b/a Hen-Ridge Dirt Works, LLC, filed suit in Alabama against Rayco, Beard, and several Beard employees in connection with Beard’s sale of a forestry mower to Akridge, alleging fraud and breach of warranty claims. Under the Dealership Agreement, Beard was required to provide the buyer with a warranty registration certificate to be completed and returned to Rayco in order for the customer to obtain warranty coverage. Akridge claimed that Beard did not provide him with a warranty registration.
- In 2010, while the Alabama litigation was still pending, Rayco brought suit in an Ohio state court, alleging that Beard had breached the Dealership Agreement by failing to defend and indemnify Rayco in the Alabama litigation.
- In 2011, Akridge filed an amended pleading in the Alabama litigation, alleging design and manufacturing defect claims under the Alabama Extended Liability Manufacturing doctrine. Rayco filed a motion to dismiss, which was granted.
- Later in 2011, the Ohio district court granted Rayco summary judgment against Beard, finding that Beard was contractually obligated to
defend and indemnify Rayco under the Dealership Agreement. Beard appealed, and the decision was reversed in 2014 because the agreement did not include a duty to defend; thus, Rayco’s right to indemnification would only ripen if Beard was found liable and Rayco was absolved of liability in the Alabama litigation.

- In 2014, Akridge settled its claims against Beard in the Alabama litigation, and he specifically reserved the right to any remaining claims against Rayco.
- In January 2016, the Alabama state court dismissed the remaining claims against Rayco as being governed by the forum selection clause in the Dealership Agreement.

The indemnity action filed by Rayco involved two breach of contract claims: (1) indemnification from Beard, pursuant to the Dealership Agreement, for Rayco’s costs in defending the Alabama litigation; and (2) violation of the Dealership agreement by Beard for encouraging Akridge to amend his complaint and pursue design and manufacturing defect claims against Rayco. Beard moved for summary judgment, contending that Rayco’s request for indemnification was not ripe.

The Ohio district court denied Beard’s motion for summary judgment, finding that all three factors of the ripeness test for judicial review were satisfied. First, the harm to Rayco had already occurred because (1) Rayco incurred expenses in defending the Alabama litigation; and (2) the expenses were finally determined because the statute of limitations had run on any of Akridge’s remaining claims against Rayco. Second, delaying a determination of indemnification would significantly prejudice Rayco because (1) Akridge’s claims against Rayco were time-barred, thereby precluding a determination of liability under another tort action; and (2) Beard’s settlement with Akridge similarly precluded a tort action whereby Beard’s liability could be determined. Third, the factual record was sufficiently developed because the Alabama litigation concluded and thus the factual record in the underlying tort action was as complete as it ever would be. As such, because there was no tort action under which the parties’ liabilities for the underlying tort injury would be resolved, it would be up to the Ohio district court to determine the factual basis for the parties’ duties and rights under the Dealership Agreement. Accordingly, the indemnification action was ripe for resolution and Beard’s motion for summary judgment was denied.


The U.S. District Court for the Southern District of Florida found that a franchisor may state a claim for lost future royalties for a franchisee’s breach of franchise agreement. Denying a motion to dismiss, the court concluded that the franchisor sufficiently stated breach of franchise contract claims
for both past due royalties and future royalties. Because the franchisor’s lost future royalties calculation was based on the average weekly fees and the remaining weeks in the franchise agreement, the court found that the damages were not too speculative to warrant dismissal for failure to state a claim.

Plaintiff Interim Healthcare Inc. (Interim) operates a franchise that provides healthcare staffing through over 300 franchisees throughout the United States. In 2013, Interim entered into a ten-year franchise agreement with Defendant Health Care@Home (HCH), under which HCH agreed to pay certain weekly service charges based on a percentage of sales. The agreement allowed Interim to terminate the contract in the event of HCH’s default by failing to perform and to abide by the terms of the agreement.

In 2015, Interim served HCH with a notice of default, claiming HCH owed Interim over $70,000 under the agreement. In 2017, because HCH failed to cure the default noticed in 2015, Interim terminated the agreement. Interim then filed suit for breach of the franchise agreement and sought to recover certain royalties. In the complaint, Interim alleged not only that HCH owed it almost $400,000 in past due royalties, but that it was due close to $1.5 million in “future royalties.” Interim calculated this future royalties figure by multiplying the number of weeks remaining on the franchise agreement by the average weekly service charge due from HCH. HCH moved to dismiss both claims for failure to state a claim.

Applying Florida law, the court held that both claims survived dismissal. First, the court found that to state a claim for breach of a franchise contract, a plaintiff must allege: (1) a valid contract; (2) a material breach of that contract; and (3) damages resulting from the breach. The court found Interim’s allegations of a valid agreement, HCH’s breach by failing to make required payment, and damages amounting to almost $400,000 in past royalties sufficient to state a claim for breach of contract for past due royalties. Moreover, the court found, despite HCH’s contention, Interim specifically alleged that it performed all its obligations under the agreement.

In addressing Interim’s claim for future royalties, the court found that because a non-breaching party can chose to be placed in the position it would have been in had the contract been fully performed by seeking an award of lost profits, a party may be entitled to expectation damages for breach of a franchise agreement. To recover such damages, a claimant must prove: (1) a breach of contract; (2) loss was a proximate result of the breach; (3) the loss was, or should have been, within the reasonable contemplation of the parties; and (4) the loss is not remote, contingent, or conjectural, and the damages are reasonably certain. Applying this standard, the court found that Interim sufficiently stated a claim for breach of contract for future royalties. Specifically, the court found that because the future royalties damages were based on the average weekly fees and the remaining weeks in the agreement, the alleged losses were not too speculative. The court noted that, although Interim would be required at trial to specifically demonstrate its anticipated lost profits with reasonable certainty by competent proof, at
the pleading stage Interim’s damages calculation was sufficiently certain to survive dismissal.

*Bella & Rosie Rock, LLC v. We Rock the Spectrum, LLC, Bus. Franchise Guide (CCH) ¶ 16,152, No. CV173628MCAMAH, 2018 WL 844398 (D.N.J. Feb. 13, 2018).*

The U.S. District Court for the District of New Jersey held that one party’s unilateral claim of rescission of a franchise agreement is not sufficient to invalidate a forum selection clause within that agreement. The court also rejected challenges to the validity of the forum selection clause based on fraud and New Jersey statutory law, and it found the clause valid, mandatory, and enforceable. Ultimately, after finding that the factors at issue warranted transfer, the court transferred the case to the U.S. District Court for the Central District of California pursuant to 28 U.S.C. § 1404(a).

Defendant We Rock The Spectrum, LLC (WRTS), a California company, sells franchises to operate children’s gyms under the name We Rock The Spectrum. In 2016, Plaintiff Bella and Rosie Rock, LLC (BRR) and WRTS entered into a franchise agreement to operate a We Rock The Spectrum gym in New Jersey. The agreement contained a mediation clause where the parties pledged to attempt to resolve any dispute through mediation to be conducted in Los Angeles County, California. The agreement also contained a forum selection clause that designated California as the forum for any litigation and provided that California law would govern any dispute.

The New Jersey gym location opened in August 2016. Disputes between the parties quickly arose. In September 2016, WRTS served BRR with notices claiming default and numerous breaches of the agreement. In October 2016, BRR sent WRTS a notice of rescission and demanded damages. WRTS did not actively contest the rescission letter, but it petitioned the American Arbitration Association to pursue mediation, as consistent with the agreement. In lieu of engaging in mediation, BRR filed suit in the District of New Jersey alleging numerous claims, including breaches of the agreement, false representations, and violations California and New Jersey franchise statutes. WRTS then moved to transfer the matter to California under the forum selection clause. BRR opposed the motion on the grounds that the forum selection clause was unenforceable.

The primary issue in deciding to transfer the matter was whether the agreement’s forum selection clause was enforceable. BRR’s main argument opposing the transfer was that the forum selection clause was unenforceable because BRR rescinded the agreement and that WRTS agreed to the rescission by seeking mediation instead of contesting the rescission letter. The court rejected BRR’s argument on numerous grounds. The court noted that finding that BRR effectively rescinded the agreement and invalidated the forum selection clause would have been premature. Such a finding essen-
tially would have granted BRR the relief it sought without requiring it to prove its case. Additionally, the court reasoned that BRR could not credibly assert that the agreement and its forum selection clause were no longer operative while simultaneously basing some of its claims for damages on alleged breaches of the agreement. Finally, the court found that WRTS’s pursuit of mediation did not amount to acquiescence to BRR’s rescission. On the contrary, by seeking mediation, WRTS acted consistently with the agreement.

The court also rejected BRR’s two other arguments that the forum selection clause was invalid. BRR argued that the forum selection clause was unenforceable because the agreement was allegedly fraudulent. But, the court noted, for fraud to render a forum selection clause unenforceable, the forum selection clause itself must have been procured by fraud. BRR made no such showing. Additionally, BRR argued that the forum selection clause was invalid because it brought a claim under the New Jersey Franchise Practices Act (NJFPA), which disfavors forum selection clauses. But the NJFPA covers only franchises meeting certain required elements, including the requirement that the gross sales covered by the franchise exceed $35,000 for the 12 months preceding the action. Because BRR only generated $7,116.61 in sales during its fewer than sixty days of operation, it fell below the threshold amount necessary to receive protection under the NJFPA. Importantly, because BRR failed to provide any supporting authority, the court rejected BRR’s argument that it should consider whether BRR’s projected sales would have exceeded $35,000 had it remained in operation for 12 months.

After dismissing all BRR’s arguments against enforcement, the court found the forum selection clause valid, mandatory, and enforceable. Then, the court analyzed whether transfer was appropriate under § 1404(a). Unlike a typical § 1404(a) analysis, because the parties agreed to a forum selection clause, BRR bore the burden of establishing that the transfer to the agreed upon forum was unwarranted, and the court considered only public interest factors, not the parties’ private interests. Ultimately, the court found that the public interest factors were neutral and that BRR failed to meet its burden to show that transfer to California was unwarranted. As a result, the court granted WRTS’s motion to transfer venue to the Central District of California.

**DAMAGES**


This case is discussed under the topic heading “Contract Issues.”
Plaintiff Machinery Solutions, Inc. (MSI) filed a lawsuit seeking damages from defendant Doosan Infracore America Corporation (Doosan) for terminating its dealership contract with MSI. During discovery, MSI moved to compel Doosan to provide responses to a number of interrogatories and requests for admission, and the U.S. District Court for the District of South Carolina granted in part and denied in part the motions to compel.

The lawsuit between MSI and Doosan arose from Doosan’s termination of its distributor agreement with MSI in August 2015. Doosan replaced MSI with Ellison Technologies, Inc. (Ellison). MSI responded by asserting claims against Doosan and Ellison for conspiracy and against Doosan for breach of contract; violation of the South Carolina Unfair Trade Practices Act; and violation of the Fair Practices of Farm, Construction, Industrial, and Outdoor Power Equipment Manufacturers, Distributors, Wholesalers, and Dealers Act (FPA). On July 31, 2017, MSI filed a motion to compel seeking to compel full and proper answers by Doosan in response to its various discovery requests, including interrogatories, requests for admission, and requests for production.

Amended Rule 26 of the Federal Rules of Civil Procedure provides that parties may obtain discovery regarding “any non-privileged matter that is relevant to any party’s claim or defense and proportional to the needs of the case.” Thus, courts look to three factors to determine whether information sought is within the scope of discovery: (1) privilege; (2) relevance to a claim or defense; and (3) proportionality to the needs of the case. Whether a discovery request is proportional is determined by considering several factors, including the importance of the issues at stake in the action, the amount in controversy, the parties’ relative access to the relevant information, the parties’ resources, the importance of discovery in resolving the issues, and whether the burden or expense of the proposed discovery outweighs its likely benefit. If a party fails to make a required disclosure, the other party may move to compel after it has conferred or attempted to confer with the party purportedly failing to make required disclosures. Federal Rule of Civil Procedure 37(a).

The court first addressed the interrogatories at issue. Several interrogatories sought “all facts” concerning or relating to various allegations made by Doosan. The court held that by asking Doosan to provide “all facts” relating to Doosan’s legal claims or defenses, MSI’s requests were overly broad and unduly burdensome. The court held that interrogatories may seek opinions or contentions that call for application of law to facts but that contention interrogatories are overly broad and unduly burdensome if they asked for “all facts” supporting a claim or defense such that the answering party would be
required to provide a narrative account of its case. To render such contention interrogatories not overly broad, a party must ask for only the “principal or material” facts that support an allegation or defense. Therefore, the court granted MSI’s motion to compel with respect to its contention interrogatories but directed Doosan to provide only the “principal and material” facts supporting its defenses rather than “all facts.”

MSI also sought information via interrogatory about in-person meetings occurring between Ellison and Doosan between January 2014 and August 2015. Doosan objected on the grounds that the interrogatory was overly broad, unduly burdensome, not proportional, and that it sought irrelevant information. Finally, Doosan argued that, pursuant to Federal Rule of Civil Procedure 33(d), it produced documents containing information that MSI sought in response to MSI’s request for production. The court disagreed with Doosan, noting that the information was relevant and that identifying meetings and providing information about them would not be overly burdensome. Finally, the court held that Doosan’s reliance on Rule 33(d) was improper because Doosan failed to specify the records that must be reviewed in sufficient detail to enable MSI to locate and identify them as readily as Doosan could. Federal Rule of Civil Procedure Rule 33(d)(1). By failing to provide Bates numbers in which the relevant information could be found, Doosan failed to meet its obligations under Rule 33(d)(1). Thus, the court granted MSI’s motion to compel.

MSI also asked Doosan to provide all facts that would support Doosan’s contention that it would qualify as a dealer under the FPA. Doosan objected on the grounds that the interrogatory called for a legal conclusion. The court held, however, that this was a proper contention interrogatory, asking Doosan to apply facts to the law and granted MSI’s motion to compel but limited the requests to “material or principal” facts, rather than “all facts.”

MSI sought a request for admission asking Doosan to admit that MSI was a “dealer or equipment dealer” for purposes of South Carolina Code Section 36–6–20. Doosan objected on the grounds that the request for admission improperly called for a legal conclusion on a matter of law. The court held that under Federal Rule of Civil Procedure 36, parties may request admissions regarding purely factual matters or the application of law to facts, but not matters of law. MSI’s request was improper under Rule 36 because it asked Doosan to admit a legal conclusion by requesting Doosan admit that MSI was a dealer under the FPA. Thus, the court denied MSI’s motion to compel a response to this request for admission.

In response to another request for admission, Doosan argued that it was vague and ambiguous and that it assumed facts not in evidence. Rule 36, however, requires the answering party to specifically deny the matter or set forth in detail the reasons why the answering party cannot truthfully admit or deny the matter. Thus, Doosan’s standard form objections were insufficient to meet its obligations under Rule 36, and therefore, the court
granted MSI’s motion to compel a response to this particular request for admission.

MSI also sought an order from the court requiring Doosan to produce documents identified in its privilege log that it refused to produce based on unsubstantiated claims of attorney-client privilege. The court held that to comply with the Federal Rule of Civil Procedure 26, a party asserting privilege must produce a log that identifies each document withheld, information regarding the nature of the privilege claimed, the name of the person making and receiving the communication, the date and place of communication, and the document’s general subject matter. The court held that Doosan’s privilege log did not allow MSI or the court to test the applicability of the attorney-client privilege as to each document it sought to withhold, and, therefore, the court ordered Doosan to provide a revised privilege log that would allow MSI and the court to determine whether the claimed privilege applied.

Finally, MSI made a general request for an order requiring Doosan to produce documents that it withheld on the grounds of relevancy but the court denied this motion to compel. It held that MSI did not point to a specific disclosure that Doosan failed to make as required by Rule 26.


Complete Nutrition, a retailer of nutritional supplements, approved two franchised stores in Tennessee for J. Howell, one in Alcoa and another in Knoxville. In the franchise agreement, franchisee agreed to the following: (1) the stores would be used for no other purpose other than operation of Complete Nutrition stores; (2) neither it nor its owners would directly or indirectly compete with Complete Nutrition; (3) for two years after termination of the agreement, neither it nor its owners would directly or indirectly have an interest in a competing business within a twenty-five-mile radius of each store; and (4) neither it, nor its owners or families, would employ or seek to employ any person who was at the time employed by Complete Nutrition.

Following the closure of the Alcoa location in early 2017, the Knoxville Complete Nutrition store was rebranded as “Alpha Nutrition” in late October 2017. The majority of Complete Nutrition’s trade dress was removed from the store, and the franchisee began representing itself solely as Alpha Nutrition. Additionally, while continuing to sell all Complete Nutrition products, the Knoxville location sold them at a steep discount. After the Knoxville location ignored Complete Nutrition’s demand letter, Complete Nutrition brought suit against the franchisee seeking a preliminary injunction.

When deciding whether to issue a preliminary injunction, the court weighed the four Dataphase factors: “(1) the threat of irreparable harm to
the movant; (2) the state of the balance between this harm and the injury that granting the injunction will inflict on other parties; (3) the probability that the movant will succeed on the merits; and (4) the public interest.” *Johnson v. Minneapolis Park & Recreation Bd.*, 729 F.3d 1094, 1098 (8th Cir. 2013) (citing *Dataphase Sys., Inc. v. C L Sys., Inc.*, 640 F.2d 109, 114 (8th Cir. 1981) (en banc)). As to the first factor, a preliminary injunction cannot issue without a showing of irreparable harm. The movant must show that there is a clear and present need for equitable relief, and that the harm is actual and not theoretical. Further, if the harm can be compensated, it is not considered irreparable.

The court concluded that Complete Nutrition showed a threat of irreparable harm in this case. The court noted that Alpha Nutrition was built, “at least in part, on Complete Nutrition’s goodwill, which Alpha Nutrition is now arguably misappropriating.” Alpha Nutrition’s business was also partially built on “education and instruction provided to its employees by Complete Nutrition, as consideration for services that are no longer provided.” Further, the sale of Alpha Nutrition products with its new trade dress alongside Complete Nutrition products and trade dress “creates a likelihood of confusion that has often been held to establish an irreparable injury.” Evidence suggested that Complete Nutrition’s efforts to “reestablish a franchise in the market will be impaired by the presence in the market of a former franchise.” Accordingly, it is “difficult to quantify the degree to which the defendants will be unjustly enriched by their use of the support they received from Complete Nutrition.” The court found that these damages could not be remedied with money damages; therefore, Complete Nutrition sufficiently showed irreparable harm.

With respect to the “likelihood of success on the merits” factor, the court noted that this is the most important factor in deciding whether or not to grant a preliminary injunction. In this case, the court had to determine if the Knoxville location violated the franchise agreement, related to the restrictive covenants. The court agreed that the noncompete provisions were enforceable under Nebraska law.

With respect to the last two factors, the court agreed with Complete Nutrition that public interest was not implicated in this case, but disagreed that the harm the franchisee might suffer from an injunction “is slight by comparison” to the harm sustained by Complete Nutrition. The court acknowledged that franchisee was a small business and that moving the competing operations outside the twenty-five-mile area proscribed by the franchise agreements would hardly be an inconsequential undertaking.

However, the court found that a preliminary injunction was appropriate. The court recognized that although the injunction would impose a severe burden on the franchisee, it was a burden the franchisee contracted for and was warranted considering the flagrant breach of those contracts as evidenced here. Further, the court noted that the franchisee took no corrective action, nor did it offer any defense for its ongoing conduct.
Plaintiff Tesla Motors, Inc. (Tesla) served third-party subpoenas on three car dealers, who are also members of the Michigan Automobile Dealers Association (MADA), in connection with Tesla’s challenge of a Michigan statute that prohibits car manufacturers from selling vehicles directly to consumers. Through the third-party subpoenas, Tesla requested communications between the dealers and MADA involving lobbying efforts in favor of legislation that subsequently prevented Tesla from obtaining a dealership license in Michigan. MADA filed a motion to quash the third-party subpoenas, which the trial court partially denied. MADA then appealed the trial court’s partial denial of its motion to quash, alleging that the third-party subpoenas infringed upon the First Amendment associational privilege. Tesla moved to dismiss the appeal for lack of jurisdiction, claiming that the discovery order was not appealable.

The Sixth Circuit dismissed MADA’s appeal for lack of jurisdiction. As a general rule, discovery orders are not immediately appealable “unless the trial court enters a final judgment disposing of all claims.” The Perlman Doctrine provides that discovery orders directed at disinterested third parties are immediately appealable because a disinterested third party “presumably lacks a sufficient stake in the proceeding to risk contempt by refusing compliance.” Here, the dealers were not disinterested third parties because they were closely affiliated with MADA and expressed opposition to complying with the third-party subpoenas. Further, similar to MADA, the dealers asserted the First Amendment associational privilege in opposition to the subpoenas. As such, because the dealers were not disinterested parties who could not be expected to submit to a contempt order to preserve a claim of privilege, the denial of the trial court’s motion to quash the third-party subpoenas was not immediately appealable.

Further, contrary to MADA’s assertions, the trial court’s discovery ruling was not a “collateral order” or an order that effectively amounted to an injunction. First, a collateral order (1) conclusively determines a disputed issue, (2) decides an issue separate from the merits of the action, and (3) is effectively unreviewable on appeal after final judgment. However, the collateral-order doctrine does not make an “individualized jurisdictional inquiry” regarding the particular order at issue but rather considers whether similar orders in that context would satisfy the collateral-order doctrine. With regard to discovery orders involving privilege, the Supreme Court has previously held that the collateral-order doctrine does not include discovery rulings addressing the attorney-client privilege. Similarly, here the Sixth Circuit declined to apply the collateral-order doctrine to a discovery order involving the First Amendment associational privilege.

Finally, the trial court’s ruling was not the functional equivalent of an injunction. Under Supreme Court precedent, a federal court order that relates
only to the progress of litigation ordinarily is not considered an injunction. Accordingly, the trial court’s partial denial of MADA’s motion to quash third-party subpoenas was not immediately appealable under the Perlman Doctrine.

FORUM SELECTION

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

FRAUD

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

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

INJUNCTIVE RELIEF

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

*In re: Jimmy John’s Overtime Litig.*, Bus. Franchise Guide (CCH) ¶ 16,105, 877 F.3d 756 (7th Cir. 2017)
This case is discussed under the topic heading “Class Actions.”

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

This case is discussed under the topic heading “Contract Issues.”
A restaurant employee alleged age discrimination against Clark Foods, Inc. (Clark), Sunshine Partners (Sunshine), and IHOP Corporation (IHOP). IHOP and Sunshine moved for summary judgment on the grounds that neither IHOP nor Sunshine exercised any control over employment-related matters with respect to franchisee Clark’s business, which was an independent, third-party entity. The U.S. District Court for the Middle District of Georgia agreed with IHOP and Sunshine that the only relationship relevant to Boone’s age discrimination claims was the relationship between her and Clark, her direct employer.

Boone filed her action against Clark, Sunshine, and IHOP for claims of discrimination in violation of the Age Discrimination and Employment Act (ADEA), 20 U.S.C. § 621. IHOP and Sunshine took the position that they never employed Boone and were not involved in her discharge or in any events forming the basis for her ADEA claim. The claim itself was based on conduct committed by Clark’s manager, Jessica Pitts, who made a number of comments regarding Boone’s age and purportedly treated her differently from other employees based on her age. Boone asked the court to deny the motion for summary judgment because it was premature and she sought the opportunity to first conduct discovery. The court held that discovery may result in the production of a franchise agreement entered into between IHOP and Sunshine, and between Sunshine and Clark, but those documents would not change the fact that Clark was the sole employer as defined by the ADEA.

The court held that when determining whether a party other than a direct employer can be liable for employment claims, courts consider two factors: (1) how much control the purported employer exerted on the employee; and (2) whether the alleged employer had the power to hire, fire, or modify the terms and conditions of the employee’s employment. The court found three circumstances in which two or more separate entities should be treated as a single, integrated enterprise when determining whether both entities can be deemed employers. First, where two ostensibly separate entities are highly integrated with respect to ownership and operations, courts may count them as a single entity or a “single employer” or “integrated enterprise.” Second, where two entities contract with each other for the performance of some task, and one company retains sufficient control over the terms and conditions of employment of the other company’s employees, the two entities can be treated as joint employers. Finally, where an employer delegates sufficient control of rights over employees to a third party, courts may treat the third party as an agent of the employer and aggregate the two into a single entity for purposes of employment-related claims.

The court held that Boone presented no evidence that IHOP or Sunshine could be included in a single entity with Clark. Although IHOP and Sun-
shine both conducted periodic inspections, those inspections were limited to ensuring that franchisees were in compliance with branding, advertising, menu specifications, and other contract specifications. The only connection between Clark and IHOP and Clark and Sunshine was the existence of a subfranchise or license agreement, and courts have consistently held that a franchise relationship does not create an employment relationship between a franchisor and a franchisee’s employees. Here, there was also no evidence that IHOP or Sunshine employed Boone or those who discriminated against her, and there was no evidence that either IHOP or Sunshine exercised any authority in the decision to fire Boone. Because IHOP and Sunshine did not exercise control over Clark—Boone’s direct employer—with respect to daily operations and employment practices, and because there was no evidence that IHOP or Sunshine were directly involved in the hiring or firing of Clark’s employees, the court granted Sunshine and IHOP’s motion for summary judgment.


Defendant International House of Pancakes, LLC (IHOP) hired plaintiff Autumn Lee Tangas (Tangas) as a franchise bureau consultant to act as a liaison between IHOP corporate and various franchisees. Among the franchisees Tangas oversaw was Tarek Elkafrawi (Elkafrawi), who operated IHOP franchises in Ohio and Indiana. Tangas became increasingly concerned about Elkafrawi’s “poor business structure and weak management skills” and even told her supervisor that she questioned whether Elkafrawi was under-reporting sales. IHOP corporate ignored Tangas’s concerns.

In 2004, several years after Tangas met Elkafrawi, Tangas’s domestic partner, Lisa Ross (Ross), loaned Elkafrawi $50,000 from her and Tangas’s joint bank account. Though there was a dispute as to whether it was merely a loan from Ross or an investment by Ross and Tangas, eventually Elkafrawi returned the money to Ross. Tangas never disclosed these events to IHOP or her supervisor.

In September 2011, the FBI raided five IHOP restaurants that were overseen by Tangas and operated by Elkafrawi. Initially, at the request of IHOP’s parent organization, DineEquity, Tangas cooperated with the FBI’s investigation. When asked about Elkafrawi during an interview with two FBI agents, Tangas disclosed Ross’s loan to Elkafrawi. This led to an internal investigation by IHOP. Soon after speaking with IHOP’s in-house counsel, Tangas hired an attorney at her own expense. IHOP’s legal department asked Tangas to travel to California to participate in an interview, but, on the advice of counsel, Tangas declined. In March 2012, IHOP terminated Tangas for violating the IHOP Code of Conduct and refusing to participate in the California interview.

In May 2012, a federal grand jury indicted Tangas, Elkafrawi, and more than fifteen others on charges arising from Elkafrawi’s operation of his
IHOP franchises. In May 2014, after Tangas incurred more than $130,000 in legal fees, the charges against Tangas were dismissed with prejudice.

In 2015, Tangas filed suit against IHOP, alleging: (1) wrongful termination in violation of Ohio’s public policy favoring the right to consult with counsel, and (2) indemnification for the legal fees she incurred in the criminal case. Though IHOP moved to dismiss both claims, the court held that Tangas stated a plausible cause of action for wrongful discharge. However, the court dismissed Tangas’s indemnification claim with leave to amend as to whether Ohio or Delaware law applied. After Tangas amended her complaint, both IHOP and Tangas filed motions for summary judgment regarding the indemnification claim. The parties’ motions addressed two issues: (1) whether Tangas had the right to indemnification under DineEquity’s bylaws, and (2) whether Tangas had the right to indemnification under IHOP’s LLC agreement.

The court granted IHOP’s motion for summary judgment and denied Tangas’s motion. First, the court found that Tangas did not have the right to indemnification under DineEquity’s bylaws because (1) Delaware law only requires corporations to indemnify officers and directors, not employees, and (2) Tangas was an employee of IHOP, not DineEquity. Second, Tangas did not have the right to indemnification under IHOP’s LLC agreement because (1) Tangas was no longer a “covered person” under IHOP’s operating agreement after her employment was terminated, and (2) IHOP was relieved of its duty to indemnify a “covered person” who engaged in “fraud, willful misconduct, bad faith or gross negligence.” Specifically, IHOP reasonably determined that Tangas engaged in fraud by failing to disclose her conflict of interest with respect to Ross’s loan to Elkafrawi. Further, IHOP reasonably determined that Tangas engaged in willful misconduct when she refused to attend the internal IHOP interview in California. As such, no reasonable jury could find that IHOP and DineEquity failed to undertake an adequate investigation and make “a reasoned business judgment not to indemnify Tangas.”

NEGLIGENCE


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

RICO


This case is discussed under the topic heading “Class Actions.”
RIGHT OF FIRST REFUSAL


The U.S. District Court for the District of Minnesota vindicated a manufacturer in its application of its right of first refusal and transfer provisions in a dealer agreement. Plaintiff Bobcat of Duluth (Bobcat of Duluth), an independent dealer of defendant Clark Equipment Co. d/b/a Bobcat Co. (Bobcat), sued Bobcat for violating the Minnesota Heavy and Utility Equipment Manufacturers and Dealer Act (MHUEMDA) and the Minnesota Agricultural Equipment Dealers Act (MAEDA), and for breach of contract, alleging that Bobcat placed unreasonable restrictions when Bobcat of Duluth tried to sell its dealership and cut the purchase price by more than half.

Bobcat of Duluth signed annual dealer agreements with Bobcat for many years. In 2002, a Bobcat representative suggested that Bobcat of Duluth supplement its sales by selling equipment manufactured by Kubota Tractor Corporation (which had competitive product lines), and Bobcat of Duluth did so. In 2012, Bobcat changed its policies to require new dealers to sell Bobcat products exclusively, but this policy was not added to Bobcat of Duluth’s annual dealer agreements.

In 2014, Bobcat of Duluth informed Bobcat that it wanted to sell its business, and Bobcat informed Bobcat of Duluth that it would require the buyer to sell Bobcat products exclusively and suggested that Bobcat of Duluth sell the Kubota portion of its dealership separately. When Bobcat of Duluth found a buyer—Quality Forklift Sales and Service, Inc. (Quality Forklift)—it wanted to buy both the Bobcat and the Kubota portions of the dealership. Bobcat of Duluth sent the letter of intent (LOI) to Bobcat. Bobcat conditionally approved this transfer, but then also sent a letter requiring exclusivity to Bobcat products. When Quality Forklift would not agree to these terms, Bobcat refused to consent to the transfer.

Bobcat sought summary judgment on Bobcat of Duluth’s claims. The MHUEMDA and MAEDA provide that “no equipment manufacturer ‘may terminate, cancel, fail to renew, or substantially change the competitive circumstances of a dealership agreement without good cause.’” Bobcat argued that Bobcat of Duluth’s claims under these acts failed because it was still a dealer under the dealer agreement. Bobcat of Duluth argued that the “substantial change” element of the acts had been breached. But the court cited law defining “substantial change” under the acts, which provide that it “is a change that has substantially adverse although not necessarily lethal effect on the dealership. It is a change that is material to the continued existence of the dealership, one that significantly diminishes its viability, its ability to maintain a reasonable profit over the long term or to stay in business.” The court found that Bobcat of Duluth did not identify how this change harmed its ability to make a reasonable profit in the long term or
to stay in business, and thus there was no substantial change in the competitive circumstances of the dealership agreement. The court also found that the acts do not provide a claim for unreasonably failing to consent to a transfer. Accordingly, the claims under both acts were dismissed.

Bobcat of Duluth also claimed that Bobcat breached the right-of-first refusal provisions of the dealer agreement by refusing to approve the sale. Bobcat first argued that the separate assignment provision in the dealer agreement gave it the right to approve or deny a proposed transfer; in response, Bobcat of Duluth argued that the right-of-first refusal provision of the agreement controlled this situation instead. The court agreed with Bobcat, as these provisions covered different rights. Bobcat had a right to choose its dealers, and withholding its consent under this provision did not breach the agreement or the covenant of good faith and fair dealing.

Bobcat also argued that the right-of-first refusal provision of the agreement, even if it applied, was not triggered because the letter of intent was not an offer in that it was not final and allowed further negotiation. The court agreed that the letter of intent was an agreement to develop an offer and thus was not an actual offer. It also noted that even if it was an offer, that would mean that Bobcat would have had to purchase the whole dealership, including the Kubota portion, which would lead to the absurd result of Bobcat purchasing its competitor’s product lines. Here, too, the court found that Bobcat did not breach the agreement or the covenant of good faith and fair dealing due to its absolute right to choose its dealers.

The motion for summary judgment was granted in its entirety in favor of Bobcat.


The U.S. District Court for the Middle District of Pennsylvania held Audi of America, Inc. (Audi) to its right of first refusal and no more. Plaintiff Audi sued defendant Bronsberg & Hughes Pontiac, Inc. (referred to as Wyoming Valley in the opinion)—which operated seven dealerships, including an Audi dealership under a dealership agreement—to prevent a transfer of the dealership. Wyoming Valley had entered into an asset purchase agreement with North American Automotive Services, Inc. and related entities (referred to as Napleton in the opinion) for its seven dealerships in one single transaction, without separately pricing the dealerships. Napleton ultimately also intervened in this action.

When Wyoming Valley informed Audi of the transaction, Audi responded that it could not analyze its right of first refusal under the dealership agreement without the Audi dealership being separately apportioned in the deal, and it requested a breakdown of the price or a withdrawal of the deal. Wyoming Valley responded that the deal did not have an allocation of the purchase price and that would require more negotiations and an amendment to the deal. Later, Wyoming Valley provided Audi with an
$8 million value for the Audi dealership (almost half of the deal total), but also stated that such a breakdown in the context of an auto multiplex was very complicated.

Audi held that this was not a good-faith breakdown and sued Wyoming Valley to enjoin the sale to Napleton and to seek a declaration that Wyoming Valley breached the dealership agreement and the Pennsylvania Board of Motor Vehicles Act. After an initial temporary restraining order and preliminary injunction preventing Wyoming Valley from selling any of the assets under the Napleton deal, the court lifted the restrictions on the sale of unrelated dealerships (for brands unrelated to Audi) but kept in place the restrictions on the sale of Audi and Volkswagen dealerships.

After the lawsuit commenced, however, Wyoming Valley and Napleton amended their deal to remove the Audi dealership from the sale altogether, although the purchase price did not change. Audi alleged that this was not a valid amendment because it was just trying to get around Audi’s right of first refusal. Wyoming Valley and Napleton later amended the deal a second time to specifically state what dealerships Napleton was purchasing and excluding any assets of the Audi and Volkswagen dealerships.

Audi and Wyoming Valley sought summary judgment on Audi’s claims of breach of the dealership agreement, breach of the Act, and declaratory judgment. The dispute focused on whether Audi still had an active right of first refusal so that it could purchase Wyoming Valley’s Audi dealership. Audi first argued that the Audi assets were still included in the asset purchase agreement, despite the second amendment, because these assets were still a critical and essential part of the deal. The court found, however, the standard under both the Act and the dealership agreement was not if the assets were critical to the deal, but rather if Wyoming Valley was attempting “to transfer substantially all of its Audi assets or substantially change the ownership interest of its Audi dealership.” Because the amended deal did not do this, it did not create Audi’s right of first refusal under the Act or the dealership agreement.

Audi next argued that the right of first refusal turned into an irrevocable option to purchase the Audi dealership. The court relied on a New York Court of Appeals case, *Lin Broadcasting Corp. v. Metromedia, Inc.*, 542 N.E.2d 629 (N.Y. 1989), which analyzed the difference between a right of first refusal and an option to purchase—the difference being that an option creates the power of the optionee to compel the seller to sell at an agreed price, while a right of first refusal has a willing seller who wants to part with the property. The court found Audi only had a right of first refusal. It pointed to Audi’s allegation that it had been unable to use its right of first refusal because Wyoming Valley did not provide a good faith breakdown. It also noted that Audi’s only right was to prevent the sale of the assets to another party, which Audi accomplished when Wyoming Valley and Napleton dropped the assets from the deal and the court previously ordered those assets severed from the deal. Audi tried to argue, in addition, that...
Wyoming Valley removed the assets from the deal in bad faith and thus was subject to a case-law exception referenced in *Lin Broadcasting*, but the court rejected this argument because the supporting case was distinguishable—where the party used a long-term lease to maneuver permanently around a five-year right of first refusal, which did not happen here. Accordingly, the court granted summary judgment on Audi’s claims in favor of Wyoming Valley.

**STATUTORY ISSUES**


This case discussed under the topic heading “Right of First Refusal.”

**TORTIOUS INTERFERENCE**


The plaintiff Oneida Group, Inc. (Oneida) sued a number of defendants, including Steelite International U.S.A. Inc. (Steelite), Tablewerks Inc. (Tablewerks), and certain former Oneida employees who went to work for Steelite for misappropriation of trade secrets and tortious interference with business relations. Several defendants moved to dismiss Oneida’s claims. The U.S. District Court for the Eastern District of New York denied the motion to dismiss with respect to the trade secret misappropriation claims but granted the motion to dismiss with respect to Oneida’s claim for tortious interference with business relations.

Oneida designs and sells dinnerware and sourced many of its products from Royal Porcelain Public Co. Ltd. (Royal Porcelain). Oneida purchased the Royal Porcelain products through Tablewerks and alleged that it had the exclusive right to sell Royal Porcelain products in North America. In December 2016, however, Steelite purchased Tablewerks’ assets and notified Oneida that Steelite would begin self-distributing Royal Porcelain products in North America and that it did not believe there was an agreement between Oneida and Tablewerks. Oneida alleged that Steelite and Tablewerks were now selling dinnerware designs that Oneida had previously sold and that it had trade dress protections in those designs. Moreover, Oneida argued that Steelite had misappropriated trade secrets, including its go-to-market strategy based on proprietary customer segmentation, end-user analysis, product margins, costs, rebate programs, proposed changes in those rebate programs, sales forecasting, and customer-specific account strategy.
In order to prevail on its claim for misappropriation of trade secrets under the Ohio Uniform Trade Secrets Act, Oneida had to show: (1) the existence of a trade secret; (2) the acquisition of a trade secret as a result of a confidential relationship; and (3) the unauthorized use of a trade secret. The court first held that the purported trade secrets were sufficiently alleged as trade secrets because other courts have granted trade secret protection to similar information, such as grand strategies, pricing, distribution and marketing strategies, and confidential business relationships. Moreover, the court held that Oneida had sufficiently alleged it took steps to keep that information secret by having third parties execute nondisclosure agreements and including confidentiality provisions in its employee handbook.

With respect to the acquisition of trade secrets as a result of a confidential relationship, Oneida alleged that two former employees were privy to the purported trade secrets and that they brought these trade secrets with them when they went to work for Steelite. Although Oneida could not specifically allege which trade secrets each of the former employees was privy to, the court held that at the motion to dismiss stage, Oneida’s pleadings were sufficient because it identified trade secrets with specificity and sufficiently alleged that the two former employees had acquired trade secrets as a result of their confidential relationship with Oneida.

With respect to whether or not Steelite used the trade secrets, the court held it was a very close call because the allegations were at most circumstantial. The court held that Oneida barely met its pleading standard to allege unlawful use of trade secrets but that it did so by alleging that, within two months of acquiring Tablewerks, Steelite offered dishes previously sold by Oneida at a trade show; that Steelite was attempting to sell dishes to Oneida’s customers; and that it had two examples showing Steelite employees in possession of confidential Oneida information. Therefore, the court held that Oneida sufficiently alleged facts at the motion to dismiss stage for a claim for misappropriation of trade secrets.

The court then turned to Oneida’s claim for tortious interference with business relations. The elements of a tortious interference claim are: (1) the plaintiff had business relations with third parties; (2) the defendant interfered with those business relationships; (3) the defendant acted for a wrongful purpose or used dishonest, unfair, or improper means; and (4) the defendant’s act injured a business relationship. The court held that Oneida failed to adequately allege the existence of business relations with a third party. Although Oneida made general reference to customers, the court held that this was insufficient to allege the element of business relations with a third party because it was vague and had no specifics as to which business relationship had been injured. The court, therefore, dismissed Oneida’s claim for tortious interference but did so without prejudice, offering Oneida thirty days to amend its complaint to address the shortcomings in its claim for tortious interference.
TRADEMARK INFRINGEMENT


This case involves a trademark dispute between the owners of the Splenda® sweetener brand and the Applebee’s and IHOP franchises. After the U.S. District Court for the Southern District of Indiana denied the defendant franchisors’ motion to dismiss, the case continued as to whether each defendant engaged in infringing activity through their manufacture of off-brand artificial sweetener in yellow packets and their distribution of same to their Applebee’s and IHOP franchisee restaurants.

In 2015, Plaintiffs Heartland Consumer Products LLC and TC Heartland LLC (collectively, Heartland) purchased the Splenda® brand; with that purchase came several design trademarks that were either registered or pending registration in the U.S. Patent and Trademark Office. Several of the design trademarks protected the artificial sweetener’s yellow packaging color. DineEquity, Inc., which owns and operates Applebee’s and IHOP, began packaging and selling off-brand, lower-quality sucralose sweetener in yellow packets similar to those used for packaging Splenda®. DineEquity then distributed the Non-Splenda Sweetener packets to Applebee’s and IHOP restaurants in their franchise network and allegedly represented that the Non-Splenda Sweetener packets contained genuine Splenda®. Heartland received multiple reports from Applebee’s and IHOP customers expressing their confusion over what sweetener they received, and some even stated they believed that Splenda® is of a lesser quality than the Non-Splenda Sweetener they may have consumed.

As a result, Heartland conducted an investigation and discovered that at forty-six Applebee’s and IHOP franchises around the country, the restaurant staff affirmatively represented that the Non-Splenda sweetener offered to customers was in fact Splenda®. Due to these misrepresentations and the existence of customer confusion, Heartland brought suit against DineEquity and other franchisors alleging trademark infringement, false design of origin, unfair competition, and trademark dilution. Specifically, Heartland asserted that franchisors DineEquity, Applebee’s, Applebee’s Franchisor, IHOP, IHOP Franchising, and IHOP Franchisor maintained “significant control” over their respective Applebee’s and IHOP franchisee restaurants. Further, Heartland alleged that the defendant franchisors infringed upon Heartland’s
trademark rights and misrepresented Non-Splenda Sweetener as Splenda® by providing customers with Non-Splenda Sweetener without Heartland’s authorization and without distinguishing it from Splenda®, thereby causing customer confusion.

In response, the defendant franchisors filed a motion to dismiss, arguing that the yellow packaging color served a functional purpose in that the yellow color distinguished the sweeteners as sucralose rather than low-calorie sweetener or sugar and that such packaging was therefore not a protectable trademark feature. Further, the defendant franchisors asserted that Heartland’s complaint collectively referred to the franchisors and therefore did not provide sufficient notice to each individual defendant as to its alleged wrongdoing.

The court denied the franchisor defendants’ motion to dismiss regarding both the trademark infringement claims and notice pleading requirements under Federal Rule of Civil Procedure Rule 8. First, under precedent established in *Qualitex Co. v. Jacobson Products Co., Inc.*, 514 U.S. 159, 162 (1995), color alone may be protected as a trademark where the color signifies a product’s brand and identifies and distinguishes it from other products. Color cannot be protected as a trademark, however, “if it serves a functional purpose that would place competitors at a disadvantage by significantly hindering their ability to ‘replicate important non-reputation-related product features.’” Here, the court held that the complaint’s allegations supported the inference that the yellow packaging has a secondary meaning and serves only to signify that the contents in the packets are Splenda®, not sucralose generally. Further, Heartland’s claims against the defendant franchisors, collectively, were not insufficient to satisfy the notice pleading requirements under Rule 8. Specifically, Heartland’s complaint alleged that DineEquity packaged the Non-Splenda Sweetener in yellow packets, that each defendant distributed the Non-Splenda Sweetener packets to Applebee’s and IHOP customers, and that the defendants maintained “significant control” over their respective Applebee’s and IHOP restaurants that made misrepresentations regarding the Non-Splenda Sweetener to customers. As such, Heartland’s complaint plausibly alleged that each defendant directly participated in infringing activity due to the control they exerted over their franchised restaurants. The discovery process will make it clear whether the allegations of infringing activity against each defendant franchisor prove to be true. Accordingly, despite Heartland’s collective reference to all defendant franchisors, Rule 8’s notice pleading requirements were satisfied.


This case discussed under the topic heading “Discovery.”
TRADE SECRETS


This case discussed under the topic heading “Tortious Interference.”