STATEMENT OF OWNERSHIP

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Deadline for 2017 Rising Scholar Award Announced

The deadline for the 2017 Rising Scholar Award will be Monday, July 17, 2017. To be eligible, entrants must be members of the ABA Forum on Franchising and zero to four years out of law school. Qualified participants should prepare articles according to the *Franchise Law Journal*’s author guidelines. The submissions will be judged by current and former members of the *Franchise Law Journal* and the *Franchise Lawyer* editorial boards. The current Forum chair will also be consulted and provide input on the selection of the winning article.

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

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

We look forward to receiving the submissions!
From the Editor-In-Chief

Gary R. Batenhorst

I am writing this column on a beautiful fall day, a week before the 39th Annual Forum on Franchising in Miami Beach and two weeks before the end of one of the strangest and most interesting president campaigns we have ever seen. When you receive this issue the weather will be colder here, the presidential race will be over—I hope—and you will be able to look back at some great programs you attended at the Forum.

We have some great articles in the fall issue to complement the things you learned at the Forum. In this issue we also have a good mix of Forum veterans and newer authors—but more about that later.

Leading off this issue, past Forum Chair Susan Grueneberg and two of her colleagues, Lulu Chiu, and Joshua Schneiderman, give us After Patterson v. Domino’s: Avoiding the Minefield of Vicarious Liability and Joint Employment. Readers of the Franchise Law Journal know that we have had a number of recent articles on joint employment and vicarious liability issues. What makes this article important is its treatment of these issues from a franchise agreement drafting, rather than a litigation, perspective.

Supply chain management is a very important, but sometimes overlooked, issue in franchise systems. Two long-time active Forum members, Joyce Mazero and Leonard MacPhee, make sure we do not overlook these issues with their article Setting the Stage for a “Best in Class” Supply Chain. Whether you represent established franchisors and franchisees or newcomers to franchising, you will find many valuable insights on supply chain management.

If you have franchise clients interested in expanding into Québec, you will not want to miss La Belle Province: A Practical Business Guide to Key Legal Issues When Franchising in Québec by Andraya Frith, Éric Préfontaine, and Gillian Scott. This article provides a very interesting analysis of the unique issues related to expansion into Québec. You will also find it a helpful primer on
the differences franchisors and franchisees will confront when expanding into other civil law jurisdictions.

Joseph Aboyoun shares his auto industry franchising expertise with us in *The Franchisor’s Right of First Refusal: An Automotive Industry Perspective*. Although you may be familiar with issues related to rights of first refusal generally, the application of these issues in automotive franchises makes for a very interesting read. We follow that with an illuminating look at how the SEC’s new crowdfunding rules may benefit franchising in *Regulation Crowdfunding: A Viable Option for the Franchising Industry?* Samuel Wieczorek makes his debut as a *Journal* author in this review of the new crowdfunding rules in a well-written article that you do not need a securities law background to understand.

Those of you who enjoyed Andrae Marrocco’s article on representations and warranties in franchise mergers and acquisitions will be pleased to see a sequel by Andrae—*Negotiating Critical Representations and Warranties in Franchise Mergers and Acquisitions—Part II*. In this article, Andrae concludes his very informative look at the issues in negotiating these provisions that are an important part of any franchise purchase transaction.

For our final article in this issue we turn to a real newcomer—Tyler Jones, who is currently a third year law student at Indiana University School of Law. Tyler gives us *Keeping the Entire Pie and the Dog Fed: Why the Modern Instrumentality Test Fails to Reflect the Realities of the Franchisor-Franchisee Relationship*. He provides a very interesting critique of the instrumentality test, a test which appears to be playing an increasingly important role in vicarious liability cases.

Our thanks to Griff Towle, Jennifer Dolman, and Elliot Ginsburg for their hard work on the Currents section of this issue. Special thanks to Jennifer for her dedication in editing the franchising in Québec article, which she encouraged her colleagues to write, and the representations and warranties article. We welcome two new editors to the editorial board. Kevin Shelley of Kaufmann Gildin & Robbins LLP joins us as an Associate Editor, and Bill Bryner of Kilpatrick Townsend & Stockton LLP joins us as a Topic and Article Editor.

So you see we have a good mix of experienced and new authors in this issue. That is great, but we are missing one thing—your contribution. Our supply of articles in progress is running low and we need more authors—both experienced authors and talented rookies like we have in this issue—to fill this gap. Writing for the *Journal* is a great way to increase your involvement in the Forum. Please contact me for a list of open topics or to discuss a topic in which you have an interest. We would love to hear from you!
Drafting Franchise Agreements After *Patterson v. Domino’s*: Avoiding the Minefield of Vicarious Liability and Joint Employment

Susan A. Grueneberg, Joshua Schneiderman, and Lulu Y. Chiu

Lauded as one of the most important franchise cases in the recent past,1 *Patterson v. Domino’s*2 established a new standard for addressing vicarious liability issues in California.3 In reaching its decision that Domino’s was not responsible for the sexual harassment of a franchisee’s employee by the franchisee’s manager, the California Supreme Court presented an analysis of franchising as a unique method of product and service distribution. The court acknowledged that a certain level of control is necessary to protect the intellectual property and the system of operations owned by the franchisor and licensed to the franchisee. The court stated that these types of control should not subject a franchisor to vicarious liability.

There have been many thoughtful articles written about *Patterson* in the two years since the California Supreme Court opinion was issued.4 This article will explore important considerations of the decision in the context of drafting franchise agreements. We examine

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3. Snell & Wilmer, L.L.P., the law firm with which the authors are affiliated, represented Domino’s in its appeal to the California Supreme Court.
4. E.g., M.C. Sungaila & M. Ellison, *Joint Employer Liability in the Franchise Context: One Year After Patterson v. Domino’s*, 35 Franchise L.J. 339 (2016), which provides a detailed discussion of the *Patterson* case and how it was interpreted during the first year after the decision was issued.

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several key provisions that are frequently the subject of vicarious liability cases, identify examples of those provisions, and analyze how they have been addressed in the context of various cases. We also examine how franchisors can structure communications with franchisees and customers to minimize exposure while protecting the franchisor’s brand and system.

Of course, the decision in Patterson is pivotal, but since this area of the law is far from settled in other jurisdictions, we have also included other decisions in our analysis. In addition, it is important to note that, although the California Supreme Court reversed the lower court’s decision, that reversal was decided on a five-to-four vote, and there have been changes in the composition of the court since Patterson was decided.

I. Background of Vicarious Liability and Joint Employment in Franchising

Following is a brief discussion of the background of approaches to vicarious liability and joint employment.

A. Vicarious Liability

Vicarious liability is a theory frequently asserted by third parties attempting to hold franchisors liable for the acts of their franchisees. Stemming from the legal doctrine of respondeat superior—or agency—as applied in the traditional employment context, vicarious liability makes an employer liable for the torts of its employees committed while acting within the scope of their employment. “Actual authority” is the term often used to describe such actions. Outside of the employer-employee context, a non-employer principal may also be vicariously liable for the acts of its agent if the agent acts with the apparent authority of the principal. Agency theory is based on the premise that the “principal has control or the right to control the physical conduct of the agent such that a master/servant relationship can be said to exist.”

Vicarious liability, when applied in the franchising context, would make a franchisor liable for the acts of a franchisee or a franchisee’s employees, based on the assumption that the franchisor has control over, or the right to control, the franchisee’s actions, thereby making the franchisee an agent of the franchisor. Courts have struggled, however, with the practical application of the “control or right to control” test to franchising due to the

5. The sample clauses in this article are for illustration only, and the authors do not necessarily recommend them as clauses to be included in every franchise agreement.
7. Id.
8. Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328, 331 (Wis. 2004) (affirming summary judgment for the franchisor in a case involving an employee of an Arby’s franchisee’s restaurant, a work-release inmate who ambushed and shot his ex-girlfriend and her boyfriend, and then committed suicide in a nearby parking lot).
9. Id. at 337.
unique nature of the franchise relationship not present in a traditional master/servant relationship. This has resulted in two divergent lines of cases: those applying the “means and manner” test and those applying the “instrumentality” test.

1. Means and Manner Test

Courts have traditionally applied the “means and manner” test, which focuses on whether the franchisor exercised “general ‘control’ over the ‘means and manner’ of the franchisee’s operations.” This typically involves an analysis of whether the franchisor controls the day-to-day operations of the franchisee. Under this test, a franchisor could be liable for the acts of the franchisee if the franchisee is operating under the actual, or even under the apparent, authority of the franchisor.

Courts that find evidence of a sufficient amount of control by the franchisor over the franchisee’s day-to-day operations often point to the extensive list of requirements imposed by a franchisor in the franchise agreement and operations manual.

For example, in Billops v. Magness Construction Co., the Supreme Court of Delaware reversed the lower court’s grant of summary judgment in favor of the franchisor after finding sufficient facts to prove the franchisor’s day-to-day control of the franchisee’s Hilton Inn hotel, such that an actual agency relationship could exist. The court relied on various requirements imposed by the operating manual, which was incorporated into the franchise agreement. These included a requirement to keep detailed records so that the franchisor could ensure compliance with the manual and the franchisor’s right to enter the premises to inspect compliance. The court also concluded that a jury might find that the franchisee was operating under the franchisor’s apparent authority because the franchisee was required to identify itself solely as a Hilton-branded hotel, and the evidence suggested an ordinary person would likely have no reason to know he or she was dealing with anyone other than the franchisor.

On the other hand, in Cislaw v. Southland Corp., the California Court of Appeal affirmed summary judgment for the franchisor, concluding that the franchisee exercised full and complete control over the franchised store and made all operational decisions, including hiring and firing employees, determining discipline, setting compensation and work schedules, choosing and purchasing inventory, and marketing and advertising. The franchise agreement was limited in the requirements imposed on the franchisee and to the extent it did impose requirements, they were limited to protection

10. Id. at 331.
of the franchisor’s interest in its trademarks and goodwill. At its essence, the court opined,

the agreement obligates the 7-Eleven store owners/franchisees to complete an operations training program, keep the store and its surroundings clean and maintain the equipment in good repair, carry an inventory of a “type, quality, quantity and variety” consistent with the 7–Eleven image, operate the store from 7:00 a.m. to 11:00 p.m. 364 days a year, make daily deposits of all receipts into a designated account, provide [the franchisor] with copies of purchase and sales records, make the books available for inspection during normal business hours and pay a percentage fee based on receipts from sales less cost of goods sold.14

Absent from the franchise agreement was a provision making the agreement terminable at will by the franchisor. Also absent was the right to control every detail of the store’s construction.15 This latter provision was key to distinguishing Cislaw from a prior case, Kuchta v. Allied Builders Corp. (finding a relationship of implied agency), which involved a franchise agreement that gave the franchisor most of the same rights that the franchisor in Cislaw reserved, but also the right to control construction.16

Thus, the use of the “means and manner” test can result in unpredictable rulings, which may be based on no more than one or two factors in any given franchise agreement.

2. Instrumentality Test

Over time, as courts began to recognize that the traditional master/servant agency and vicarious liability doctrines are ill-suited to franchising,17 a second test has emerged that lends itself to greater predictability for franchisors. Namely, courts have been moving toward applying an instrumentality test, which focuses the vicarious liability analysis more narrowly on whether a franchisor controls, or has the right to control, “the daily conduct or operation of the particular ‘instrumentality’ or aspect of the franchisee’s business that is alleged to have caused the harm.”18

In adopting the instrumentality test, the Wisconsin Supreme Court in Kerl v. Rasmussen found that “a franchisor may be held vicariously liable for the tortious conduct of its franchisee only if the franchisor has control or a right of control over the daily operation of the specific aspect of the franchisee’s business that is alleged to have caused the harm.”19

Although the California Supreme Court did not specifically adopt the instrumentality test in Patterson, it did shift the focus away from the means and manner test and toward the instrumentality test. Pursuant to the Patterson ruling, a franchisor becomes potentially liable for actions of the franchisee’s

14. Id. at 391–92.
15. Id. at 394.
16. Id. at 392.
17. Id.
18. Id. at 394.
employees only if “it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees.”20 The court held that Domino’s could not be vicariously liable for the acts of the franchisee’s employee because there was no basis on which to find a triable issue of fact that an employment or agency relationship existed between Domino’s and its franchisee.21 In particular, Domino’s had no right to establish a sexual harassment policy or training program governing the franchisee’s employees. There was no procedure by which the franchisee’s employees could report such complaints to Domino’s, and the franchisee implemented its own sexual harassment policy and training program for its employees.22

In adopting this quasi-instrumentality standard, the court recognized that “[a]ny other guiding principle would disrupt the franchise relationship.”23 If the stated goal of vicarious liability is to protect the public interest and secure compensation from companies that can absorb the loss related to a tort, seeking compensation from a party that “did not directly control the workforce, and could not have prevented the misconduct and corrected its effects” does nothing to further such a policy goal.24 As such, the court stated that it could not “conclude that franchise operating systems necessarily establish the kind of employment relationship” at issue in Patterson and that “[a] contrary approach would turn business format franchising ‘on its head.’”25

The rising popularity of the instrumentality test is a positive trend for the franchising world. The test is more reliable and objective than the means and manner test and can generate more stability in franchise relationships by respecting the independence of the franchisee as an independent business owner while allowing the franchisor to impose the requirements necessary to protect its brand, trademarks, and goodwill.

B. Joint Employment

Joint employer liability, as a category of vicarious liability, has been a meaningful concern for franchisors for decades. Until recently, the well-established standard required a showing that a franchisor maintained direct and immediate control over day-to-day employment matters relating to the franchisee’s employees for the franchisor to be held liable as a joint-employer.26 In other words, for a franchisor to be held liable as a joint employer, there had to be evidence that the franchisor “meaningfully affects

21. Id. at 742.
22. Id.
23. Id. at 739.
24. Id.
25. Id.
matters relating to the employment relationship, such as hiring, firing, discipline, supervision, and direction” of the franchisee’s employees. 27

In 2010, the established standard came under significant scrutiny following the submission of a report by Dr. David Weil, at the time a professor at Boston University, to the Wage and Hour Division (WHD) of the U.S. Department of Labor.28 In the report, entitled Improving Workplace Conditions through Strategic Enforcement, Dr. Weil examined what he referred to as the “fissuring of the American workforce,” which he asserted has caused a significant increase in “vulnerable workers.”29 According to Dr. Weil, the United States has witnessed the breaking down or “fissuring” of the traditional large employer by the reduction of direct employees through subcontracting, franchising, and outsourcing.30 Vulnerable workers are those who work at or near minimum wage. According to Dr. Weil, they are subject to de facto reductions by being asked to work “off the clock,” have no benefits, and are often subject to discrimination and capricious conduct by supervisors. 31

To protect the vulnerable employees in a fissured industry (which, according to Dr. Weil, includes food service and hospitality where franchising is common), Dr. Weil suggested that enforcement must focus on both “workplaces where labor standards violations occur . . . and also at the higher level of industry structure, where ‘lead firms’ play a key role in setting the competitive and employment conditions for employers at ‘lower levels’ of the industry structure.”32 In franchising terminology, what Dr. Weil suggested amounted to an enforcement focus not just at the franchisee level, but also at the franchisor level. Among the strategies that Dr. Weil proposed to reach the “lead firms” was to “target several major brands that had documented histories of systemic violations among their franchisees. . . . Once identified, the WHD could undertake broad and coordinated investigations in multiple parts of the country and across multiple franchisees . . . and pursue statutory penalties for those violations.”33 In effect, the franchisor would be held liable if it intentionally violated laws itself or if the mere nature of the franchise system indirectly contributed to a deterioration of working conditions within an industry generally. In furtherance of that notion, the joint employer doctrine served as a convenient basis for the attempted imposition of liability and statutory penalties on franchisors. Dr. Weil further expanded on these theories in his 2014 book, The Fissured Workplace.34

29. Id. at 9.
30. Id. at 21.
31. Id. at 18–19.
32. Id. at 76–77.
33. Id. at 78.
34. DAVID WEIL, THE FISSURED WORKPLACE (2014).
In 2015, in *Browning-Ferris Industries of California*, the National Labor Relations Board (NLRB) tossed aside thirty years of joint liability precedent and extended joint employer liability to putative employers that exert “indirect” or “potential” control over an employee. By extension to franchising, regardless of whether control is actually exercised, the franchisor can be held jointly liable for unfair labor practice liabilities of the franchisee as long as a franchisor has the potential to control its franchisees’ employees.

Despite the *Browning-Ferris* decision, the NLRB has not gone so far as to say that all franchise relationships should result in franchisors being deemed to be joint-employers with their franchisees. In an April 2015 Advice Memorandum issued by the NLRB’s Office of the General Counsel with respect to the Freshii fast food franchise system, the NLRB indicated that franchise relationships can be structured in a way to avoid creating a joint employer relationship. In the Freshii system, franchisees are solely responsible for hiring, disciplining, and terminating employees and for setting employee salary and benefits. Noting such factors as lack of mandatory personnel policies or procedures, the General Counsel’s office concluded that there was no evidence to establish that “Freshii meaningfully affects any matters pertaining to the employment relationship between [the franchisee] and its employees,” and therefore, there was no joint employment relationship.

The *Freshii* decision has given franchisors a ray of hope that *Browning-Ferris* will not represent a sea change in business format franchising by requiring franchisors to relinquish a disconcerting level of autonomy in their operations to franchisees. At the time this article is being published, countless joint employer liability cases are winding their way through the courts. These will ultimately shape the franchising landscape. For the time being, franchisors must rely on the few cases that have been finally resolved in this context, most notably *Patterson*, for guidance on how to structure their franchise systems.

**II. Franchise Agreement Provisions**

In this section, we examine specific provisions in franchise agreements and analyze examples of each in the context of the *Patterson* decision and other recent cases.

**A. Relationship of the Parties**

Most franchise agreements have a provision stating that the franchisor and franchisee are independent contractors and not responsible for the acts of one another.

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37. *Id.*
The California Supreme Court in *Patterson* confirmed that the contract should emphasize the independent contractor relationship and that the franchisee does not have any authority to act on behalf of franchisor. It noted that “[t]he contract said there was no principal-agent relationship between Domino’s and [the franchisee]. The latter also had no authority to act on the former’s behalf.”

Similarly, the U.S. District Court for the Southern District of California in *Vann v. Massage Envy* addressed the issue of whether the franchisor was the joint employer of a franchisee employee who claimed wage and hour violations. The *Vann* court granted summary judgment to Massage Envy. The applicable provision in the Massage Envy franchise agreement stated that the franchisee was an independent contractor and had “no authority, express or implied, to act as agent of [franchisor].” The franchise agreement also stated that the parties did not intend to be “partners, associates, or joint employers in any way” and that the franchisor had no relationship with the franchisee’s employees.

However, according to the Florida District Court of Appeal in *Parker v. Domino’s Pizza, Inc.*, courts look beyond the “descriptive labels employed by the parties themselves” and analyze the facts as to whether the relationship between the parties can be said “to occupy the status of principal and agent.” In *Parker*, the court reversed summary judgment in favor of the franchisor in an action by plaintiffs who were injured in the aftermath of an automobile accident allegedly caused by a delivery driver employed by one of Domino’s franchisees. In applying the means and manner test for vicarious liability, the court noted that “whether one party is a mere agent rather than an independent contractor as to the other party is to be determined by measuring the right to control and not by considering only the actual control exercised by the latter over the former.”

**Independent Contractor**

An example of this type of provision is the following, which was proposed as part of an ABA Forum on Franchising program “The Annotated Franchise Agreement”:

The parties hereto hereby acknowledge and agree that, except as expressly provided in this Agreement, each is an independent contractor, that no party shall be considered to be the agent, representative, mas-

40. Id. at *5.
41. Id.
42. 629 So. 2d 1026, 1027 (Fla. Dist. Ct. App. 1993).
43. Id. at 1027.
44. Id.
ter, or servant of any other party hereto for any purpose whatsoever, and that no party has any authority to enter into any contract, assume any obligations or to give any warranties or representations on behalf of any other party hereto. Nothing in this Agreement shall be construed to create a relationship of employment, partners, joint venturers, fiduciaries, or any other similar relationship among the parties.

Franchisors should consider adding to this provision one that addresses the relationship of the parties in general and the status of the franchisee’s employees in particular.

Conduct of Franchisee’s Business

Following is a suggestion on an additional provision to consider:

It is acknowledged that Franchisee is the sole and independent owner of its business, shall be in full control thereof, and shall conduct such business solely in accordance with its own judgment and discretion, subject only to the provisions of this Agreement. Franchisee shall conspicuously identify itself as the independent owner of its business and as a franchisee of Franchisor. Franchisor shall not be liable for any damages to any person or property, directly or indirectly, arising out of the operation of Franchisee’s business, whether caused by Franchisee’s negligent or willful action or failure to act. Neither party shall have liability for any sale, use, excise, income, property, or other tax levied upon the business conducted by the other party or in connection with the services performed or business conducted by it or any expenses incurred by it.


A clear, thorough, and current manual is an essential component of every franchise system. It provides a franchisee with a roadmap to develop its business in a manner consistent with the franchisor’s policies and procedures to ensure consistency of brand standards and improve the likelihood of success of the franchise relationship for both the franchisor and franchisee. As such, it is customary for a franchise agreement to contain a provision requiring the franchisee to comply with the provisions of the franchisor’s manual.

That said, the California Court of Appeal in Patterson found that many aspects of Domino’s Managers Reference Guide raised inferences supporting the idea that the franchisee was not an independent contractor. These included requirements related to

- bank deposits, safes, “front till” cash limits, type of credit cards that must be accepted, mobile phone use, store closing procedures, store records, refuse removal, radar detectors, phone caller identification requirements, security, delivery staff-
ing, holiday closings, stereos, tape decks, wall displays, franchisee web sites, “in-
store conversations,” and literature that is “allowed in store.”

Although the California Supreme Court did not find these factors conclusive, their citation by the California Court of Appeal reflects the approach by courts in jurisdictions that apply the means and manner test and, therefore, provides helpful guidance in drafting.

Similarly in Parker, the Florida District Court of Appeal pointed to the operations manual as key “documentary evidence demonstrating Domino’s control over its franchisees.” According to the court, “[t]he manual which Domino’s provided to the franchisees is a veritable bible for overseeing a Domino’s operation. It contains prescriptions for every conceivable facet of the business.” Some of the requirements in the operations manual that the court identified included preparing pizza, tending the oven, maintaining accurate books, giving advertising and promotion ideas, giving routing and delivery guidelines, providing instructions on taking orders, and discussing organization and sanitation.

Other courts have been more willing to accept some level of operational procedures in the manual. In 2015, the Vann court relied heavily on the California Supreme Court’s decision in Patterson and noted that it is permissible for a franchisor to provide its franchisees with a manual that “contained mandatory and suggested specifications, standards, operating procedures and rules that [franchisor] periodically prescribe[s] for operating a [franchise].”

While the line between a “veritable bible” for overseeing operations and permissible system controls and standards is admittedly blurry, one thing that is clear is that courts are more accepting of provisions in manuals that establish brand standards and are more concerned about provisions that delve into the minutia of day-to-day operations. In light of that, it would seem prudent for a franchisor not to handicap itself by labeling its manual an “Operations Manual.” A term such as “Brand Standards Manual” is preferable because it suggests its purpose is to protect the standards exemplified by the trademark and franchise system and to preserve system goodwill rather than to mandate day-to-day operations of the franchisee’s business. In addition, when describing the purpose of the manual in the franchise agreement, the franchisor should refrain from any language that suggests its purpose is to serve as a guide to day-to-day operations. This point should be emphasized in the franchise agreement provision requiring compliance with the manual.

46. Patterson v. Domino’s Pizza, LLC, 143 Cal. Rptr. 3d 396 (Ct. App. 2012), review granted and opinion superseded sub nom. Patterson v. Domino’s Pizza LLC, 287 P.3d 68 (Cal. 2012), rev’d, 333 P.3d 723 (2014). Although the California Supreme Court reversed the decision of the California Court of Appeal, as noted above, it is instructive to study the provisions of the franchise agreement that the appellate court found salient in reaching its decision.
47. Parker, 629 So. 2d at 1028.
48. Id.
49. Id.
The provision might read as follows:

**Brand Standards Manual**

Franchisor will lend to Franchisee for use during the term of this Agreement a copy of Franchisor’s proprietary and confidential brand standards manual which Franchisor may amend from time to time, containing specifications, standards, procedures, and rules for the System designed to protect and maintain the value of the Marks and the System (“Brand Standards Manual”). Franchisee must comply with specifications, standards, procedures, and rules prescribed from time to time in the Brand Standards Manual that Franchisor has designated as mandatory. Franchisee shall keep the Brand Standards Manual and its contents confidential. Franchisee will not at any time copy any part of the Brand Standards Manual, disclose any information contained in it to others, or permit others access to the Brand Standards Manual. Franchisee acknowledges and agrees that the Brand Standards Manual may be modified from time to time to reflect changes in the standards of authorized services or the System. All modifications to the Brand Standards Manual shall be binding upon Franchisee upon being transmitted to Franchisee. Franchisee agrees to accept, implement, and adopt any such modifications at Franchisee’s sole cost. The Brand Standards Manual will contain proprietary information belonging to Franchisor and Franchisee acknowledges that the Brand Standards Manual is, and shall remain, the property of Franchisor. Franchisee shall promptly return the Brand Standards Manual to the Franchisor upon termination or expiration of this Agreement. Franchisee understands and agrees that it is of substantial value to Franchisor and other franchisees of Franchisor, as well as to Franchisee, that the System establish and maintain a common identity. Franchisee agrees and acknowledges that full compliance with the Brand Standards Manual is essential to preserve, maintain and enhance the reputation, trade demand, and goodwill of the System and the Marks and that failure of Franchisee to operate the Franchised Business in accordance with the Brand Standards Manual can cause damage to the Franchisor and all other franchisees within the System as well as to Franchisee. Notwithstanding the foregoing, and consistent with the goals of the System, Franchisee shall be responsible for the day-to-day operation of the Franchised Business.

C. **Training**

Training is also critical to most franchise systems, but the term “training” is ambiguous. Who is responsible to train whom, and the scope of that training, have proven to be key factors in courts’ analyses of vicarious liability and joint employer liability cases.
The California Supreme Court in *Patterson* was swayed by the fact that Domino’s took a hands-off approach when it came to sexual harassment training of the franchisee’s employees. As the court noted, “Consistent with the exclusive control vested in [franchisee] over its own employees, neither the contract nor the MRG [Manager’s Reference Guide] empowered Domino’s to establish a sexual harassment policy or training program for [franchisee’s] employees. Nor was there any procedure by which franchisee’s employees could report such complaints to Domino’s.”51 Also persuasive to the court was the fact that even though Domino’s provided new employees with orientation materials in both electronic and handbook form, primary training was done by the franchisee and the materials provided by Domino’s merely supplemented the franchisee’s training program.52

Similarly, the U.S. District Court for the District of Arizona in *Courtland v. GCEP-Surprise, LLC* granted summary judgment in favor of the franchisor in a case brought by a former bartender and server at a franchised Buffalo Wild Wings restaurant alleging employment discrimination claims under Title VII of the Civil Rights Act of 1964.53 The franchisor mandated training for the franchisee’s general manager, operational manager, and assistant manager only. It did not train non-managerial staff. To the extent the franchisor provided the franchisee with human resources training material, it was provided on an advisory basis. The franchisor worked with and trained the franchisee’s managerial staff only to the extent necessary to protect its brand name and dictate product presentation.54

Also influenced by the provision of training, but reaching a different result, the Illinois Appellate Court in *Greil v. Travelodge* reversed a lower court’s grant of summary judgment in favor of the franchisor, finding it persuasive that the franchisee was required to send personnel responsible for management of its motel to the franchisor’s training program.55

The trend that emerges from these cases is that courts generally accept that the franchisor can train the franchisee and its executive level management. A franchisor may also provide training materials. The franchisor should, however, require that the franchisee be responsible for training of lower level employees. As for employee conduct policies, these are best left as the...

52. *Id.* See also *Domino’s Pizza, L.L.C. v. Reddy*, Case No. 09-14-99958-CV, 2015 Tex. App. LEXIS 2578 (Tex. App. Mar. 19, 2015), where in dismissing a vicarious liability claim for death and injuries caused by a franchisee’s delivery driver, the Texas Court of Appeal found it relevant that Domino’s provided training materials to the franchisee, but did not train the franchisee’s employees.
54. *Id.* The court in *Courtland* applied the instrumentality test.
55. Greil v. Travelodge Int’l, Inc., 541 N.E.2d 1288 (Ill. Ct. App. 1989). The court in *Greil* applied the means and manner test to determine whether the franchisor was responsible for injuries to a hotel guest who jumped from his second story hotel room to the sidewalk when a robber entered his room.
responsibility of the franchisee. While the franchisor can advise franchisees that they should consider adopting these policies and training their employees with respect to them, the franchisor should not take on that responsibility itself. Another consideration is outsourcing certain types of training or designating third party trainers as system suppliers. Mature franchise systems with independent franchisee associations should consider establishing training programs conducted under the auspices of the association.

Training provisions in franchise agreements vary widely depending on system needs. An example of a simple form of a requirement for initial training and for development of employment policies and procedures follows:

**Initial Training**

Franchisor will conduct an initial training program during such period of time as Franchisor designates at a location Franchisor designates (“Initial Training Program”). Franchisee and Franchisee’s executive management must complete the Initial Training Program to the sole satisfaction of Franchisor before the Franchised Business is permitted to open to the public. Franchisee is responsible for all travel and living expenses and all wages payable to any members of Franchisee’s executive management attending the Initial Training Program. Franchisee acknowledges that it will be solely responsible for training Franchisee’s employees in the operation of the Franchised Business.

**Franchisee’s Employment Policies and Procedures**

Franchisee acknowledges that Franchisor may, from time-to-time, make certain recommendations as to employment policies and procedures, including without limitation, a sexual harassment policy. Franchisee will have sole discretion as to adoption of any such policies and procedures and the specific terms of such policies and procedures. Training with respect to all such policies and procedures shall be Franchisee’s sole responsibility.

D. **Ongoing Franchisor Guidance**

Most franchisors provide some type of ongoing support and guidance to franchisees. There is a distinction, however, between a franchisor providing advice and suggestions to its franchisees, and the franchisor making decisions on behalf of franchisees. Courts have made clear that this distinction is fundamental to the determination of vicarious liability, especially when the advice concerns employment issues.

In analyzing this distinction in the McDonald’s system, the U.S. District Court for the Northern District of California did not have an issue with the franchisor making suggestions to a franchisee as long as the franchisee had
the final say in whether to accept McDonald’s advice.\textsuperscript{56} In \textit{Ochoa v. McDonald’s}, the court observed that McDonald’s monitors its franchisees by hiring business consultants who review data from franchisee restaurants and speak to franchisees and their managers about practices and metrics that McDonald’s wants to improve.\textsuperscript{57} The business consultants’ involvement goes so far as to include speaking to general managers about staffing levels when the franchisee and supervisor that managed employment and operations at the franchised restaurants were not present.\textsuperscript{58} However, the court found that this did not create a joint employer relationship because even the franchisee admitted “that he sometimes rejected advice from the business consultant” and the franchisee did not argue otherwise.\textsuperscript{59}

Particularly when it comes to employment related advice, however, the safest approach would be one of complete detachment. The California Supreme Court found this approach influential in its decision in \textit{Patterson}: “If a franchisee asked Domino’s for [advice on handling personnel issues], the company would recommend that the franchisee resolve the situation himself or retain counsel to do so. A similar response was expected of any area leader asked to answer a sexual harassment question posed by a franchisee.”\textsuperscript{60}

In light of the case law that has emerged in this area, following is a sample provision for a franchise agreement:

\textit{Periodic Advice and Consultation}

Franchisor will, from time to time, to the extent it deems necessary, furnish Franchisee advice or consult with Franchisee on the operation of the Franchised Business in order to communicate new developments, techniques, and services. Franchisor will periodically, with such frequency as Franchisor determines in its sole discretion, send field consultants to the Franchised Business to consult with Franchisee in the development of its business and may conduct on-site inspections. Any guidance, suggestions, or advice provided to Franchisee in the course of such consultation shall be deemed suggestions only, and the decision to follow any such guidance, suggestions, or advice will be made by Franchisee in Franchisee’s sole discretion. In particular, and not in limitation of the foregoing, Franchisee will be solely responsible for all policies and decisions concerning its employees and will

\textsuperscript{56.} Ochoa v. McDonald’s Corp., 133 F. Supp. 3d 1228 (N.D. Cal. 2015). The court in Ochoa granted summary judgment in favor of McDonald’s with respect to plaintiff franchisee employees’ wage and hour claims in light of the \textit{Patterson} decision, but declined to grant summary judgment with respect to ostensible agency claims, finding \textit{Patterson} did not apply to those claims.

\textsuperscript{57.} Id. at 1238.

\textsuperscript{58.} Id.

\textsuperscript{59.} Id.

\textsuperscript{60.} Patterson v. Domino’s Pizza, LLC, 333 P.3d 723, 731 (Cal. 2014), \textit{reb’g denied} (Sept. 24, 2014).
consult with its own independent advisors with respect to those policies and decisions.

E. Conduct of Franchised Business

Subject to the specific nature of the franchise system, it is customary for franchise agreements to contain provisions governing certain aspects of the day-to-day conduct of the franchised business (as opposed to simply the relationship between the franchisor and franchisee). These types of provisions include required hours of operations, trade dress, signage, staffing, and method of operation. Many of these provisions are particularly problematic in the context of vicarious liability risk. Nevertheless, in some franchise systems these provisions may be associated with the essence of the franchise system.

1. Hours of Operation

Franchisors will sometimes require that the franchisee operate during certain hours of the day or even twenty-four hours a day. Although not all franchisors impose specific hours of operation, some may give general guidelines as to hours of operations and some will include requirements concerning hours of operation in the franchise manual.

Courts have sometimes deferred to franchisors that impose requirements on hours of operation, because, as one court put it, these are “precisely the types of controls that a franchisor may legitimately exercise over its franchisee without incurring vicarious liability.” In another case, Smith v. Foodmaker, Inc., the Texas Court of Appeals observed that “[e]ven where the franchisor has instructed the franchisee on hours of operation, an agency relationship has not been established.”

In particular, in jurisdictions that have adopted the instrumentality test, courts have often considered a specification of the franchisee’s hours of operation irrelevant to a decision when it is unrelated to the particular act resulting in the claim. In Vann, the court noted that the franchisor implemented standard business hours for all franchise locations, but because it was not the particular instrumentality causing the harm alleged, it was irrelevant to the court’s ultimate refusal to hold the franchisor vicariously liable for the alleged wrongful act of the franchisee.

61. In re Motor Fuel Temperature Sales Practices Litig., No. 06-2582-KHV, 2012 WL 1536161, at *6 (D. Kan. Apr. 30, 2012) (holding franchisor, Circle K, was not vicariously liable for its franchisee’s alleged violation of the Kansas Consumer Protection Act because franchisor did not control or have the right to control franchisees in the particular instrumentality that harmed plaintiff (i.e., the selling of motor fuel)).

62. Smith v. Foodmaker, Inc., 928 S.W.2d 683, 688 (Tex. App. 1996) (citing Cislaw v. Southland Corp., 6 Cal. Rptr. 2d 386, 393 (Ct. App. 1992) (holding the franchisor not vicariously liable for the wrongful death of an employee killed by another employee because the franchisor did not have control or the right to control the hiring and firing of franchisee’s employees).)

Even where hours of operations were a possible contributing factor to the alleged harm, at least one court has not imposed liability on the franchisor. In *Hong Wu v. Dunkin’ Donuts*, the U.S. District Court for the Eastern District of New York acknowledged that it was “undisputed that the franchise agreement provided that the [franchisee’s] store would remain open 24 hours a day” and that such a “requirement that the donut store remain open through the night may well have heightened the need for adequate security.”64 However, because the franchise agreement did not “mandate specific security measures or otherwise control or limit [the franchisee’s] response to this increased risk,” the court declined to hold the franchisor vicariously liable for the plaintiff’s injuries.65

If a franchisor chooses to include this type of provision because of its importance to the brand and the system, the provision should reflect that. Franchisors should consider including requirements relating to hours of operation only where necessary to the system.

Following is a sample provision:

**Hours of Operation**

Franchisee will operate the Franchised Business during such days, nights, and hours as may be designated by Franchisor from time to time. Franchisee acknowledges and agrees that the hours of operation are integral to the value of the System and the Marks, and any failure by Franchisee to operate during the designated hours of operation is detrimental to the System and the Marks. Franchisee further acknowledges and agrees that the day-to-day operational decisions relating to the opening and closing procedures of the Franchised Business, including any security, staffing, and other similar matters, shall be made solely by the Franchisee.

2. Trade Dress

Trade dress generally refers to characteristics of the visual appearance of the franchised business that can include the décor, design, and color scheme of the premises; service professional appearance; grooming and uniforms; and the general look and feel that signify the source of the product or service to consumers.

For franchisors, the uniform appearance of franchised locations and employees can be essential to a consistent customer experience. Franchisors commonly impose requirements related to the uniforms, grooming, and appearance of the franchisee’s employees as well as the design, layout, and construction of the premises, to ensure that the experience is the same—no mat-

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65. Id.
ter which location a customer visits. It is generally understood that these types of restrictions are meant to protect the franchisor’s brand since one bad customer experience at a substandard franchise location can sully the reputation of the entire system.

This desire to ensure the consistent appearance of the business and employees can pose a challenge for franchisors when it comes to vicarious liability. Courts have vacillated on whether and to what extent such requirements provide evidence of sufficient control or right to control the franchisee’s operations to justify a finding of vicarious liability on the part of the franchisor.

The Patterson case suggests that certain qualitative controls over the franchisee’s relationship with its employees are permissible. The California Supreme Court specifically acknowledged that the franchisor’s manual “set forth detailed clothing and accessory guidelines”; imposed “[v]arious grooming and hygiene standards,” which “were designed to promote neatness and sanitation”; prohibited employees from possessing or consuming “alcohol or illicit drugs while working or on store premises”; and limited tobacco use.66 Despite these controls, the court agreed with Domino’s disclaimer of “any rights or responsibilities as to [the franchisees’] employees” and stated that “nothing in the contract granted Domino’s any of the functions commonly performed by employers.” Instead, it found that “[a]ll such rights and duties were allocated to [the franchisee].”

Similarly, the court in Kerl concluded that “the standardized provision commonly included in franchise agreements specifying uniform quality, marketing and operational requirements, and a right of inspection does not establish a franchisor’s control or right to control the daily operations of the franchisee sufficient to give rise to vicarious liability for all purposes or as a general matter.”67

However, these courts’ leniency toward such controls is in contrast to the more rigorous scrutiny by the courts in Ochoa and Billops of franchise agreement provisions giving franchisors the ability to control the appearance of the franchisee’s business and employees. In Ochoa, the plaintiffs submitted declarations stating that they believed McDonald’s was their employer, in part because they wore McDonald’s uniforms; served McDonald’s food in McDonald’s packaging; receive paystubs and orientation materials marked with the McDonald’s name and logo; and, with the exception of one plaintiff, applied for a job through McDonald’s website.68 The court held that there existed triable issues of fact under an ostensible agency theory under these facts.69

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68. Ochoa v. McDonald’s Corp., 133 F. Supp. 3d 1228, 1238 (N.D. Cal. 2015).
69. Id.
The Billops court highlighted the fact that the “Hilton logo and sign are required to be displayed to the exclusion of all others” and that the franchise agreement “forbids the mention of any name other than Hilton to the customers of the hotel as management of the Brandywine Hilton Inn.”\textsuperscript{70} The Billops franchise agreement required complete identification with the “Hilton ‘system,’ including color schemes and design of the Inn which must be consistent with the ‘system.’”\textsuperscript{71} It noted that even the franchisor admitted there was no reasonable basis for an ordinary person to know he or she was dealing with anyone other than the franchisor.\textsuperscript{72} Thus, the court held there was sufficient evidence to suggest a jury might find that the franchisee was the apparent agent of the franchisor.

In light of the contradictory decisions by various courts, franchisors should consider limiting the extent franchisees can or are required to use its name and logos. In addition to the common requirement that a franchisee identify itself as an independent business, franchisors should also mandate that the franchisee’s name appear where necessary to communicate to its employees that it (and not the franchisor) is their employer. Examples are printing only the franchisee’s name and logo on employees’ paystubs, employment applications, and employee communications.

Keeping in mind the seemingly contradictory decisions by the courts thus far, following is a sample provision:

\textit{Trade Dress}

Franchisee acknowledges that each and every detail of the design, layout, décor, color scheme, supplies utilized, services offered, appearance of the premises, and personnel of the Franchised Business and other elements of trade dress (“Trade Dress”) is essential to Franchisor and the System. In order to protect the System, Franchisee shall comply with all mandatory specifications, standards and procedures relating to (1) the type and quality of the products and services offered by the Franchised Business; (2) the appearance, color, indicia, and signage of the Franchised Business premises; (3) appearance of employees; (4) cleanliness, standards of services, and operation of the Franchised Business; (5) submission of requests for approval of materials, supplies, distributors, and suppliers; and (6) safety procedures and programs prescribed by Franchisor. Franchisee also agrees to use all equipment, signage, and services as have been approved for the System from time to time by Franchisor. Mandatory specifications, standards, and procedures may be prescribed from time to time by Franchisor in the Brand Standards Manual, or otherwise communicated to Franchisee in writing.

\textsuperscript{71} Id. at 199.
\textsuperscript{72} Id.
As to the signage and other identifying indicators, following is a sample provision:

**Signage**

All signage and decorating materials at the Franchised Business site must conform to Franchisor’s specifications. In particular, Franchisee must post a prominent sign in the Franchised Business identifying Franchisee as a franchisee in a format that Franchisor deems acceptable, including statements (1) that Franchisee independently owns and operates the Franchised Business, (2) that the Marks are owned by Franchisor, and (3) that Franchisee uses the Marks pursuant to a license Franchisor has issued to Franchisee.\(^\text{73}\)

3. **Staffing**

Claims related to employment and staffing have led to some of the most high-stakes franchisor vicarious liability cases in recent years, including *Patterson*. Therefore, it is crucial that franchisors refrain from getting involved with franchisees’ hiring and firing decisions.

The *Patterson* court observed that “[t]he contract stated that persons who worked in the [franchised] store were the employees of [the franchisee], and that no employment or agency relationship existed between them and Domino’s. Domino’s disclaimed any rights or responsibilities as to [the franchisee]’s employees.”\(^\text{74}\) Key to the California Supreme Court’s decision in *Patterson* was the fact that the franchisee “exercised sole control over selecting the individuals who worked in his store. He did not include Domino’s in the application, interview or hiring process.”\(^\text{75}\) The court in *Patterson* indicated that a franchisor could provide advice and consultation, even recommendations as long as the final decision to hire, discipline, or terminate an employee was within the franchisee’s sole discretion. In *Patterson*, the court was not concerned that the Domino’s area representative would occasionally encounter “an employee whose performance was so deficient that it was hurting Domino’s brand or endangering the franchise” and would recommend or suggest that the employee might not be the right fit for the job.\(^\text{76}\) Instead, because the franchisee had the ultimate decision-making power as to its own employees, including developing its own sexual harassment guidelines and training, the court declined to find Domino’s vicariously liable for the acts of the franchisee’s employee.

Other courts have echoed the position that as long as the franchisee retains the sole right to hire, discipline, fire, and set the schedules of its em-

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\(^{73}\) Adapted in part from K. Olson et al., *The Annotated Franchise Agreement*, supra note 45.

\(^{74}\) *Patterson* v. Domino’s Pizza, LLC, 333 P.3d 723, 741 (Cal. 2014), reh’g denied (Sept. 24, 2014). See suggested provision below under “Staffing.”

\(^{75}\) *Id.*

\(^{76}\) *Id.*
ployees, the franchisor will not be subject to vicarious liability or joint employer status for merely providing advice, recommendations, and consultation in regards to employment issues. The Ochoa court was not bothered by the fact that McDonald’s provided detailed recommendations to the franchisee on employee scheduling, staffing, and discipline because, as the court stated, the franchisee “was adamant that these were just suggestions.” Further, although McDonald’s “extensively monitor[ed] and evaluate[d]” the franchisee and used mystery shoppers and business consultants, the court believed that “mere monitoring of these customer service metrics is not active employee control.” To the Ochoa court, “the fact that McDonald’s would have to resort to economic and business relationship sanctions to motivate Smith [the franchisee] to implement service changes underscores its lack of direct authority or control.”

The franchisor will often not be found vicariously liable as long as the franchisee has the final say in decisions relating to its employees, the franchisor cannot step in and take over the management of the franchisee’s employees, and the franchisor’s right to terminate arises only because of an uncured violation of the franchise agreement. These types of scenarios have been determined not to create “the equivalent of the right to control the actual daily operation of the restaurant” by the franchisor. Other activities found acceptable include:

- preparing a standard application for franchisees to use in hiring employees if the franchisee handles the details of the hiring process and makes the hiring decision;
- reviewing employees’ work schedules and requiring that employees remain at work until another employee arrives;
- mandating that the franchisee “hire, train, maintain, and properly supervise sufficient, qualified, and courteous personnel for the efficient operation” of the franchised business;
- requiring that a designated person in charge attend a management training seminar conducted by the franchisor; and

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77. Ochoa v. McDonald’s Corp., 133 F. Supp. 3d 1228, 1236 (N.D. Cal. 2015).
78. Id. at 1236, 1239.
79. Id. at 1236.
82. Orozco v. Plackis, 757 F.3d 445 (5th Cir. 2014). In this case involving the Fair Labor Standards Act, the court applied the economic reality test to determine whether the franchisor’s owner was an employer of the plaintiff. Under the economic reality test, the court evaluates whether the alleged employer: (1) possessed the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records.
83. Kerl, 682 N.W.2d at 332.
• providing “guidelines for hiring, training, and supervising employees in accordance with applicable labor laws and to achieve an efficient, courteous, and satisfied work force.”

However, if the California Supreme Court in *Patterson* had not overturned the appellate court’s decision, franchisors in California may have been faced with having to take even more of a “hands off” approach. The appellate court’s opinion strongly suggested that joint employer liability may apply if there was an atmosphere leading the franchisee to believe (rightly or wrongly) that termination of the franchise would result if it did not adhere to Domino’s suggestion that one of its employees be terminated. To the appellate court, there was at least a triable issue of fact as to whether there was a lack of local franchisee management independence because, in at least one incident, Domino’s purportedly told the franchisee to fire an employee and the franchisee believed he “had to pull the trigger on the termination, [and] it was very strongly hinted that there would be problems if [he] did not do so.” This incident suggested to the court that the franchisee perceived he had to comply with Domino’s advice “or else.” The dissenting opinion from the California Supreme Court’s decision was particularly swayed by the fact that the franchisee felt he had to follow Domino’s recommendation to terminate the harasser, stating that “[w]hile no one factor is determinative, the power to discharge an employee offers ‘strong evidence’ both of the fact of control and of the ultimate existence of an employment relationship.”

Given these decisions, it is advisable to restrict franchisees’ employment decisions as little as possible in the franchise agreement and manual. Any advice or guidance should make clear to the franchisee that all decisions regarding hiring, firing, and scheduling are to be made ultimately and exclusively by the franchisee. To that end, franchisors should reconsider providing sample employee manuals to be distributed to franchisee’s employees; imposing personnel policies or procedures on the franchisee; and becoming involved in the hiring, firing, scheduling, compensation, review, discipline, promotion, demotion, or other supervision of franchisees’ employees. Some franchisors have moved in the direction of instead approving third party human resource companies to provide guidance to franchisees.

Because provisions related, even tangentially, to a franchisee’s employees typically appear throughout the franchise agreement and manual, it would not be practical to attempt to draft suggested provisions for every single situation where employee matters may arise. However, in line with the guidance the existing case law provides, franchisors should clearly indicate in the
franchise agreement that the franchisee has sole and complete control over its own employees and that any suggestions made by the franchisor are optional and never mandatory.

See the following sample provision disclaiming any control over franchisee’s employment matters:

Franchisee’s Employees

Franchisee’s employees are under Franchisee’s sole control. Franchisor is not the employer or joint employer of Franchisee’s employees. Franchisor will not exercise direct or indirect control of Franchisee’s employees’ working conditions. Franchisor does not share or codetermine the terms and conditions of employment of Franchisee’s employees or participate in matters relating to the employment relationship between Franchisee and its employees, such as hiring, promotion, demotion, termination, hours or schedule worked, rate of pay, benefits, work assigned, discipline, response to grievances and complaints, or working conditions. Franchisee has sole responsibility and authority for these terms and conditions of employment. Franchisee must notify and communicate clearly with its employees in all dealings, including, without limitation, its written and electronic correspondence, paychecks, and other materials, that Franchisee (and only Franchisee) is their employer and that Franchisor is not their employer.

4. Method of Operation

Provisions in franchise agreements addressing methods of operations can be wide ranging, depending on the franchise system.

One example of a common operational system is proprietary software. Often proprietary software will be used in the operation of the business, such as point-of-sale software in restaurants and other retail locations that tracks sales and provides useful information to both franchisors and franchisees.

Software that is involved in payroll processing has been addressed in the joint employment context. In the Ochoa case, one of the issues raised by the plaintiffs involved McDonald’s proprietary software called “ISP” or “In-Store Processor” as well as a point-of-sale software called “NewPOS,” both of which were mandatory. The Ochoa court even acknowledged that it was “entirely possible that the alleged labor law violations at issue here would not have occurred if the ISP had been programmed differently.”

The court noted that the ISP’s labor law parameters were pre-programmed and the franchisee did not change them. However, the court held that “simply providing the ISP software is not enough to convert McDonald’s into an employer” under clear precedent that “franchisors who mandate

89. Id.
use of their payroll processing services are not liable as joint employers, even when the labor law violations at issue allegedly arose out of the way the franchisor set up the payroll system.”

Doing so would unreasonably expose companies that provide employment related software, which as a practical matter may be necessary for a franchisee to use, to employer liability for programming or bugs that result in labor law violations.

In addition, the Ochoa court noted that McDonald’s provides a voluntary software tool called R2D2 or Regional Restaurant and Data Diagnostics that is also pre-programmed to identify labor law violations. The court held that because the program was used only to monitor the performance of the restaurants and could not be used to exercise control over wages, hours, and working conditions, it did not result in joint employer liability.

Another common provision in franchise agreements relates to quality assurance and involves periodic inspections and occasional mystery shopper programs. The Courtland court found that periodic evaluations and mystery shoppers sent to ensure that the franchisee was following the franchise agreement guidelines did not show the requisite degree of control to impose vicarious liability.

On the other hand, the court in Greil indicated that the following provisions in the franchise agreement were indicia of control: the facility was required to be built and maintained in accordance with the franchisor’s specifications, regular inspections by the franchisor were permitted, approval by the franchisor was required for all advertising, the relationship between the franchisor and franchisee amounted to profit sharing, the franchisor had the ability to audit the franchisee’s books, and the franchisor had the right to cancel the agreement if there were substantial violations of any of the covenants in the franchise agreement.

Because of the variety of provisions that could be included in this category, we do not have a specific example of one. However, in general, the franchise agreement should set forth the standards related to the work, but should make clear that the procedures utilized to implement those standards rest with the franchisee. “The franchise agreement merely sets forth the standards related to the work; the responsibility of implementing the details of those standards is left to [the franchisee’s] discretion. Neither an occasional assertion of control or sporadic action directing the details of the work is sufficient to destroy the agreement forming the basis of the parties’ independent contractor relationship.”

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90. Id.
91. Id. at 1237–38.
92. Id. at 1238.
5. Safety/Security

Depending on the nature of a franchise system, safety and security at the franchised business may be a particularly significant concern. For instance, a restaurant franchise that is required to serve customers twenty-four hours a day raises greater security concerns than a restaurant franchise that is open only during daylight hours. Although the franchisor undoubtedly has an interest in ensuring that the system on the whole has a reputation of providing a safe and secure environment for late night diners, the degree to which the franchisor mandates such safety and security measures will affect the degree to which the franchisor is exposed to claims of vicarious liability and joint employment.

Notably, the California Supreme Court’s decision in Patterson was not affected by the fact that Domino’s computer system touched on safety and security matters. The system did not train employees on how to treat each other at work or how to avoid sexual harassment.96

The Reddy case involved a requirement that vehicles used by delivery drivers be inspected.97 This did not affect the Texas Court of Appeals’ decision that Domino’s was not vicariously liable for death and injuries caused by a franchisee’s delivery driver. Domino’s did not specify how the inspections should be performed nor did it conduct the inspections or receive the results of inspections.98

The above decisions are consistent with the standard applied in New York by the court in Hong Wu, a case involving an overnight assault on an employee of a Dunkin’ Donuts franchisee.99 In determining whether the franchisor could be held vicariously liable, the court analyzed whether the franchisor exercised a considerable degree of control over the instrumentality that caused the harm.100 In deciding whether the franchisor’s actions give rise to a legal duty, courts typically draw distinctions between recommendations and requirements.101 Particularly relevant in Hong Wu were the following:

- Even though the franchisor required the store to remain open twenty-four hours a day, which did create an increased security risk, the franchisor did not mandate specific security measures or otherwise control or limit the franchisee’s response to the increased risk.102

- Although the franchisor made security equipment available for purchase and suggested that alarm systems and other burglary prevention tech-

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98. Id. at *7.
100. Id. at 87.
101. Id. at 89.
102. Id. at 91.
niques were important, the franchisor did not require the purchase of security equipment.103

- Although the franchisor’s inspectors observed that certain safety measures had been taken, the inspectors did not evaluate the necessity or sufficiency of the security measures.104

Balancing the tension between providing greater recourse for victims and incentivizing franchisors to ensure security measures are in place, the court in *Kerl* held that “the imposition of vicarious liability has less effectiveness as an incentive for enhancing safety and the exercise of care in the absence of the sort of daily managerial supervision and control of the franchise that could actually bring about improvements in safety and the exercise of care.”105 Although “the rationale of encouraging safety and the exercise of due care is present in the domain of franchising, as elsewhere, it has less strength as a justification for imposing no-fault liability on a franchisor” because the “typical franchisee is an independent business or entrepreneur, often distant from the franchisor and not subject to day-to-day managerial supervision by the franchisor.”106

Specific provisions concerning safety concerns are frequently addressed in a franchisor’s manual. Following is a sample provision that is more generic:

*Operation in Accordance with Public Health and Safety*

Franchisee shall operate the Franchised Business in a safe and secure manner that optimizes public health and safety. Franchisee is solely responsible for determining and addressing all safety concerns relating to the condition of the premises and surrounding areas, the operation of any vehicles in connection with the Franchised Business and otherwise.

6. Compliance with Laws

Most franchise agreements require franchisees to comply with all applicable laws in the operation of their businesses. This seems to be the extent of the involvement of franchisors in most franchise systems and, as a result, this type of provision has not caused issues in cases involving vicarious liability or joint employment allegations.

For example, in *Courtland* the extent of the franchisor’s guidance to franchisees on employment discrimination, including sexual harassment, was to tell franchisees “to follow all federal state, local regulations and rules.”107 The California Supreme Court found it relevant that Domino’s lacked contractual authority to enforce employment laws. “Domino’s lacked contrac-

103. Id. at 91–92.
104. Id. at 92.
106. Id.
tual authority to manage the behavior of [the franchisee’s] employees while performing their jobs, including any acts that might involve sexual harassment.”

Following is a sample of a typical provision requiring compliance with applicable law:

**Compliance with Law**

Franchisee will operate in full compliance with all applicable laws, ordinances and regulations, including, without limitation, such laws, ordinances and regulations relating to occupational hazards and health, worker’s compensation insurance, unemployment insurance and withholding and payment of federal and state income taxes and Social Security taxes, trade name and advertising restrictions, building codes, and handicap access. In particular, and not in limitation of the foregoing, Franchisee shall comply with the Americans with Disabilities Act.

F. **Management by Franchisor**

Some franchisors include the right to step in and manage the franchised business if the franchisee is in default of the franchise agreement. The reason behind this provision is to allow the franchisor to continue operations on behalf of the franchisee in the event of death or serious default so as to avoid closing the location, even temporarily. The franchisor or its nominee typically receives a management fee for undertaking these additional duties.

Exercising the franchisor’s right under such a provision would be more likely to result in vicarious or even direct liability issues for employee or other claims resulting from the operations by the franchisor. Also of concern is the degree of control the mere presence of such a provision communicates. While the authors are not aware of any determination based on the inclusion of such a provision, franchisors should consider whether such a provision is worth the effect it may have on the overall control a franchisor is imposing as part of its franchise program. In *Patterson*, the California Supreme Court found relevant that “Domino’s had no duty to operate” the franchisee’s store, “[n]or did Domino’s have the right to direct [the franchisee’s] employees in store operations.” In *Kerl*, the Wisconsin Supreme Court also took into consideration the fact that the franchisor “could not step in and take over the management of [the franchisee’s] employees” when determining that the franchisor was not vicariously liable for the negligent supervision of employees by the franchisee.

Courts have also more generally considered the ability of a franchisor to directly or even indirectly control the franchisee and its operations in their

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109. Id.

110. Kerl, 682 N.W.2d at 340.
analyses of vicarious liability and joint employer claims. In *Ochoa*, the court noted that McDonald’s had “the ability to exert considerable pressure on its franchisees” through many means, including termination, but still held that McDonald’s was not the joint employer of the franchisee’s employees because “an entity’s ability to convince an employer to carry out certain acts by threatening economic sanctions does not itself make it an employer.”

Should a franchisor feel that such a right is necessary, however, it should attempt to resolve any breaches or defaults through other means and only exercise its right to take over management as a last resort. If desired, the following language may help guide the drafting of such a management provision.

**Option to Manage**

If Franchisee is in default under this Agreement, in addition to Franchisor’s right to terminate this Agreement set forth in Section ___, and not in lieu thereof, Franchisor may elect to enter into and manage the Franchised Business until such time as Franchisor shall determine that the default of Franchisee has been cured and that Franchisee is capable of complying with the requirements of this Agreement. If Franchisor assumes the management of the Franchised Business, Franchisee must pay Franchisor a management fee equal to __________ Dollars ($___) per day (“Management Fee”) and reimburse Franchisor for all expenses incurred by Franchisor’s personnel so long as such personnel are necessary and in any event until the default has been cured. Franchisee acknowledges that the Management Fee shall be in addition to any other fees required under this Agreement and shall be paid in accordance with the methods of payment set forth in Section ___. If Franchisor assumes the Franchised Business’ management, Franchisee acknowledges that Franchisor will have a duty to utilize only commercially reasonable efforts and will not be liable to Franchisee or its owners for any debts, losses, or obligations the Franchised Business incurs, or to any of Franchisee’s creditors for any supplies or services the Franchised Business purchases.

**III. Manual**

As noted above, the contents of the traditional operations manual (or as we suggest labeling it, the “brand standards manual”) that the franchisor provides to its franchisees should also be re-examined and re-focused to provide information and procedures that relate more directly to protection of the brand and the standards the franchisor has established to protect that brand.

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112. *Id.* at 1239.
Some franchisors are considering excising from their manuals all materials relating to a franchisee’s employees. The court in Vann emphasized that all personnel policies and procedures described in the Massage Envy manual were optional.113 Anything that is included should be informational only, and the franchisee should be directed to formulate its own employment policies and procedures with the assistance of its advisor.

Some courts have expressed concern with the detail of operational control set forth in operations manuals. A list compiled by the California Court of Appeal in Patterson is instructive:

- The franchisee’s computer system was not within its exclusive control. Domino’s had independent access to the data.
- Domino’s had the right to audit the franchisee’s tax returns and financial data.
- Domino’s determined store hours, advertising, handling of customer complaints, signage, the franchisee’s email capabilities, equipment, furniture, fixtures, décor, and the method and manner of payment by customers.
- Domino’s regulated the pricing of items at the counter and home delivery and set the standards for liability insurance.

Thus, according the California Court of Appeal, “Domino’s claims the franchise agreement grants [the franchisee] the freedom to conduct its own independent business. But provisions of the agreement substantially limit franchisee independence in areas that go beyond food preparation standards.”114

Similarly, the Billops court highlighted the fact that the Hilton operations manual was detailed and in part mandatory and was incorporated into the franchise agreement. The manual regulated a variety of operational matters, required the franchisee to keep detailed records so that the franchisor could ensure compliance with the manual, and reserved the right of the franchisor to enter the premises to inspect compliance. Some of the operational matters regulated by the manual included

- identification, advertising, front office procedures, cleaning and inspection service for guest rooms and public areas, minimum guest room standards, food purchasing and preparation standard, requirements for minimum supplies of “brand name” goods, staff procedures and standards for soliciting and booking group meetings, functions and room reservations, accounting, insurance, engineering and maintenance, and numerous other details of operation.115

Together with the ability of the franchisor to unilaterally terminate the franchisee for violation, these requirements provided sufficient evidence that cre-

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ate a triable issue of fact and caused the court to reverse the lower court’s grant of summary judgment in favor of Hilton.116

IV. Relations with Employees/Customers

Although it is important to properly draft the franchise agreement and the manual to address vicarious liability and joint employment issues, it is equally important that the supervision and guidance actually provided by franchisors comport with the principle that the franchisee is the sole employer of its employees. The actions of the Domino’s area leader or field representative were significant factors in the Patterson case. The franchisee had testified that he felt pressured into acquiescing to the area leader’s suggestions because “a franchisee who did not ‘play ball’ with the area leader might be ‘in jeopardy,’ ‘in trouble’ or ‘out of business.’”117 The franchisee also emphasized that his area leader had told him to get rid of the manager who allegedly harassed the plaintiff.118 The California Supreme Court found, however, that the evidence showed that the franchisee acted with the understanding that the decision on what to do about the manager at issue was his alone to make.119

The lesson from Patterson is that the franchisor’s field representatives should be trained to avoid becoming involved in a franchisee’s relationships with its employees. Except for compliance with the requirements of the franchise system, the field representative’s guidance should be limited to suggestions on operational improvements that the franchisee should consider making, and there should never be an implication that failure to follow these suggestions will result in termination of the franchise. Moreover, the field representative’s communication should be restricted to the franchisee or its senior management and not directed to employees of the franchisee.

In Patterson, the California Supreme Court also found relevant that Domino’s had no procedure for processing sexual harassment complaints by franchisees’ employees.120 Similarly, the Courtland case noted that if a franchisee or employee contacted Buffalo Wild Wings with an employment-related question, the franchisor would refer that person back to the franchisee’s human resource personnel.121

Too often, a franchisor may try to be helpful by answering franchisees’ questions on human resource issues. Franchisees should instead be instructed early in the relationship to secure the services of their own labor

\[116. \textit{Id.}\]
\[117. \text{Patterson v. Domino’s Pizza, LLC, 333 P.3d 723, 730 (Cal. 2014), reb’g denied (Sept. 24, 2014).}\]
\[118. \text{Id. at 744.}\]
\[119. \text{Id. at 742.}\]
\[120. \text{Id. at 731.}\]
\[121. \text{Courtland v. GCEP-Surprise, LLC, No. CV-12-00349-PHX-GMS, 2013 WL 3894981, at *7 (D. Ariz. July 29, 2013).}\]
and employment law/human resource advisor. Some franchise systems have designated outside vendors to provide these services to franchisees on an optional basis.

In addition, most franchise systems have established customer service procedures to field complaints and other operational issues that arise. Indeed, Domino’s had a “1-800” telephone number for customer complaints about products and services.

If there is a complaint about how a customer was treated in a franchisee’s store, franchisors should consider referring the complaint to the specific franchisee for resolution. This is another situation in which the franchisor should weigh the protection afforded for vicarious liability claims against the possible damage to the brand if customers are left without recourse for their complaints about franchisee conduct or service.

V. Conclusion

The inconsistent and sometimes contradictory case law on vicarious liability and joint employment has thus far generated a great deal of uncertainty for the franchising community and will almost certainly continue to do so. Patterson was a pivotal decision for franchisors and franchisees in California, but it is unclear whether other jurisdictions will follow suit or how far subsequent courts (including those within California) will extend the California Supreme Court’s decision. This article highlights just a handful of the provisions of the franchise agreements and brand standards manuals that are affected by these decisions and provides suggestions on the language of these provisions, but should in no way be considered a definitive guide to how to draft a franchise agreement. Every franchise system must balance the importance of mandating certain controls to protect its brand against the specter of being found liable for its franchisees’ actions. Therefore, franchisors should continue to review and update their franchise documents to adapt to evolving case law.
Setting the Stage for a “Best in Class” Supply Chain

Joyce G. Mazero and Leonard H. MacPhee

A competitive supply chain is critical to the success of a franchisor and its franchisees. Without timely, accurate, and safe distribution of high quality products to franchisees and customers, a franchisor’s brand performance expectations will not be met and relationships across the supply chain spectrum will suffer, ultimately resulting in significant harm to the customer experience every franchisor seeks to competitively optimize.

Integration of disciplined supply chain practices and measurement of supply chain performance is a critical linchpin for improving overall unit economics. Unit economics are the fundamental financial predictors of the franchise business model. Measuring unit profitability is a strategic tool that smart franchisors and franchisees use to leverage the parts of their business having the most significant level of marginal investment. Service excellence companies measure unit economics by focusing on the customer experience—businesses today have increasing access to real-time data regarding customer experience and there has never been a stronger focus on service delivery. Amazon and Zappos have created a significant competitive advantage based on customer loyalty with their online retail services. Product excellence companies focus on the supply chain holistically, driving costs out of each leg of producing, buying, and selling


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goods—delivering and requiring their suppliers to deliver the highest value at the lowest cost. Apple is a competitive example. Other companies focus on eliminating waste following lean management principles in managing their supply chain at each stage and anticipating problems at the earliest stage possible. Companies in the banking, technology, insurance, consulting, food service, and health care industries are prime examples of active integrators of lean management principles. Franchise companies care about excellence in each of these areas.

However, the supply chain management bar for many franchisors has too often been set low, limiting their ability to use serious strategic planning processes that the brands noted above have adopted. As a result, analyses of unit economics may not provide the economic benefit to franchisors that a more studied approach could provide. The reasons vary. Sometimes franchisors believe it is too costly and time-consuming and that they have insufficient leverage to drill down into supply chain costs when they are hostage to large distributors or believe their “practical experience” is sufficient; others rely on form contracts or standard terms and conditions, which may include boilerplate or old language that is not applicable to the franchisor’s supply chain relationship or appropriately tailored to the franchisor’s business needs.

Integration of certain best practices conducted by brands known for superior supply chains is possible on a cost-efficient basis when franchisors consider the aggregate spend contemplated by their manufacturing, distribution, supply, and logistics contracts; the projected monetary value of those contracts to the franchise system; and the potential risk and liability to the franchise system if any of those contracts fail.

2. “Suppliers” is used to refer to suppliers of products and services as well as manufacturers of products and components, distributors, logistics providers, freight forwarders, and transportation service providers.


This article focuses on setting the stage for “best in class” supply chain management, including selected key considerations, processes, and material provisions the authors believe provide a baseline for negotiating and drafting approaches to supply chain arrangements that franchise counsel may want to consider. This article will identify and discuss the following considerations: (1) the selection of qualified suppliers, (2) identification of fundamental terms for supply agreements critical to achieving timely supply of conforming products, (3) methods of managing supplier performance through key performance indicators and corrective action plans to resolve performance issues, and (4) corporate responsibility and transparency considerations.

I. Selecting Critical and Qualified Players in the Supply Chain

A. Conducting a Due Diligence Investigation for Basic Information

Prompt and thorough due diligence is a critical step in selecting suppliers of products and services. The supplier’s ability to satisfy the franchisor’s performance criteria is critical to the franchisor and its franchisees receiving high quality products and services from their manufacturers, suppliers, distributors, formulators, and logistics providers. The failure of any player in the supply chain to meet design specifications, quality standards, inventory management, or shipping or delivery requirements can cause delays in delivery of currently usable inventory and the cost of the product or service to skyrocket.8

Before conducting more specific investigations through requests for proposals and bid processes, a franchisor should initially obtain basic data about the supplier. Such basic information may inform the franchisor about the supplier’s risk profile and permit the franchisor to assess the bidder’s market position,9 mitigate additional risks, and identify commercial and financial conditions that should be included in the final contract with the successful bidder.


9. A franchisor also should consider the implication of antitrust laws in establishing supply chain relationships. The FTC has identified potential antitrust issues that arise in supply chain relationships, including manufacturer-imposed requirements, e.g., pricing restrictions; exclusive dealing or requirements contracts; and anti-competitive agreements to refuse to supply competitors. Dealings in Supply Chain, FTC GUIDE TO ANTITRUST LAWS, https://www.ftc.gov/tips-advice/competition-guidance/guide-antitrust-laws/dealings-supply-chain (last visited Aug. 22, 2016). For example, antitrust liability may arise if a “dominant” company locks up suppliers in a market, making it difficult for other competitors to succeed. See McWane, Inc. v. Fed. Trade Comm’n, 783 F.3d 814 (11th Cir. 2013). In addition, franchisors frequently require franchisees to use only “approved” suppliers. Franchisees have challenged franchisor-imposed supplier restrictions under tying theories following the U.S. Supreme Court’s decision
Essential information to request in a basic due diligence investigation includes: ownership and organizational structure; the most recent financial statements and tax returns; the company’s history and management, including biographies of management and key personnel; verification of insurance and any relevant licenses; credit reports; previous complaints regarding the supplier (Better Business Bureau, FTC, state attorneys general); criminal records, legal filings, and bankruptcy filings; any regulatory compliance materials relevant to the potential transaction; and a list of references. 10 For international suppliers and U.S. suppliers that maintain offshore plants or subsidiaries or that do business with offshore component suppliers that are material to the contract, a franchisor’s basic due diligence investigation should also include verification of the subsidiary’s or supplier’s corporate registration with applicable government registries; business, government, and political affiliations; analysis of domestic and foreign press sources for information that may be harmful or derogatory in nature; and confirmation of government sanctions and watch lists, including the lists of “Specially Designated Nationals” or “Blocked Persons” maintained by the U.S. Treasury Department’s Office of Foreign Assets Control (OFAC). 11

Internet searches may provide publicly available information regarding the supplier, including political affiliations and endorsements, negative media coverage, and information regarding the supplier’s history and management personnel. Third party investigative services may provide corporate and individual due diligence at varying levels of investigation, depending upon the franchisor’s needs, which can expedite the obtaining of information. 12 Franchisors should be aware that certain types of data collected regarding a supplier’s principals or management personnel (e.g., financial data, geographical information, and Social Security numbers) may require

in Eastman Kodak Co. v. Image Technical Services, Inc., 504 U.S. 451 (1992) (addressing whether Kodak had unlawfully tied the aftermarket sale of service of Kodak copying machines to the sale of parts for those machines). Courts have largely rejected such claims against franchisors primarily because franchisees have been unable to establish that franchisors have sufficient market power in any relevant market. See, e.g., Schlotzsky’s, Ltd. v. Sterling Purchasing & Nat’l Distrib. Co., 520 F.3d 393, 408 (5th Cir. 2008); Queen City Pizza, Inc. v. Domino’s Pizza, Inc., 124 F.3d 430, 438–44 (3d Cir. 1997); Mumford v. GNC Franchising LLC, 437 F. Supp. 2d 344, 359 (W.D. Pa. 2006).


12. In addition to customary areas of due diligence, third party providers provide various investigative services, such as international due diligence and FCPA compliance at varying service levels, including verification of corporate registration, identification of business affiliations, analysis of domestic and foreign press sources, review of criminal and civil records, political affiliations, regulatory compliance, investigative due diligence to uncover inappropriate political affiliations, links to organized crime, improper payment arrangements, and purposely hidden ownership.
the consent of the individual and/or only be collected and used in accordance with applicable law.\textsuperscript{13}

B. Soliciting Information and Bids

Several options are available to obtain information regarding a specific supplier’s ability to fulfill a franchisor’s needs with respect to products and services, including a request for information, a request for quote, and a request for proposal. Each approach meets a certain need in the supplier selection process.

A request for information (RFI) focuses on gathering information about vendors, products, and services prior to a formal request for quote/request for proposal process.\textsuperscript{14} RFIs can assist a franchisor in narrowing the list of prospects for an eventual request for proposal (RFP). For example, a restaurant franchisor that is evaluating whether to select regional or local sources for menu ingredients may issue an RFI to a broad scope of regional and local suppliers to determine supplier ability to meet its product specifications for the ingredients and use the information received to tailor its RFP to the type of supplier that is capable of delivering products meeting its product specifications most closely and efficiently. Similarly, a franchisor that is experiencing technology integration issues but is uncertain of the solution may issue an RFI to a variety of technology service providers requesting how those providers have resolved such integration issues and, based upon the responses, craft an RFP for suppliers that are capable of providing a specific solution.

A request for quote (RFQ) (sometimes called an invitation to bid) requests responses with pricing and information on the availability of products or services.\textsuperscript{15} The RFQ is generally used when the terms that the franchisor is looking to determine are primarily financial and the franchisor is less concerned with supplier performance.

An RFP is the most formal type of procurement request. It generally includes information regarding the project scope, purpose, and anticipated deliverables, including detailed specifications of the products or services sought; RFP response and performance timelines; RFP submission and acceptance criteria; pricing models and expectations; technology project work; restrictions on the use of subcontractors; ownership of intellectual property brought to and developed from the project; allocation of risk and treatment of losses and damages in production and shipment; a sample of the relevant supplier contract (or summary of key terms and conditions); metrics upon which supplier performance will be measured; requests for in-


\textsuperscript{15} Id.
formation about the supplier’s organization and account management structure, facilities, insurance, security, and data breach programs; references; and any other information the franchisor believes will allow respondents to tailor their responses to the particular project. The RFP should request that responding suppliers identify a point of contact with whom the franchisor may communicate during its evaluation of RFP responses and provide the franchisor opportunities to visit the facilities of any respondent at its option.

1. Legal Considerations in Drafting RFIs, RFQs, and RFPs

Generally, for private contracts, a franchisor may select a potential supplier based on any criteria it deems fit, as long as the criteria are in compliance with applicable legal requirements. A franchisor can accept whichever bid bests suits its purposes or can decide to reject them all if none is acceptable.

An RFI, RFQ, or RFP should constitute a request to receive offers and/or an invitation to negotiate and not an offer under applicable contract law. Under general contract law, an offer requires an expression of a promise, undertaking, or commitment to enter into a contract; that it be definite and certain in its terms; and that it be communicated to the offeree. An offer is generally not required to contain all material terms, but must contain enough of the essential terms of a contract to make it capable of being enforced. However, if an RFP, for example, states that one respondent will be awarded the contract from all respondents based on set criteria, the request is likely to be treated as an offer. Given its detailed nature, an RFP is at the largest risk of being construed as an offer because it is more definitive than an RFI or RFQ. A franchisor can minimize the risk of an RFP being construed as

16. Id. References to RFPs in this article are to generic supplier RFPs; RFPs issued by governmental agencies or in connection with identifying providers of construction services, architectural services and other regulated industries may be subject to laws or regulations in the applicable jurisdiction that govern the content of requests for proposals. See, e.g., LA. REV. STAT. ANN. § 38:2237(A)(8) (methods of procurement) (2002); 70 ILL. COMP. STAT. 1505/26.10-6 (solicitation of design build proposals) (2009); 199 IOWA ADMIN. CODE 40.5(476) (RFPs) (2002). In addition, this article does not address considerations, including compliance with diversity and discrimination policies, that may apply to suppliers generally.

17. Howard O. Hunter, Modern Law of Contracts § 3:18 (2016); see also Five Star Airport Alliance, Inc. v. Milwaukee Cty., 393 F. Supp. 2d 936, 941 (E.D. Wis. 2013) (issuer of RFP had the right to reject all bids and issue a new RFP).


21. Olympia Equip., 797 F.2d at 381 (noting that an offer must be definite and certain in its terms).
an offer by reserving its right to reject any bids, modify any relevant criteria, and/or to accept a bid that is not submitted in conjunction with the RFP. Courts generally do not find an offer has been made if the RFP states the buyer has discretion to reject any and all bids.22

A supplier’s response to an RFP can be considered an offer because it will likely contain all the material terms that would allow a franchisor to create a contract by accepting the supplier’s response.23 A response to an RFQ can also be considered an offer because it tells the franchisor that the supplier will perform the actions required by the project for the price stated in the supplier’s response.24 Since a supplier’s response to an RFI only gives information about the supplier’s capabilities, skills, and experience, and normally does not contain any material terms of a project, it should usually not be considered an offer.25

Whether a franchisor can modify or withdraw its RFP depends on whether the RFP constitutes an offer under applicable contract law.26 If the RFP does not constitute a legal offer, the franchisor should retain the right to withdraw and modify terms at will while negotiating potential offers from multiple suppliers.27 On the other hand, if the RFP constitutes an offer, the RFP may be withdrawn prior to acceptance but may not be withdrawn or modified after it has been accepted by a supplier responding to an RFP that states the contract will be awarded to a respondent meeting the criteria.28

Finally, a franchisor putting a contract out to bid to multiple suppliers must be wary of bid rigging. Bid rigging occurs when bidders coordinate their actions to undermine the competitive bidding process, resulting in more expensive or otherwise less attractive bids to the franchisor.29 Essentially this means competitors agree in advance who will submit the winning bid on a contract being awarded on a competitive bidding process.30 Examples of bid rigging include bid rotation (competing bidders take turns sub-

24. See id.
25. See id.; RESTATEMENT (SECOND) OF CONTRACTS § 26(d).
28. See RESTATEMENT (SECOND) OF CONTRACTS § 42 (“An offeree’s power of acceptance is terminated when the offeree receives from the offeror a manifestation of an intention not to enter into the proposed contract.”); W.J. Wagner, Some Problems of Revocation and Termination of Offers: Necessity of Communication-Time of Revocation-Death, 38 NOTRE DAME L. REV. 138, 139 (1963) (a purported revocation after the offer has been accepted is ineffective; a contract having been entered into, the offeror will have to perform it or respond in damages”).
30. Id.
mitting the lowest bid); bid suppression (some suppliers sit out of a bidding round); complementary or cover bidding (some suppliers submit inflated bids to cover up the scheme); or subcontracting (subcontracting part of the main contract to the losing bidders).\footnote{31} Bid rigging is an illegal form of collusion subject to criminal prosecution by the DOJ’s Antitrust Division.\footnote{32} Because bid rigging is based on the assumption that one of the bidders will be awarded the contract, an RFP that clearly states that the franchisor may not choose any of the bids and allows the franchisor to look beyond the submitted bids for a supplier would be a strong deterrent.\footnote{33}

2. Franchisor’s Confidential Information

Confidentiality is often important to both the franchisor soliciting bids and the bidding suppliers. Issues of confidentiality can be addressed in any of the requests described above. For example, a franchisor can require prospective suppliers to sign a non-disclosure agreement before providing them with details necessary to formulate an RFP response, including, for example, any of a franchisor’s proprietary information. If a responding supplier needs key details of its response to the request be kept confidential, it can so state in its response. Where a supplier’s bid response contains a request for confidentiality, some courts have found an implied-in-fact contract is created that prevents a buyer from disclosing the information that the supplier sought to keep confidential.\footnote{34} However, the responding supplier runs the risk of its response being deemed a non-conforming bid by doing so.\footnote{35}

II. Identification of Terms Important to Timely Supply of Conforming Products

After selecting the supplier, a franchisor must reach agreement on the terms of the relationship. This section identifies and describes some important terms relating to timely supply of product that meets specifications and quality standards as well as some of the considerations that go into the drafting and negotiation of the same. This list is not exhaustive, and this section does not address all of the considerations and issues that arise with respect to

\footnote{31} Id. at 2–3.
\footnote{32} Id. at 1. Violation of the Sherman Act is a felony punishable by a fine of up to $100 million for corporations, $1 million for individuals, and 10 years imprisonment. Id.
\footnote{33} See id. at 5 (explaining that collusion is more likely to occur in conditions that would make it difficult for the solicitor to find another seller including: few sellers, products cannot be easily substituted, competitors are familiar with one another, bidding occurs in a place that gives bidders access to one another prior to bidding).
\footnote{35} See PricewaterhouseCoopers Public Sector, 126 Fed. Cl. at 354 (deciding that an offeror’s response to an RFQ changing the requirements regarding data rights failed to conform to the material terms and conditions of the contract).
these terms. Rather, this section identifies and highlights a few key issues and general framework.

A. Inventory and Forecasts

It is critical to the supply chain that suppliers timely fill orders and maintain the inventory and capacity necessary to do so. Thus, franchisors should require timely supply and consider terms that require suppliers to maintain sufficient inventory and capacity. The key contract terms include setting how quickly the supplier must fill an order and requiring certain inventory levels.

The supply contract should include a lead time for the products, which is the time from the placement or confirmation of the order to delivery of the product, and require that the supplier meet the set lead times, and maintain inventory and a pipeline of raw materials and components, as well as capacity, to do so.

For a supplier to maintain sufficient inventory and capacity, it likely will request that the franchisor provide periodic forecasts of anticipated orders. The franchisor should work with suppliers to provide anticipated need as a business matter, and including forecasts as a term in supply agreements is relatively standard. Considerations in connection with forecast provisions include whether the forecast is binding or non-binding on the franchisor and what level of inventory and capacity the supplier must maintain relative to the forecast.

If a franchisor agrees to language creating a binding forecast, the franchisor will be obligated to order and purchase a certain amount of products, and that amount will be tied in some way to the forecasted amount. Essentially, through the forecast, the franchisor agrees to a minimum purchase obligation. If a

36. The supply contract should describe the order and confirmation of order process and documentation requirements. In most supply contracts, the buyer places an order by sending the supplier a purchase order describing the quantity of the product(s) ordered, and the supplier is required to confirm receipt and the date by which it will fill the order. Use of these and a bill of lading and other shipping and delivery documentation are critical to measuring performance and ensuring products are made, shipped, and delivered on time and to specifications. The supply agreement should state that the terms of the supply agreement regarding ordering, shipping, and delivery supersede those documents and control the terms of the parties’ relationship to the extent any language included with the forms is inconsistent, e.g., different payment terms set forth on the supplier’s invoice in order to avoid a “battle of the forms.”

37. More specifically, manufacturing lead time is the “total time required to manufacture an item, including order preparation time, queue time, setup time, run time, move time, inspection time, and put-away time. For make-to-order products, it is the time taken from release of an order to production and shipment. For make-to-stock products, it is the time taken from the release of an order to production and receipt into finished goods inventory.” Manufacturing Lead Time Definition, BUS. DICTIONARY, http://www.businessdictionary.com/definition/manufacturing-lead-time.html#ixzz4HdWvux7S (last visited Aug. 29, 2016).


39. Further, in some cases, the supplier may be seeking a certain purchasing volume to compensate for initial start-up costs and/or ensure that pricing and margins remain consistent with its assumptions of volume and return on investment. If the parties do agree on some minimum
minimum purchase obligation is not intended, language within the lead time clause should make clear that the forecasts are non-binding and place no obligation on the franchisor or franchisees to purchase certain quantities.

The obligation on the supplier to maintain inventory and capacity to meet lead times for products is often expressed as a percentage of the forecasted amount. For example, the supplier will be required to fill orders within the specified lead time up to 100 percent or 125 percent of the forecasted amount before the supplier will be entitled to relief from supplying the product within the required lead time. Suppliers, of course, want to have some assurances that they will not be left with too much inventory of products or of raw materials and components or be required to carry the same for long periods. These concerns can be addressed through automatic reduction of the required percentage of capacity if forecasted amounts are not met and/or a requirement that the franchisor make additional purchases if the actual purchases are significantly lower than the forecast.

B. Warranties

Supplier warranties are important terms in supply contracts. Warranties obligate the supplier to provide products that meet and conform to set standards. As discussed later, franchisors and suppliers should consider and be aware of the impact of the Uniform Commercial Code (U.C.C.) pertaining to warranties, but in most supply contracts the supplier disclaims U.C.C. warranties and the parties agree on express warranties that are stated in the supply contract. Indeed, a franchisor should expressly list and describe the supplier warranties it intends to include instead of relying on implied disclaiming intended warranties.40 The franchisor should require that the supplier expressly warrant that the products will be made to specifications and standards, fit for intended purposes, provided in compliance with labeling requirements, and will not be adulterated or misbranded.41 Nonetheless, purchase commitment, care in drafting should be taken to ensure precision in the obligation and the remedies for failure to order the minimum quantity, e.g., a sliding scale or a tiered pricing structure, with supplier’s prices decreasing as volume of purchases increases. Other options in drafting to satisfy supplier’s concerns include (1) franchisor paying a portion of supplier’s start-up costs, (2) franchisor working with supplier on other projects, and/or (3) franchisor making an additional payment if volumes are not reached (after notice and opportunity to cure).

40. While beyond the scope of this article, other articles of the U.C.C. may apply; for example, if financing and security are parts of the arrangement or to the extent warehousing is part of the services, Articles 7 and 9 may also apply and need to be considered.

41. This is not an exhaustive listing of the representations and warranties from a supplier that a franchisor should seek to include in a supply agreement. In addition, supplier representations and warranties should also include that the products will be sold free and clear of all liens and encumbrances and with good title; the supplier will not infringe on any third party’s intellectual property rights; and the supplier is in full compliance with applicable law, including with respect to the supply chain and its suppliers and operations of facilities; and the supplier is not on any watch lists, etc. (see below). These are in addition to the normal and customary representations and warranties, e.g., that supplier has the corporate authority to enter into the supply agreement and will not breach any other contract or obligation to a third party in doing so. This article
a franchisor negotiating supply agreements should have a basic understanding of the warranties in the U.C.C. because they provide context for negotiating and drafting supply agreements.

U.C.C. Article 2 provides for certain express and implied warranties in contracts for the sale of goods. Almost every state has adopted the U.C.C. and Article 2. Although some variations exist from state to state, the basic tenets are fairly uniform and consistent with the U.C.C. Below are some of the basic aspects of warranties.

The U.C.C. recognizes express warranties of the supplier. Express warranties include statements of fact, promises made, and descriptions provided by the supplier relating to the goods, which are made part of the basis of the bargain, and also include samples or models provided by the supplier that are made part of the basis of the bargain; such representations constitute a warranty that the goods will conform to the statement of fact, description, or model. Express warranties must be stated in the contract or the merger and integration clause(s) will be deemed to supersede them. Including written specifications and descriptions of the goods, as well as standards applicable to the goods, in schedules attached to the supply agreement is one preferred way to create an express warranty.

The U.C.C. also provides for implied warranties, which are automatically included in contracts for the sale of goods unless they are disclaimed. These include merchantability, “fitness for a particular purpose,” non-infringement, title, and freedom from encumbrances. The implied warranties focus on warranties from supplier to franchisor or the buyer pursuant to supply agreements. Of course, the warranties to the consumer from, among others, the supplier, are important as well, although beyond the scope of this article.

42. Article 2 of the U.C.C. governs sales of goods of over $500 between merchants (as defined therein) and, in the absence of a disclaimer or specific terms regarding the warranties (and other terms otherwise applicable), applies to most supply transactions. Article 2 has been adopted by forty-nine states (Louisiana is the single exception). Although largely uniform, states can and have adopted the U.C.C. and Article 2 with some modifications so it is important to review the state specific commercial code. See generally Martin Carrara, The Basics of U.C.C. Article 2–Sales, ASS’N OF CORP. COUNSEL (June 2013), http://news.acca.com/accnj/issues/2013-06-07/3. html. Links to the commercial code as adopted by various states may be found at the Cornell University Law School Legal Information Institute website at http://www.law.cornell.edu/uniform/uss/html.

44. See generally Carrara, supra note 42.
45. U.C.C. § 2-314, which generally provides that the goods will pass without objection in the trade.
46. U.C.C. § 2-315, which applies if the supplier has reason to know the buyer’s particular purpose for which the goods are being purchased; and if the buyer is relying on the supplier in that regard, the supplier is deemed to warrant that the goods will meet that purpose for which the buyer intends to use them.
47. U.C.C. § 2-312(3), which is a warranty that the goods will not infringe on the rightful claim of a third party.
48. U.C.C. § 2-312(1)(a), which is a warranty that the supplier has and transfers good title to the buyer.
49. U.C.C. § 2-312(1)(b), which is a warranty that the goods are sold free and clear of any liens, security interests, or other encumbrances.
warranty of merchantability and the implied warranty of fitness for a particular purpose apply only in certain sales of goods. The implied warranty of merchantability applies only in sales where the supplier is a merchant in the goods of the kind sold.\(^{50}\) The implied warranty of fitness for a particular purpose applies only where the supplier knew or had reason to know of the specific purpose for which the buyer needed the goods at the time of the sale.\(^{51}\)

As noted above, suppliers often disclaim the U.C.C. warranties. The U.C.C. provides that the implied warranties may be disclaimed.\(^{52}\) Courts often will enforce such disclaimers and limits.\(^{53}\)

C. Responsibility for Shipping Costs, Risk of Loss, and Transfer of Title

The supply agreement should specify where and how the supplier will ship and deliver the goods, including which party bears the cost and risk of loss up to and in the transition of possession and title. Allocation of, and obtaining reliable data about, the costs and risks of loss are critical to being able to assess the impact of unit economics on the supply chain.

There are multiple ways to allocate these costs and responsibilities, from situations in which the buyer takes possession and title at the manufacturing facility and bears all transportation costs and risks thereafter, to an arrangement whereby the seller is responsible for shipping to the buyer’s designated location, and everything in between. There are terms regularly used to describe these various arrangements.

Many contracting parties use Incoterms (known otherwise as International Commercial Terms), which are a series of defined commercial terms published by the International Chamber of Commerce (ICC) that are updated periodically—most recently in 2010.\(^{54}\) While originating in an international context, Incoterms can be used in any supply or related distribution agreement, whether a domestic or cross-border agreement or agreement with domestic and international content, as is the case with many U.S. contracts given that components or other raw materials often originate outside of the United States. Incoterms provide good examples of the various

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\(^{50}\) U.C.C. § 2-314.

\(^{51}\) U.C.C. § 2-315.

\(^{52}\) U.C.C. § 2-316. The U.C.C. provides that to effectively disclaim the warranties of merchantability and fitness for a particular purpose, the disclaimer must be in a “conspicuous” writing (often bold and/or all caps) and that to disclaim the warranty of merchantability, the word “merchantability” also must be specifically included.


arrangements concerning shipment and delivery of goods and allocation of responsibility for costs and risk of loss in connection with the same. Current Incoterms categories and definitions are provided in the footnotes.\textsuperscript{55} How-

\textsuperscript{55} Id. A list with general definitions taken from the ICC website follows:

- **EXW/Ex Works**—“Ex Works” means that the seller delivers when it places the goods at the disposal of the buyer at the seller’s premises or at another named place (i.e., works, factory, warehouse, etc.). The seller does not need to load the goods on any collecting vehicle nor does it need to clear the goods for export, where such clearance is applicable.

- **FCA/Free Carrier**—“Free Carrier” means that the seller delivers the goods to the carrier or another person nominated by the buyer at the seller’s premises or another named place. The parties are well advised to specify as clearly as possible the point within the named place of delivery because the risk passes to the buyer at that point.

- **CPT/Carriage Paid To**—“Carriage Paid To” means that the seller delivers the goods to the carrier or another person nominated by the seller at an agreed place (if any such place is agreed between parties) and that the seller must contract for and pay the costs of carriage necessary to bring the goods to the named place of destination.

- **CIP/Carriage and Insurance Paid To**—“Carriage and Insurance Paid to” means that the seller delivers the goods to the carrier or another person nominated by the seller at an agreed place (if any such place is agreed between parties) and that the seller must contract for and pay the costs of carriage necessary to bring the goods to the named place of destination. The seller also contracts for insurance cover against the buyer’s risk of loss of or damage to the goods during the carriage. The buyer should note that under CIP the seller is required to obtain insurance only on minimum cover. Should the buyer wish to have more insurance protection, it will need either to agree as much expressly with the seller or make its own extra insurance arrangements.

- **DAT/Delivered at Terminal**—“Delivered at Terminal” means that the seller delivers when the goods, once unloaded from the arriving means of transport, are placed at the disposal of the buyer at a named terminal at the named port or place of destination. “Terminal” includes a place, whether covered or not, such as a quay; warehouse; container yard; or road, rail, or air cargo terminal. The seller bears all risks involved in bringing the goods to and unloading them at the terminal at the named port or place of destination.

- **DAP/Delivered at Place**—“Delivered at Place” means that the seller delivers when the goods are placed at the disposal of the buyer on the arriving means of transport ready for unloading at the named place of destination. The seller bears all risks involved in bringing the goods to the named place.

- **DDP/Delivered Duty Paid**—“Delivered Duty Paid” means that the seller delivers the goods when the goods are placed at the disposal of the buyer, cleared for import on the arriving means of transport ready for unloading at the named place of destination. The seller bears all the costs and risks involved in bringing the goods to the place of destination and has an obligation to clear the goods not only for export but also for import, to pay any duty for both export and import, and to carry out all customs formalities.

In addition, the Inco terms include the following, which apply to sea and inland waterway transport:

- **FAS/Free Alongside Ship**—“Free Alongside Ship” means that the seller delivers when the goods are placed alongside the vessel (e.g., on a quay or a barge) nominated by the buyer at the named port of shipment. The risk of loss of or damage to the goods passes when the goods are alongside the ship, and the buyer bears all costs from that moment onwards.

- **FOB/Free on Board**—“Free On Board” means that the seller delivers the goods on board the vessel nominated by the buyer at the named port of shipment or procures the goods already so delivered. The risk of loss of or damage to the goods passes when the goods are on board the vessel, and the buyer bears all costs from that moment onwards.
ever, caution should be taken to define the meaning of the terms based on the selected Incoterm as it is intended to be used in the agreement. The use of Incoterms has become casual in both business and legal usage, the Incoterms change periodically, and similar acronyms and abbreviations used by various suppliers have different meanings.

Indeed, defining the meaning of the terms used and specifically describing the allocations of costs and responsibility for shipment and delivery are also important for purely domestic supply contracts because the U.C.C. Article 2 includes shipping and delivery terms as well. The same acronyms or three letter abbreviations used under the U.C.C. are sometimes different in the Incoterms, and there are variations among states with respect to the shipping and delivery terms under the various commercial codes.

D. Inspections

The supply contract should address the inspection of the product and requirements for notifying the supplier of defects, non-conforming products, and under supply. Typically, the franchisor or franchisee will be obligated to provide prompt notice (a few days or less for perishable products) of defects that should be obvious from initial inspection and a longer period or as soon as reasonably practicable after discovery for latent defects. Further, to ensure quality standards are being met and products are being manufactured to specifications at the factory, as well as in compliance with laws concerning factories and working conditions, the franchisor should have the right to inspect and audit frequently.

- **CFR/Cost and Freight**—“Cost and Freight” means that the seller delivers the goods on board the vessel or procures the goods already so delivered. The risk of loss of or damage to the goods passes when the goods are on board the vessel. The seller must contract for and pay the costs and freight necessary to bring the goods to the named port of destination.

- **CIF/Cost, Insurance, and Freight**—“Cost, Insurance, and Freight” means that the seller delivers the goods on board the vessel or procures the goods already so delivered. The risk of loss of or damage to the goods passes when the goods are on board the vessel. The seller must contract for and pay the costs and freight necessary to bring the goods to the named port of destination. The seller also contracts for insurance cover against the buyer’s risk of loss of or damage to the goods during the carriage. The buyer should note that under CIF the seller is required to obtain insurance only on minimum cover. Should the buyer wish to have more insurance protection, it will need either to agree as much expressly with the seller or to make its own extra insurance arrangements.

*Id.*

56. Further, in international supply agreements, for several reasons, the authors recommend expressly disclaiming that the United Nations Convention on Contracts for the International Sale of Goods applies to the agreement. Because Incoterms are incorporated into the Convention, the parties should expressly include and define the desired terms to avoid inadvertently disclaiming Incoterms they intended to incorporate into the supply agreement.

57. U.C.C. § 2-319.

58. Carrara, *supra* note 42.

59. Use of technology and any requirements with respect to delivery times should be addressed in the supply agreement; franchisors should be aware of the inspection and notice practicalities “on the ground.” For example, with hand held readers used by the driver of the delivery
E. Establishing Key Performance Indicators (KPIs) for Measuring Supplier Performance, Modifying Metrics, and Consequences for Failed KPI Performance or Incentives for Exceeding KPI Performance

1. Measuring Supplier Performance Using KPIs

A franchisor invests significant money and undertakes risk in any supply relationship. The investment and risks include allocating research and development, sourcing, logistics and marketing resources to the relationship; undertaking the risks of monetary loss if the supplier fails to perform or products are defective; and undertaking the risk of harm to the franchisor’s reputation if the supplier fails to perform and damages customer esteem for the brand. In order for a franchisor to manage expectations about the supplier’s performance and these risks, much work is needed after the supply contract is executed. One important post-execution method involves the use of KPIs to measure performance metrics material to the performance of the supplier—metrics which, if the supplier meets or exceeds, will likely enhance the value of the franchise system and which, if the supplier fails to meet, will likely devalue the franchise system.

Franchisors commonly focus on measures of past actions, i.e., “results indicators,” to gauge performance.60 Examples of results indicators include customer loyalty and satisfaction and brand recognition.61 Although results indicators can demonstrate whether a business is moving in the right direction toward achieving the factors critical to its ongoing success and health (critical success factors), results indicators do not reveal what a company can do to improve the results.62 Conversely, KPIs are current or future-oriented measures of performance. They contribute to improved results achieving critical success.63 Effective KPIs generally have the following common factors: nonfinancial or financial measures; measured periodically on a consistent basis, normally starting with the supplier’s self-report scorecard; reviewed and determined by the franchisor’s management with the results communicated to the supplier with performance measurements; and, if applicable, corresponding corrective actions that are easily understood.64

2. Implementing KPIs

Using the statement of work that describes the services the supplier is required to provide under the supply agreement, a franchisor should first iden-
tify the critical success factors, i.e., those aspects of the services that are key to maintaining a successful relationship. Different categories of suppliers will require industry-specific approaches to developing KPIs. Transportation service providers may be measured only on cost savings achieved from the arrangement, whereas advertising agencies of record may be measured on less quantitative metrics, including brand engagement, brand health, and customer loyalty. Other suppliers may provide services where quality of performance, market growth, or capturing a specific market is integral to the franchisor receiving value from the arrangement with such supplier.

KPIs are normally measured by a supplier daily or weekly, recorded on the self-report scorecard (as referred to above) monthly, and submitted to the franchisor. The franchisor cross-checks the scorecard against its internal data on the supplier’s performance, and the parties discuss the scorecard during periodic business review meetings between the franchisor and supplier during which corrective action plans are established for any unsatisfactory KPIs. This ongoing assessment of supplier performance provides the opportunity for the franchisor to identify supplier issues early and prescribe the appropriate corrective action as well as ensure accountability of the supplier for its performance to maximize the benefits to the franchisor and the franchise system. In some cases where the potential economic opportunity or loss is significant, use of KPIs may be made more effective by incorporating a pain-share/gain-share program to drive supplier performance. Under such a program, the monetary consequences of exceeding performance (i.e., a premium payment) and failing to meet performance expectations (i.e., a charge to the supplier) are specified in the supply agreement. A charge may be made in the form of a credit to the franchisor’s and/or franchisees’ invoice costs (which may be adjusted through a distributor intermediary that actually purchases or facilitates the purchase of products from the supplier) or provides the opportunity for the supplier to receive incentive payments from the franchisor if the supplier exceeds the KPIs, which may be treated as an additional payment on the franchisor’s or franchisees’ product invoices.

An alternative and the more common approach to managing supply relationships is for the franchisor and supplier to enter into an agreement setting forth certain obligations of the supplier and revisit the details of the supplier’s obligations only when the relationship has become so fractured (e.g., following franchisee complaints regarding performance or customer complaints regarding quality) that default and termination, which would necessitate a

65. Id.
66. For example, KPIs for a supplier of chicken to a fast-casual restaurant franchisor’s distributor may include KPIs for order entry and acceptance accuracy, conformance to quality standards/defects in product, inventory management accuracy, cost competitiveness, on-time delivery, rate of rejection of product, and overall customer satisfaction.
68. Kaplan, supra note 67, at 90.
painful and costly wind down, transition, and replacement process, is the only viable option. If a franchisor desires to implement a more focused, measurement-driven approach to supplier performance, there are certain legal implications worth considering.

3. Legal Considerations for Establishing KPIs

Ensuring that KPIs are objective measurements and that enforcement is consistent across suppliers is imperative to avoiding pitfalls. However, pitfalls commonly arise in connection with the termination of a supplier for failure to satisfy specified benchmarks of performance in the form of claims by such supplier for breach of contract.69

Subject to compliance with certain disclosure requirements under the FTC Franchise Rule,70 a franchisor is free to require that franchisees make certain purchases of goods and services integral to the franchised business only from suppliers approved by the franchisor. The requirement that franchisees make certain purchases only from franchisor-approved suppliers is commonplace in the franchise industry. However, a few states require that a franchisor satisfy certain conditions in connection with any restrictions imposed on franchisees with respect to sourcing and supplier selection.71

In addition, courts have imputed an obligation of a franchisor to manage performance of its franchisees’ suppliers—notwithstanding the typical disclaimers in franchise agreements that a franchisor makes no warranties with respect to products and services provided to franchisees by its approved suppliers and franchisees must look solely to the supplier for any defects or claims related to such products or services. In Ponderosa Systems, Inc. v.
Brandt, following a brief, unsuccessful period operating its Ponderosa Steakhouse Restaurant, a franchisee was sued by its franchisor for failing to pay royalty fees and payment for supplies. The former franchisee filed counterclaims for breach of contract, breach of implied warranties, breach of duty of good faith and fair dealing, and fraud. The former franchisee claimed that the reason its Ponderosa Steakhouse failed was the repeated shipment of meat that arrived at its Ponderosa Restaurant defective and inferior in quality. At trial, the former franchisee presented evidence that the franchisor had received numerous complaints from franchisees and customers that the meat products were of “poor quality, poor consistency, odorous, spoiled, rotten and rodent damaged” but refused to allow the former franchisee to purchase meat products from another supplier. The franchisee prevailed on its counterclaims and defeated the franchisor’s claims.

Failure to manage supplier performance may result not only in liability of a franchisor to its franchisees, but also to its franchisees’ employees and customers. For example, franchisor Mercedes-Benz USA, LLC (MBUSA) required its franchisees to use certain suppliers in the finish out of retail showrooms, including the supplier of the showroom floor finish. After sustaining injuries from a fall in a Mercedes-Benz franchisee’s showroom, an injured customer brought a negligence claim against MBUSA because its authorized supplier provided the franchisee’s floor finish that caused the customer’s fall. The court denied MBUSA’s motion to dismiss and allowed the customer’s negligence claim to proceed against MBUSA.

Finally, and perhaps the strongest case for managing supplier performance, Chipotle Mexican Grill continues to serve as a warning of the importance of ensuring that suppliers perform in accordance with the company’s product specifications and applicable law. Despite its attempt to recover following an outbreak of E. coli in Chipotle restaurants last fall by implementing food safety requirements for its suppliers and restaurants, Chipotle continues to report double-digit declines in earnings quarter after quarter, rapidly heading for what some anticipate may be the demise of the com-

72. 767 F.2d 668, 670 (10th Cir. 1995).
73. Id. at 671.
74. Id. at 672.
75. Id. at 671–73.
76. Id.
78. Id.
79. Id. at *3–4 (citing Wise v. Kentucky Fried Chicken, 555 F. Supp. 991, 995 (D.N.H. 1983) (finding that a franchisor could be held directly liable for injuries sustained by a franchisee’s employee during use of a pressure fryer purchased by such franchisee from the franchisor’s approved supplier); Whitten v. Kentucky, 570 N.E.2d 1353, 1356–57 (Ind. Ct. App. 1991) (finding a franchisor could be held directly liable for injuries sustained by a franchisee’s employee where the franchisor recommended or selected specific equipment for the franchisee that injured its employee)).
The impact of this type of crisis for a franchisor would be devastating, with the franchisor likely facing claims from franchisees for failing to maintain the integrity of the brand reputation in addition to claims from regulatory authorities and customers for failing to comply with health and food safety standards or data security and consumer privacy standards.\(^\text{82}\)

\[\text{G. Insurance}\]

Insurance is an important tool available to franchisors to assist in managing and mitigating risk in the supply chain. Although the franchisor should have its own insurance, requiring the supplier to carry insurance can be even more important in managing risk. Therefore, terms in the supply agreement pertaining to required insurance are important and should not be left to boilerplate.

The supply agreement should set forth the types of insurance and the amounts of coverages, require certain provisions extending the coverage to benefit the franchisor, and set standards for the rating of the insurance carrier. In connection with the types of insurance and amounts, the franchisor should assess the risks and exposures with respect to the supplier, the product, and the supply chain. This includes evaluation of, among other things, the nature of the product(s) the supplier is providing, the supplier’s experience, wherewithal and reputation, and the location and method of transit to be used to transport the product(s). Involving a risk manager is often an important part of this analysis.\(^\text{83}\)

In the supply agreement’s insurance provision, the franchisor should require that the supplier have several key provisions in the supplier’s policies. These include: that the franchisor and affiliates, successors, and assigns (company indemnitees) are additional insureds; a standard separation of insureds provision; an endorsement providing that coverage for the company indemnitees will be primary to and not contributory to any policies carried by franchisor; and an endorsement in which the insurance carrier waives any rights of subrogation with respect to the company indemnitees. Further, to ensure the supplier does in fact obtain and maintain the insurance, it is important to include in the supply agreement the requirement that the supplier must provide the franchisor with evidence of the insurance in the form of


\(^\text{82}\) Although devastating incidents of suppliers failing to perform in a restaurant system typically involve food recalls or food safety issues, a data breach can be equally catastrophic to a restaurant system. In February 2016, Wendy’s experienced a criminal cyber-attack that affected over 1,000 franchised restaurants that Wendy’s believes resulted from a compromise of the service provider’s credentials that services its franchisees. Tribune Media Wire, *Wendy’s Releases List of Over 1,000 Restaurants Affected in Credit Card Hack*, ABC 16 WNEP (July 7, 2016), http://wnep.com/2016/07/07/wendys-releases-list-of-over-1000-restaurants-affected-in-credit-card-hack/.

\(^\text{83}\) For example, if the supplier is located in a part of the world prone to political unrest or will be shipping products through a region where political unrest is a concern, a franchisor should consider requiring the supplier to obtain political risk insurance.
III. Corporate Social Responsibility

Corporate social responsibility (CSR), sometimes called supply chain transparency, is a broad phrase referring to a company’s business practices on issues like human rights, fair labor practices, the environment, and ethical sourcing. While there is no uniform definition, the “most often cited definition” is “[t]he social responsibility of business encompasses the economic, legal, ethical, and discretionary expectations that society has of organizations at a given point in time.” Such responsibility is not merely aspirational. Companies today face potential liability or reputational damages if suppliers commit illegal or unethical acts, such as human rights violations, unethical employment practices, environmental harm, bribery, or corruption. As discussed later, new federal and state laws increasingly require companies to make disclosures or undertake affirmative acts regarding their supply chains and impose potential criminal or civil liability for noncompliance. Aside from legal liability, companies risk public condemnation and resulting loss of business for their suppliers’ unethical or inhumane conduct.

Faced with such potential liability and reputational concerns, it is a best practice for franchisors doing business in the United States, even privately held franchisors, to implement a CSR compliance program. A carefully drafted and properly enforced CSR program can help a franchisor comply with CSR-related laws and regulations, preempt costly lawsuits and noncompliance actions, maintain reputational capital and competitive advantage, and enhance consumer sentiment and system morale.

84. An ACORD certificate of insurance is generally not considered to be legal evidence of insurance and does not itself provide insurance or alter the terms of the policy. See W. Rodney Clement Jr., Is A Certificate of Commercial Property Insurance a Worthless Document?, PROBATE & PROP., May/June 2010, at 48. Therefore, many supply agreements provide the right to the franchisor to obtain copies of the policies.


89. See, e.g., Hirose, supra note 86, at 48–54; Ostrau & Walter, supra note 87.
CSR-related violation does occur, the existence of a robust CSR policy may be a mitigating factor in any punishment.90

This section discusses key CSR-related laws and regulations that may impact a franchisor’s supply chain, voluntary programs, best practices for developing and implementing a CSR compliance program, and important contractual terms to consider for supply chain contracts.

A. Key CSR-Related Laws and Regulations

A handful of laws in the United States specifically impose CSR-related due diligence or disclosures obligations on covered entities.

1. Conflict Minerals Rule

Under the Security Exchange Commission’s (SEC) Conflict Minerals Rule, which was enacted as part of the Dodd-Frank Act, companies that are subject to the reporting requirements of Sections 13 or 15(d) of the Securities Exchange Act of 1934 must conduct due diligence and make annual disclosures on SEC Form SD regarding use of “conflict minerals” in their products.91 Conflicts minerals are cassiterite, columbite-tantalite (coltan), gold, wolframite, derivatives of these minerals (including tin, tantalum, and tungsten), and other minerals designated by the U.S. Secretary of State that originate from the Democratic Republic of the Congo or the neighboring countries of Angola, Burundi, the Central African Republic, the Republic of the Congo, Rwanda, South Sudan, Tanzania, Uganda, and Zambia (collectively, the covered countries).92 Such minerals are used in many common products, including electronics, automobiles, jewelry, industrial machinery, and medical devices.93

Like any company doing business in the United States, franchisors must comply with the Conflict Minerals Rule if the franchisor files reports under the Securities Exchange Act as noted above, and manufactures, or contracts with a supplier to manufacture, products in which conflict minerals are necessary to the functionality or production of the product.94 Whether a franchisor will be deemed to “contract to manufacture” a product “depends on the degree of influence it exercises over the materials, parts, ingredients, or components to be included in any product that contains conflict minerals

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94. 17 C.F.R. § 240.13p-1.
or their derivatives.” Merely affixing the franchisor’s brand, marks, logo, or label to a generic product manufactured by a third party does not trigger the Conflict Minerals Rule.

If a franchisor is subject to the Conflict Minerals Rule, it must conduct a “reasonable country-of-origin inquiry regarding the origin of its conflict minerals.” Although the rule does not prescribe the specific actions required for such inquiry, to satisfy the requirement, a franchisor must conduct a good faith inquiry regarding the origin of its conflict minerals to determine whether the minerals originated in a covered country or did not come from recycled or scrap sources. In general, a franchisor can satisfy the country-of-origin inquiry by obtaining authoritative representations from the relevant supplier that the conflict minerals did not originate in a covered country or came from recycled or scrap sources. If the country-of-origin inquiry reveals either of the foregoing conditions, the franchisor must report its findings to the SEC in Form SD.

If, based on the country-of-origin inquiry, a franchisor knows or has reason to believe that any of the conflict minerals originated in the covered countries (and are not from recycled or scrap sources), the franchisor must conduct a heightened due diligence review on the source and chain of custody of the minerals. The review must be conducted under a nationally or internationally recognized due diligence framework for the particular mineral at issue. At present, the only recognized framework is the Organisation for Economic Co-operation and Development’s (OECD) “Due Diligence Guidance for Responsible Supply Chains of Minerals from Conflict-Affected and High-Risk Areas.” Where such a heightened review was required, a franchisor must file, as an exhibit to Form SD, a Conflicts Minerals Report that includes an independent private sector audit, the company’s certification, and a description of the measures the company has taken to exercise due diligence on the source and chain of custody of the conflict minerals.

If a franchisor is not required to report under the Securities Exchange Act, no disclosure is required under the Conflicts Minerals Rule. Nevertheless, a

96. Id.
97. Id. at 56,280.
98. Id.
100. Id. at 2; Conflicts Minerals Disclosure Requirements Checklist, supra note 93; Ostrau & Walter, supra note 87.
102. Id. at 3.
104. Id. at 56,281; Husisian, supra note 99, at 3; Conflicts Minerals Disclosure Requirements Checklist, supra note 93; Ostrau & Walter, supra note 87.
non-reporting company may be part of the supply chain of a reporting company that asks (or contractually requires) it to cooperate under the Conflicts Minerals Rule. Thus, a non-reporting company that provides inaccurate responses may jeopardize its business relationships with its customers or may incur an obligation to reimburse customers’ fines, legal fees, and other costs under the parties’ contract. Because the focus of the Conflict Minerals Rule is the source of conflict minerals, not their destination, if a non-reporting franchisor obtains conflict minerals from a supplier that is a reporting company, there would be no reason for the reporting company to require any information from the franchisor in connection with the supplier’s obligations under the Conflict Minerals Rules. By contrast, if a non-reporting franchisor supplies products containing conflict minerals to a reporting franchisee or supplier, the franchisee or supplier may look to the franchisor for information in connection with franchisee’s or supplier’s disclosure obligations.

2. California Supply Chains Act

The California Transparency in Supply Chains Act (Supply Chains Act) requires every retail seller and manufacturer doing business in California with annual worldwide gross receipts exceeding $100 million to disclose its efforts, if any, to eliminate human trafficking and slavery from its supply chain. A franchisor that meets these criteria must conspicuously disclose on its website, or in writing upon request if the franchisor does not have a website, its efforts, if any, to: evaluate and address risks of human trafficking and slavery within its supply chain; audit suppliers regarding their compliance with the franchisor’s standards for trafficking and slavery in supply chains; require direct suppliers to certify their compliance with applicable laws regarding human trafficking and slavery; maintain internal accountability standards and procedures; and provide relevant training. “[T]he Supply Chain Act does not actually require covered retailers to do any of the five things listed above; they must simply say on their websites whether or not they do them.” An action for injunctive relief by the California attorney general is the exclusive remedy for a violation of the Supply Chains Act.

105. Conflicts Minerals Disclosure Requirements Checklist, supra note 93.
107. California and Maryland have passed laws prohibiting companies that fail to comply with the Conflict Minerals Rule from contracting with the state or its agencies. See CAL. PUB. CONT. CODE § 10490 (West 2016); MD. CODE ANN. § 14-413 (West 2016). Similar bills have been proposed but not yet passed in Connecticut and Massachusetts. See Proposed Bill No. 666, Conn. Gen. Assem., Jan. Sess. (Conn. 2013); S.B. 2463, 189th Leg., (Mass. 2016).
109. CAL. CIV. CODE § 1714.43(a)(1)-(5).
111. CAL. CIV. CODE § 1714.43(d). In April 2015, the California attorney general issued guidance for companies subject to the Supply Chains Act, including information on model disclo-
While the Supply Chain Act does not create a private right of action, enterprising plaintiffs’ attorneys have attempted to use companies’ disclosures under the Supply Chains Act as the basis for claims under California’s consumer protection laws, such as the California Unfair Competition Law\(^\text{112}\) and the Consumer Legal Remedies Act.\(^\text{113}\) For example, following reports of forced labor in the Southeast Asian fishing industry, plaintiffs filed consumer protection class actions against companies whose products include seafood from Thai suppliers, including \textit{Barber v. Nestle USA Inc}\.\(^\text{114}\) Although Nestle made the disclosures required by the Supply Chains Act, the plaintiffs claimed Nestle failed to disclose the “likelihood that seafood found in [Nestle’s cat food] is produced using forced labor.”\(^\text{115}\) The plaintiffs further alleged that Nestle’s disclosures about its “supplier code of conduct” suggested that forced labor is not present in Nestle’s supply chain, making its disclosures misleading or false.\(^\text{116}\) In dismissing \textit{Barber}, the district court found Nestle had no duty to disclose information not required by the Supply Chains Act and that its disclosures about its requirements for suppliers do “not mislead [consumers] into thinking that [Nestle’s] suppliers abide by those rules and meet those expectations in every instance.”\(^\text{117}\) While \textit{Barber} and other putative class actions based on Supply Chains Act disclosures have been dismissed,\(^\text{118}\) at least one putative class action pursuing similar theories remains pending.\(^\text{119}\)

Underscoring the importance of accuracy in a company’s disclosures, at least one court has noted that plaintiffs “would have actionable [misrepresentation] claims” if a company falsely disclosed “no possibility” of forced labor in its supply chain.\(^\text{120}\) Accordingly, while a company likely will not face liability

\(^{112}\) C AL.B US.&P ROF.C ODE §§ 17200–17210 (West 2016).

\(^{113}\) C AL.C IV.C ODE §§ 1750–1784 (West 2016).

\(^{114}\) No. 8:15-cv-01364 (C.D. Cal. filed Aug. 27, 2015).

\(^{115}\) \textit{Barber}, 154 F. Supp. 3d at 957.

\(^{116}\) \textit{Id.} at 962.

\(^{117}\) \textit{Id.} at 961, 964.


\(^{120}\) \textit{Wirth}, 2016 WL 471234, at *4.
for Supply Chains Act disclosures that focus on the company’s efforts, a customer may state a viable claim if the company overstates the results of its efforts.

Like any business, franchisors and franchisees doing business in California may be subject to the Supply Chains Act’s disclosure requirements. Nevertheless, although some franchisors have general statements on their websites regarding social responsibility or human rights, including references to the franchisor’s supplier code of conduct, very few franchisors have online disclosures that reference the Supply Chains Act and contain the specific information required by the Act. This is likely because most business format franchisors do not satisfy the Act’s $100 million threshold. Based on the statutory text, a franchisor doing business in California only needs to focus on its annual worldwide gross receipts—not the worldwide receipts of all franchisees in the system—in determining whether it must make Supply Chains Act disclosures.

3. Food Safety Modernization Act

All franchisors of food and restaurant concepts should be aware of the myriad rules and regulations under the Food Safety Modernization Act (FSMA), which establishes minimum standards for the safe growing, harvesting, manufacturing, transportation, storage, and packaging of food products. FSMA aims to ensure the U.S. food supply is safe by focusing more on preventing food safety problems rather than simply reacting to problems after they occur. FSMA violations can result in criminal sanctions (including imprisonment) and significant civil penalties. Indeed, fol-


123. CAL. CIV. CODE § 1714.43(a)(1). Notably, by its express language, the Act focuses on the annual worldwide gross receipts of the specific “business entity,” not the aggregate receipts of the entity and its parent companies, affiliates, and subsidiaries. CAL. CIV. CODE § 1714.43(a)(2)(C) & (D).

124. A similar federal law has been introduced in the U.S. House of Representatives but has not yet passed. If passed, the Business Supply Chain Transparency on Trafficking and Slavery Act, H.R. 3226, 114th Cong. §§ 1–3 (2015), would amend the Securities Exchange Act of 1934 to require all reporting companies to disclose their efforts to address forced labor, human trafficking, slavery, and child labor within the companies’ supply chain.


lowing the successful prosecution of executives of Peanut Corporation of America following a salmonella outbreak, the DOJ announced in April 2016 that, in conjunction with the FDA, it has adopted a policy of initiating criminal investigations against any company that sells a product that causes human illness.

In addition to well-publicized regulations governing menu labeling, the FDA has promulgated regulations that mandate supplier verification for all food sold in the United States. The FDA’s Hazard Analysis and Risk-Based Preventative Controls and Foreign Supplier Verification Program final rules impose supplier verification requirements on all food facilities that are required to register with the FDA and all food importers. Food facilities must implement supply chain controls to ensure that certain foods or ingredients for which a hazard has been identified are received only from approved suppliers. Approved suppliers are those approved by the facility after considering various factors, including a hazard analysis of the food, the entity controlling that hazard, and supplier performance. In addition, for each food it imports, an “importer”—the person or entity in the United States who, at the time of U.S. entry, either owns the food, has purchased the food, or has agreed in writing to purchase the food—must develop, maintain, and follow a Foreign Supplier Verification Program that provides “adequate assurances” that its foreign supplier is producing food in a manner that meets U.S. safety standards, is unadulterated, and complies with allergen-labeling requirements.

132. U.S. Dep’t of Health & Human Servs./U.S. Food & Drug Admin., Key Requirements: Final Rule on Preventative Controls for Human Food (Sept. 10, 2015), http://www.fda.gov/downloads/Food/GuidanceRegulation/FSMA/UCM461834.pdf. Another entity in the supply chain, such as a broker or distributor, can conduct supplier verification activities under the Preventative Controls Rule, but the receiving facility must review and assess that entity’s documentation of the verification of control of the hazard. Id.
133. Id.
134. U.S. Dep’t of Health & Human Services and U.S. Food & Drug Administration, Key Requirements: Final Rule on Foreign Supplier Verification Programs (Nov. 13, 2015), http://www.fda.gov/downloads/Food/GuidanceRegulation/FSMA/UCM472890.pdf. An importer can rely on a third party (other than the foreign supplier) to determine and perform appropriate supplier verification activities, but the importer must review and assess the relevant documentation. Id.
Depending on the nature of its business and scope of its supply chain, other potentially relevant U.S. laws or rules may include the Foreign Corrup­tion Practices Act, which prohibits companies subject to SEC reporting requirements from giving money or anything of value that it knows will be used to bribe foreign officials and which imposes bookkeeping and internal control requirements on such companies; the U.S. Travel Act, which forbids the use of U.S. mail, interstate or foreign travel, or “any facility in interstate or foreign commerce” for the purposes of committing an unlawful act (including bribery) or distributing the proceeds of an unlawful act; the 2012 Executive Order 13,627, which prohibits federal government contractors from engaging in specific human trafficking-related activities and which requires certain contractors to certify implementation of an anti-trafficking compliance plan; and the Sarbanes-Oxley Act, which sets out rules and regulations regarding the necessary accuracy in the financial disclosures of public companies.

B. Voluntary Programs

The Customs-Trade Partnership Against Terrorism (C-TPAT) is a voluntary supply chain security program led by U.S. Customs and Border Protection (CBP) that seeks to align security requirements and maximize efforts to facilitate the movement of legitimate cargo. To become a certified partner in the C-TPAT program, a company must conduct a security risk assessment to determine the risks the company faces and how it mitigates those security challenges, submit an application, and agree to voluntarily participate in the program and complete a supply chain security profile that explains how the company is meeting C-TPAT’s minimum security criteria. In addition to good corporate citizenship and playing an active role in the war against terrorism, the CBP claims the benefits of the program include fewer CBP inspections, priority processing for inspections, penalty mitigation under certain circumstances, an assigned security consultant, and the ability to compete for contracts that require C-TPAT membership.

C. Developing a CSR Program

When designing a CSR program, a franchisor should assemble a team comprised of representatives from legal, human resources, compliance, and the specific business units subject to supply chain risk, including procurement, sales, and manufacturing; designate a high-level executive or owner to act as

point person in developing, implementing, and enforcing the CSR program; and identify applicable laws and regulations, assess the company’s culture, mission, and goals, and evaluate actual and potential supply chain liability. An effective CSR program requires the support of senior leadership. 140

A comprehensive CSR program should include a code of conduct that requires officers, employees, suppliers, agents, and business partners to meet or exceed relevant legal, regulatory, and industry standards. A written code of conduct reflects the company’s high-level commitment and establishes guidelines to allow the franchisor to make decisions that are consistent with the law and the company’s values. CSR procedures set out the acts or means to ensure compliance with the code’s supporting policies, including audit procedures, oversight mechanisms, and a process for responding to potential violations. 141

A franchisor should ensure that its executives, employees, and any third parties who must comply with the CSR program, including suppliers, are trained in and understand the program. 142 Independent internal and external auditing ensures that any defects in the procedures developed are identified early and can be resolved quickly.

D. Key CSR-Related Provisions for Supplier Contracts

In connection with its CSR program, a franchisor should consider including several provisions in supply chain agreements:

- Require the supplier to meet certain minimum CSR standards imposed by law or, if higher, the franchisor or other organizations. For example, a franchisor could contractually require its supplier be a certified C-TPAT partner or implement and enforce policies that meet or exceed the security practices required by C-TPAT.
- Grant the franchisor the right to audit the supplier.
- Require the supplier’s full cooperation in any internal investigation or review by the franchisor.
- Require the supplier to immediately notify the franchisor of any actual or potential nonperformance or CSR problems.
- Authorize the franchisor to contact the relevant authorities regarding a CSR violation.
- Require the supplier to consent to and implement any franchisor-developed action plan, changes, or both to the supplier’s CSR program in case of non-compliance.

140. See, e.g., Hirose, supra note 86, at 48–54; Ostrau & Walter, supra note 87.
141. Id.
142. Training should explain why CSR is important to the franchisor, teach trainees the required CSR policies and procedures, provide copies of or access to the franchisor’s comprehensive CSR program documents, and explain the potential personal and corporate liabilities and consequences of violating the CSR program and applicable laws.
• Require the supplier’s ongoing certification of the continued accuracy of the representations and warranties described below.

• Include a robust indemnification provision in the franchisor’s favor.\textsuperscript{143}

A franchisor should consider requiring a supplier to represent and warrant that it:

• Is (and will remain) in compliance with applicable CSR laws and regulations, as well as the franchisor’s code of conduct;

• Requires its subcontractors to do the same;

• Provides its workers with a safe work environment that complies with applicable environment, labor and employment laws, and the franchisor’s code of conduct;

• Refrains from corrupt practices, human rights violations, and certain activities connected to coerced and child labor.

IV. Conclusion

Implementing an effective supply chain is one of the most important things a franchisor can do to promote the success of the franchise system and its franchisees. Franchisors should work to identify reputable suppliers that can consistently provide high quality products to franchisees and customers on the schedule and budget the system requires. After selecting a supplier, a franchisor should ensure that the resulting supply chain contract contains terms aimed at achieving timely supply of conforming products, including provisions regarding the supplier’s required inventory and ability to meet forecasts; responsibility for shipping costs, risk of loss, and transfer of title; warranties; inspections; and insurance. We further recommend that franchisors include objective KPIs and provisions for a corrective action plan in the supply chain contract to manage supplier performance and promptly resolve performance issues. In addition, franchisors must be aware of the growing number of CSR-related laws and regulations that may impact their supply chains and include appropriate terms in the supply chain contract regarding minimum CSR standards, inspections and audits, indemnification, cooperation, and representations and warranties to allow the franchisor to meet its CSR-related obligations.

The Franchisor’s Right of First Refusal: An Automotive Industry Perspective

Joseph S. Aboyoun

The law governing rights of first refusal (ROFR) under automotive franchise agreements is not unlike the law governing ROFRs in other franchise contexts or even in other areas of law, e.g., real estate. However, peculiar nuances in the law concerning automotive ROFRs deserve special attention. This article will explore the various legal issues surrounding the ROFR in the automotive context.

The ROFR was absent from dealer franchise agreements for many years. It did not arrive on the scene until 1980 when General Motors became the first automotive manufacturer to include it in its dealer agreement. Over time, every dealer franchise agreement came to include this feature.2

Despite the introduction of the ROFR in the automotive arena, its exercise was uncommon.3 Exercising a ROFR was rare throughout most of the 1990s and early 2000s, but the last ten years have shown a significant increase in franchisor exercise.4 Franchisors consider it in virtually every deal in re-

1. For purposes of this article, “automotive” refers to the retail motor vehicle dealership business.
2. Chrysler introduced the ROFR concept in its dealer agreements in 1987; Toyota/Lexus in 1989; Mercedes-Benz in 1992; Ford in 1995; Audi/VW in 1996; and Acura/Honda in 2002.
3. As a young automotive franchise attorney in the 1980s, the author was somewhat unfamiliar with ROFRs under dealer (franchise) agreements. This was not just a function of inexperience. The ROFR was absent from many dealer franchise agreements at that time. Another reason for that unfamiliarity was the dearth of transactions where the automotive franchisor actually exercised the ROFR. Indeed, it was not until near the end of that decade that the author encountered ROFR issues in a transaction involving the sale of two high-profile Cadillac dealerships in New Jersey wherein GM decided that the buyer, who had a notorious reputation as a “flamboyant” dealer, was not up to their standards. GM exercised its ROFR to the chagrin of the buyer and assigned one of the stores to an operator of its choice and simply decided to close the other, signaling a change in the landscape of motor vehicle dealership transactions.
I. ROFR

ROFR provisions in dealership franchise agreements are similar to ROFR provisions that appear in most franchise agreements. Essentially, these give the franchisor the right to step into the shoes of the contract buyer and either (1) acquire the dealership in its own right; or (2) assign the right and obligation to purchase to a preferred operator. This is typically another franchisee of the same product line in excellent standing with the franchisor.

The following are some of the typical ROFR provisions:

(1) Exercise Period/Deadline. Most dealer agreements establish a time period within which a franchisor must exercise the ROFR. This typically ranges from fifteen business days to forty-five calendar days.

(2) Trigger Event. One of the more significant aspects concerns the timing of a ROFR exercise is what triggers the right and the running of the prescribed time period. The language in this regard is varied in franchise agreements. The common denominator is the time at which the contract buyer has completed and submitted its franchise application. Of course, the submission of the acquisition agreement is also important. Many automotive franchise agreements are surprisingly vague on this critical aspect.

5. Many manufacturers now routinely issue a letter to both the franchisor and the transferee (buyer) upon receipt of a transfer notice informing each of its ROFR rights.


7. In this instance, the franchisor can either operate the dealership itself temporarily until it finds a suitable buyer or simply terminate the franchise for marketing reasons.

8. For example, the current Ford sales and service agreement requires the exercise of the ROFR within thirty days of its receipt of a “completed proposal for the proposed sale or transaction.” ¶ 24(b)(2). Similarly, under the GM dealer sales and service agreement (standard provisions), the submission of a “proposal for a change of ownership” triggers the ROFR. ¶ 12.3.1. In contrast, in the Acura/Honda automobile dealer sales and service agreement, the ROFR is not triggered unless and until the franchisor has received the “completed documentation and information.” This is expressly specified as follows:

(1) the ownership transfer agreement(s) executed by Dealer (or Dealer Owner(s)) and the prospective buyer(s), including all exhibits, schedules, attachments, applicable real and personal property leases and any relevant “side” agreements relating to the transfer of money, value or other performance in exchange for the Ownership Interest or Assets; (2) the proposed third party purchaser’s application (as defined by American Honda); and (3) if a transfer of ownership of real property is contemplated and all of the preceding has been completed, a real estate appraisal and/or environmental report prepared in connection with or relied upon by the parties to, the proposed ownership transfer.

¶ 19.2. Needless to say, the Acura/Honda agreement leaves very little doubt as to what is required to commence the ROFR exercise period.
Reimbursement. Certain franchise agreements provide for the reimbursement of the buyer’s transactional expenses⁹ if the ROFR is exercised; however, many franchise agreements do not.¹⁰

Withdrawal Rights. Some franchise agreements entitle the selling dealer to withdraw a “buy-sell” agreement within a specified time after the ROFR is exercised,¹¹ although this is not a common provision.

Family Transfers. Many dealer agreements contain exemption provisions that do not allow the exercise of the ROFR in transactions involving family members.

Certain state franchise statutes override or modify the ROFR terms contained in the franchise documents, as discussed in Part II of this Article. The ROFR represents a significant tool for the manufacturer. It provides the opportunity to control the sale and the ultimate franchise representation in a particular market. It also averts a possible battle with the existing franchisee (seller) with regard to the qualifications of the contract purchaser—avoiding the possibility of protracted and costly litigation when the seller views a rejection of a prospective buyer as a violation of the franchise agreement or of applicable state (franchise) law.¹²

The exercise of a ROFR also brings a significant level of exposure for the franchisor. Upon the exercise of the ROFR, the franchisor effectively assumes the performance of the buyer’s obligations under the acquisition agreement. Depending upon the precise terms of the ROFR provision, as well as the pertinent provision of the state franchise statute, this may also require the purchase or lease of the dealership real estate and the reimbursement of transactional costs.

II. Statutory Regulation

As the exercise of the ROFR became more frequent, state legislatures responded with statutory restrictions and limitations. This is particularly the

⁹. Transactional expenses typically include attorney fees; accountant fees; and due diligence expenses, such as environmental studies and building inspection costs.

¹⁰. Even if the franchise agreement does not require reimbursement, several state franchise statutes do. See Part II infra.

¹¹. For example, the Chrysler sales and service agreement gives the dealer a specified time frame within which to withdraw the sale transaction. ¶ (Additional Terms and Provisions). The Mercedes-Benz passenger car dealer agreement also gives the selling dealer a ten-day period following MBUSA’s exercise of its ROFR to withdraw the deal (Art. IX B.3.). The Audi and VW dealer agreement limited this withdrawal right to transactions involving dealer owner, family members, dealership employees, and successors pre-approved by the franchisor, e.g., Audi Dealer Agreement Standard Provisions, Art. 12(3).

¹². Most (if not all) states provide a cause of action to the selling franchisee in the event that the franchisor arbitrarily or unreasonably rejects a qualified buyer, e.g., N.J. STAT. §§ 56:10-6, 56:10-29. See also Phyllis Alden Truby & David A. Beyer, Fundamentals 201: Transfer and Assignment in Franchising, ABA 37TH ANNUAL FORUM ON FRANCHISING (Oct. 15–17, 2014), App. C.
case with ROFRs in the automotive industry because many of these statutes apply only to automobile franchises.\textsuperscript{13} Other state franchise statutes do not explicitly address ROFRs.\textsuperscript{14}

Common features of the statutory provisions governing automotive ROFRs include:

1. The ROFR cannot be used by the franchisor to impair or influence the price to be paid for the franchise.
2. The franchisor must assume all obligations of the contract buyer as stated in the acquisition agreement.
3. The franchisor must reimburse the contract buyer for all transactional costs.
4. The franchisor must also purchase or lease the real estate if that component is part of the acquisition.

Many of the ROFR statutes establish a specific timeframe within which the franchisor must exercise the ROFR, which can be in conflict with the time prescribed under the pertinent franchise agreement. The statute will control the timing in such instances.

It should be noted that at least one state law expressly invalidates automotive ROFRs. Specifically, the Iowa franchise statute provides: “Notwithstanding the terms, provisions or conditions of an agreement or franchise, the sale or transfer, or the proposed sale or transfer of a franchisee’s dealership, or the change or proposed change in the executive management of a franchisee’s dealership shall not make applicable any right of first refusal of the franchiser.”\textsuperscript{15} Prior to the enactment of this statute, the Iowa Supreme Court, in \textit{Bob Zimmerman Ford, Inc. v. Midwest Auto I, LLC},\textsuperscript{16} declared BMWNA’s exercise of a ROFR to be invalid under the Iowa statutory provision, strictly limiting a franchisor’s ability to approve a change in ownership in the franchise.\textsuperscript{17}

Other statutes restrict the employment of the ROFR to varying degrees. For example, in Maryland, the ROFR may not be exercised if the proposed transferee meets the manufacturer’s reasonable qualifications and is an exist-

\begin{itemize}
  \item \textsuperscript{14} See KY. REV. STAT. §§ 190.047, 190.070 (2015); NEB. REV. STAT. §§ 60-1430, 60-1439 (2015); N.Y. VEH. & TRAF. LAW §§ 466, 467 (2015); N.C. GEN. STAT. § 20-305 (2014); OHIO REV. CODE ANN. §§ 4517.541, 4517.542, 4517.56, 4517.6; TEX. OCC. CODE ANN. § 2301.359 (2015).
  \item \textsuperscript{15} IOWA CODE § 32A.12(2)(2014).
  \item 679 N.W.2d. 606, 611 (Iowa 2004).
  \item \textsuperscript{17} IOWA CODE § 32A.12(1). The language of Iowa’s transferability statute is extremely limited. Specifically, it only allows a franchisor to decline to approve the change in franchise if the transferee is denied the right to transfer his license or the proposed transferee is denied the right to obtain a motor vehicle license.
ing dealer in good standing. Similarly, in Washington, the ROFR is restricted if the buyer falls within one of the following categories: transferee pre-approved by the franchisor; family member of a dealership owner; a manager-level employee who is qualified as a dealer-operator under the franchisor’s standards; entity controlled by a dealer-owner; or trust established for succession planning by a dealer-owner.

There is another interesting development in this area. At least one legislature, which is proposing to statutorily bar a ROFR exercise, is considering an exception to the bar if the purpose of the ROFR exercise is to assign the dealership to a minority or to a woman. The New Jersey Legislature is considering such an exception “if the motor vehicle franchisor has a formal written program to increase the number of female or minority franchisees.”

It is noteworthy that at least one jurisdiction grants motor vehicle franchisors a statutory right of first refusal. The Georgia franchise statute provides: “There shall be a right of first refusal to purchase in favor of the franchisor if the dealer has entered into an agreement to transfer the dealership or its assets.”

A comprehensive chart of the ROFR provisions in various state franchise statutes is included in the Appendix.

III. Judicial Arena

Legal challenges to ROFRs in the automotive context are numerous and have increased in recent years as the exercise of ROFRs have become more common. Interestingly, the challenges have come from several directions. Not surprisingly, the majority of the challenges come from the aggrieved contract buyer that wants to regain its contract rights. Franchisors have also joined in the challenges where the deal is structured in a manner that impairs, if not precludes, the ROFR exercise. Even the existing franchisee has sought judicial protection where the ROFR exercise creates a perceived negative result.

The ROFR issues that have made their way to the judicial arena include the following:

1. **Validity**—Is the automotive ROFR valid under the particular state franchise statute?

2. **Standing**—Who has legal standing to assert the invalidity of the ROFR? Of particular interest here is whether the contract buyer has the right to challenge the ROFR.

3. **Third-party beneficiary**—Can the contract buyer nullify the ROFR exercise as a purported third-party beneficiary of the franchise agreement?

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4. Tortious interference—Can the exercise of a ROFR constitute tortious interference?

5. Time limitation—When is the ROFR exercise period triggered under the franchise agreement or applicable law? What is the notice requirement? This seemingly simple concept can become complex in certain instances.

6. Structural issues—What happens when a sale transaction is structured, whether wittingly or unwittingly, in a manner that effectively averts or frustrates the exercise of the ROFR? A typical example is the sale of several dealerships or a variety of franchises in an integrated transaction.

7. Covenant of Good Faith and Fair Dealing—Does the covenant of good faith and fair dealing have a bearing on the exercise of the ROFR? Does the Automobile Dealers Franchise Act (ADFA)\textsuperscript{22} play a role?

This article will explore each of these aspects, the resolution of which are largely a function of the precise language of the ROFR, the case law of the particular jurisdiction, and the applicable state statute.

A. Validity

With a few exceptions, cases governing automotive ROFRs have sanctioned these arrangements, and judicial attacks on their validity have been unsuccessful. In \textit{Bayview Buick-GMC Truck, Inc. v. General Motors Corp.},\textsuperscript{23} the Florida District Court of Appeal deviated significantly from this common viewpoint. The court declared that the ROFR violated a provision of the Florida franchise statute that prohibits (with narrow exceptions) the operation of a motor vehicle dealership by a franchisor.\textsuperscript{24} Specifically, the Florida statute allows temporary franchisor operations of a motor vehicle dealership only: (1) to permit a temporary operation (not to exceed one year) during a transition period from one dealer to another; (2) to allow a reasonable period of time for a franchisor to own a dealership in conjunction with certain “qualified persons” (i.e., minorities) to assist a minority owner in the acquisition of full ownership; and (3) where there is “no independent person” available in the community to own and operate the dealership “in a manner consistent with the public interest.”\textsuperscript{25} The court stated that General Motors’ right of first refusal “collides with the legislative mandate” contained in the statute.\textsuperscript{26} Specifically, the court held as follows: “The right of first refusal clause in the franchise agreement between GM and Ace is therefore void

\textsuperscript{22} 15 U.S.C. §§ 1221–1225.


\textsuperscript{24} FLA. STAT. § 320.645(1); see also Dege v. Milford, 574 A.2d. 288 (D.C. 1990) (decided under District of Columbia’s Retail Service Station Act of 1976, D.C. CODE §§ 10-201–10-242 (1989)).

\textsuperscript{25} Id.

\textsuperscript{26} 597 So. 2d 889 (Fla. Dist. Ct. App. 1992).
as against public policy.”27 Interestingly, many states have similar statutes,28 although the courts in these states have not ruled in a similar fashion.

As noted earlier, an Iowa court also declared a ROFR invalid.29 The Iowa Supreme Court interpreted the transferability provision of the Iowa franchise statute, which mandates approval of the transfer of a franchise except for limited circumstances. Although the statute did not expressly address the ROFR, the court broadly interpreted the statute as invalidating the ROFR.30

B. Standing

As the parties to the franchise agreement, it is axiomatic that both the franchisor and franchisee have standing to enforce or challenge the exercise of a ROFR. When the challenge comes from the contract buyer, the legal requirement of standing becomes the major obstacle. Barring a specific statutory standing provision, courts have consistently rejected challenges based upon the state’s general franchise statute.

The basis for these rulings stems from the broader holding, which is well entrenched in the franchise law, that the franchise statutes are designed to protect the interests of the franchisee, not the proposed transferee, i.e., the contract buyer. In Tynan v. GM Corp.,31 GM rejected the contract purchaser, an experienced owner and operator of a Chevrolet dealership, in its efforts to purchase another GM dealership. The buyer had a less-than-favorable relationship with GM in its former franchise relationship. In rejecting the buyer, GM specifically referred to a “mutually unsatisfactory relationship.”32 GM’s rejection of the transfer likely would not have passed muster under the transfer provision of New Jersey’s franchise statute, but the selling dealer chose not to pursue this claim. The New Jersey Supreme Court rejected the buyer’s challenge on one simple principle: the New Jersey franchise law statute was not intended to protect a proposed transferee, only the existing franchisee.

Numerous holdings similarly support this principle.33 For example, in Roberts v. General Motors,34 GM exercised its ROFR in a plan to assign the right to

32. The soured relationship appeared to be due, in part, to the potential buyer’s active role as president in the National Chevrolet Dealer Alliance, an advocacy group that protested GM’s policies on behalf of Chevrolet dealers.
34. 643 A.2d 956, 958 (N.H. 1994).
purchase the dealership to a minority dealer. The contract purchaser contested the exercise of the ROFR on several grounds, including a violation of the New Hampshire franchise statute. In rejecting the claim, New Hampshire Supreme Court stated that the franchise statute was “clearly designed not to protect the plaintiff (transferee), but rather to protect existing motor vehicle dealers from oppressive conduct.” 35 The court further stated: “The clear intent of the non-consumer oriented provisions [of the franchise statute] is to protect the investment and property interest of those who are already dealers.” 36 Moreover, the buyer had “no independent right under the statute to be approved as a GMC franchisee, and he cannot stand upon the rights of [the franchisee] in order to gain standing under the statute.” 37

Similarly, in *Priority Auto Group, Inc. v. Ford Motor Company*, 38 the Fourth Circuit denied the contract buyer’s attempt to assert a claim under the Virginia franchise statute regarding Ford’s exercise of its ROFR. The court stated that the franchise statute “was designed to protect the dealer rather than the prospective buyer.” 39 In *Rosado v. Ford Motor Co.*, 40 the Third Circuit, in applying the Pennsylvania franchise statute, addressed the aggrieved buyer’s argument that the selling dealer did not receive the “same or greater consideration” under the Pennsylvania ROFR statute in the ultimate deal resulting from the ROFR exercise than he would have received under the buyer’s deal. The court ruled that the prospective purchaser lacked the standing to make that claim; only the selling dealer held that right. 41

The issue of standing becomes clouded if the dispute at hand becomes entangled with an assertion of “deemed approval.” Under many state franchise statutes, if the franchisor does not act within the statutorily prescribed time frame (typically sixty days from receiving a franchise application), the purchaser is “deemed approved.” 42 In a case contesting the ROFR exercise, the question may arise whether a deemed-approved buyer has standing to contest the ROFR because, arguably, it has now stepped into the shoes of franchisee. This concept was addressed in dictum in *Horn v. Mazda Motor of America*. 43 In that case, the New Jersey Superior court acknowledged the validity of this argument, but avoided a decision on that basis by deciding the case on other grounds. Specifically, the court addressed whether plaintiffs and the contract purchaser were denied approval under the New Jersey

35. *Id.* at 959.
36. *Id.*
37. *Id.*
38. 757 F.3d 137 (4th Cir. 2014).
39. *Id.* at 141.
40. 337 F.3d 291, 293 (3d Cir. 2003).
Franchise Act because GM did not reject him within sixty days of the date of his application. The court ultimately decided that the sixty-day clock never started due to the buyer’s numerous misrepresentations on his franchise application. The court advised:

Plaintiffs assert that by force of N.J.S.A. 56:10-6, Mazda’s approval of Mr. Brady’s transfer of his franchise to them must be “deemed granted” because Mazda did not reject their application within sixty days after they had given it statutory notice of the proposed transfer. If that assertion is correct upon expiration of the sixty-day period plaintiffs became, as a matter of law, “person[s] to whom a franchise is offered” and, therefore, “franchisees” within the definition of N.J.S.A. 56:10-3. If they were franchisees, they had standing to challenged Mazda’s action as either a wrongful refusal to transfer under the standards of N.J.S.A. 56:10-6 or as the termination of a franchise without good cause within the meaning of N.J.S.A. 56:10-5.44

Although stated in dictum, the Horn decision appears to open the door for a deemed-approved buyer to contest the ROFR. However, in the absence of a deemed approval, the barrier of standing for a contract purchaser would appear to be insurmountable. The only possible relief is an express standing provision in the relevant franchise statute.45

C. Third-Party Beneficiary

Cognizant of the standing hurdle, contract buyers have attempted to shift the bases of their challenges from franchise statutes to common law. The third-party beneficiary doctrine has been employed as an alternative ground to vitiate the ROFR, but the cases asserting this claim have been uniformly rejected.

Courts have required the contract buyer to show that it is more than an incidental beneficiary of the seller’s franchise agreement. For example, in Blair v. General Motors Corp., the Kentucky Supreme Court stated:

In this case, the Mullen/GM [Franchise] Agreement specifically provides that third parties have no rights under the contract and that the agreement is not a third party beneficiary contract. Any interpretation of the Mullen/GM Agreement must give weight to this statement. Even if the Mullen/GM Agreement did not specifically say this, it would, nevertheless, be so. The Mullen/GM Agreement is primarily concerned with governing relations between the two parties and to protecting and regulating their valid mutual interests. In no express or implied manner does it convey a special benefit to any specified or unspecified third parties. Absent any proposal by Plaintiff that it could present any evidence that a contract was entered for its direct and primary benefit, the language of the agreement will control, and Plaintiff accordingly may not claim the authority to enforce that contract.46

44. Id. at 556; see also Rassam v. Shell Oil Co., No. 97-1794, 1998 U.S. App. LEXIS 20554 (6th Cir. Aug. 18, 1998) (affirming that sixty-day clock does not start to run until franchisor receives all reasonably requested information).

45. See, e.g., FLA. STAT. ANN. § 320.699 (1) (2015) (A contract buyer is granted standing in an administrative hearing to contest an action by a franchisor in violation of the franchise statute.).

Some automotive franchise agreements contain a third-party beneficiary provision. In this regard, the GM dealer sales and service agreement provides: “17.9 NO THIRD PARTY BENEFIT INTENDED. This Agreement is not enforceable by any third parties and is not intended to convey any right or benefit to anyone who is not a party to this Agreement.” Several other franchise agreements have similar provisions. The presence of a third-party beneficiary provision in the GM dealer agreement in the Blair case was clearly a factor in its holding. It is less clear whether the absence of such a provision would weigh heavily enough to force a decision in favor of the contract buyer. Blair, at least in dicta, says no—a buyer must make a showing that it was intended as a direct beneficiary of the dealer agreement, which is no mean task.

D. Tortious Interference

Contract buyers might also challenge a ROFR with a tortious interference claim. Because it is a tort and not reliant on the franchise agreement or franchise approvability statutes, one could argue the issue of standing is obviated. A claim for tortious interference in the context of a franchisor-franchisee relationship has its own burdens.

The law of tortious interference, whether with a contract or with a prospective economic advantage, requires, inter alia, the existence of an improper motive. This element presents a formidable task in the ROFR arena. In Crivelli v. GMC, GM exercised its ROFR in an effort to redirect the selling dealer to its original buyer. It even encouraged the original buyer to reconsider the acquisition. Ultimately, the original buyer consummated the deal, and the second buyer sued GM, claiming tortious interference. In rejecting the claim, the Third Circuit cited to similar decisions for the principle that the interference must be improper. It saw nothing improper about GM’s exercise of its ROFR. Other courts have recognized the exercise of the ROFR as a legitimate contract right and the franchisor’s economic interests in selecting its franchisees. In Jackson v. Freightliner Corp., it appeared that the franchisor arbitrarily rejected the buyer and then exercised its ROFR as an integral part of a settlement agreement reached with the seller. However, the Tenth Circuit upheld the ROFR and rejected the buyer’s tor-

47. E.g., Jaguar ¶ 18.3, 19.A § XVI(J); Lexus § XIX(I); Toyota § XXVI(I).
48. RESTATEMENT (SECOND) OF TORTS § 766.
49. RESTATEMENT (SECOND) OF TORTS § 766B.
tious interference claim because the exercise did not entail the utilization of improper means.

At least one court based its decision on the so-called “not-a-stranger principle.” In Fresno Motors, LLC v. Mercedes-Benz USA, Inc., interpreting California law, the Ninth Circuit pointed out that a claim for tortious interference “may only be against ‘strangers’ or interlopers” and “cannot be against a non-party who has a direct economic interest and involvement in the contractual relationship.”55 In upholding the exercise of a ROFR by Mercedes-Benz USA, LLC, the court recognized the “symbiotic economic relationship” that existed between MBUSA and its franchisee and that MBUSA “had a pre-existing contractual right to interfere with the [acquisition agreement], based upon the right of first refusal provision in the dealer agreements.”56

E. The Timing Requirement: The Trigger Event

Franchise agreements in the retail automotive arena typically contain a specified time frame within which the franchisor may exercise its ROFR. However, several states have established a separate deadline by statute.57 The disputes surrounding this aspect typically center on the trigger event that starts the running of the specific exercise period. Contract buyers have endeavored to employ this component to invalidate a ROFR exercise.58 Of course, the starting point in this analysis is to examine the precise ROFR language of the particular franchise agreement and, where applicable, the state statute. The structure and content of these provisions can vary and may be vague.

It should also be noted that the timing requirement and identification of the trigger event bring back into question the issue of standing. For example, in Jackson, Freightliner’s ultimate purchase of the subject dealership came after the ROFR deadline had expired.59 Thus, the Tenth Circuit considered the contract buyer’s claim “irrelevant” under New Mexico law. The court further noted: “Whether Freightliner Corp. breached the contractual duties it owned Freightliner Albuquerque as a result of its decision not to commit

56. Id. For an excellent and a broader discussion of the assertion of tortious interference by aggrieved buyers (i.e., not related to either the automotive arena or limited to the ROFR context), see David A. Beyer & Scott P. Weber, Perilous Prospect – Part II: Lawsuits to Get into the Franchise System, 23 FRANCHISE L.J. 34 (2003).
58. For example, a buyer may contend that a mere written notice to the franchisor of the franchisee’s intention to sell its franchise to the buyer is sufficient to trigger the ROFR exercise period. Alternatively, the submission of a letter of intent (whether binding or non-binding) may be asserted as the triggering event. As stated in note 7 supra, the success of these arguments will, to a large extent, depend upon the precise language of the ROFR provision in the franchise agreement.
to the transfer of the dealership to Mr. Jackson is between Freightliner Corp. and Freightliner Albuquerque. Without the ability of the buyer to establish standing, the question of whether the franchisor’s exercise of its ROFR is timely is one that only the seller/franchisee may raise.

An establishment of rights under the state franchise statute can overcome this result, as shown in Bowser Cadillac, LLC v. GMC. In that case, the buyer was able to establish that GMC did not meet the exercise deadline, as specified in the state franchise statute (sixty days). In rejecting a motion to dismiss, the U.S. District Court for the Western District of Pennsylvania pointed to language in the Pennsylvania statute that entitled a prospective purchaser to the reimbursement of reasonable expenses. The court determined that the buyer had standing to raise the timeliness claim.

Some of these issues were present in Paccar, Inc. d/b/a Peterbilt Motor Company v. Ernest Wilson Capital Truck, LLC. There, the seller (franchisee) claimed that Peterbilt untimely exercised its ROFR. The seller claimed that the ROFR was triggered by the submission of a binding “letter agreement,” which followed a “less detailed proposal” sent to and received by Peterbilt. Peterbilt contended that the letter agreement was too vague to rely upon for purposes of exercising its ROFR. However, it appeared that Peterbilt did not endeavor to resolve its understanding of the terms of the deal until discovery in the litigation some three months after the letter agreement was executed and submitted. It did not exercise its ROFR until four months later. The court stated that it was “Peterbilt’s responsibility to clarify any confusion regarding these uncertain terms in reasonable time.” The court held that “Peterbilt was either aware of the essential terms of the deal or failed through diligent inquiry to attempt to clarify the essential terms.” It ruled that the ROFR exercise “was untimely and is invalid as a matter of law.” The court rejected the notion that the notice must be complete or consistent with industry standards: “[T]he standard is instead whether the right holder received sufficient notice of the terms so as to allow it to make a considered choice. If so, the burden shifts to the right holder to

60. Id.
62. Does the submission of an unsigned agreement trigger the ROFR exercise period? How about a non-binding letter of intent? Does a binding letter of intent start the ROFR period or is it deferred until the parties enter into a formal and comprehensive acquisition agreement. These questions become even more challenging when the ROFR language in the franchise agreement is unclear.
64. The record on appeal is unclear as to why the seller itself was objecting to the ROFR exercise, although footnote 12 in the case indicates that the bulk of the purchase price (over ninety percent) was to be paid over time as a percentage of distributions. Id. at 754, n.12. Conceivably, the seller was not comfortable with Peterbilt’s or its assignee’s ability to make such distributions.
65. The Peterbilt franchise agreement included a thirty-day ROFR clock.
67. Id. at 760.
68. Id.
make reasonable effort to clarify the deal.\textsuperscript{69} These principles are not limited to automotive dealer cases.\textsuperscript{70}

Where the ROFR provision in the automotive franchise agreement or the particular ROFR statute clearly enumerates what is required to trigger the ROFR, the timing issue becomes straightforward. For example, the Acura/Honda franchise agreement includes the requirements of a formal (executed) acquisition agreement, a completed application, and other specific requirements.\textsuperscript{71} However, where the franchise agreement is less clear and the statute less helpful, the burden may shift to the franchisor to confirm the trigger date and clarify the terms of the deal in a reasonable fashion.

F. Structural Issues

1. The Package Deal

ROFR disputes may arise in transactions structured, whether wittingly or unwittingly, in a way that impairs or precludes the exercise of the ROFR. These structural “failures” are often reflected in transactions that are bundled with several other deals—the so-called “package deal.” For example, in \textit{Mercedes-Benz USA, LLC v. Star Automobile Company},\textsuperscript{72} the dealer entered into an asset purchase agreement with its buyer regarding the sale of its Mercedes dealership as well as its Nissan and Volkswagen dealerships. In both a preliminary injunction hearing and subsequent hearing to remove the injunction, the U.S. District Court for the Middle District of Georgia ruled that the sale violated MBUSA’s right of first refusal under both New Jersey and Georgia law. The court enjoined the sale: “Thus it is likely that the package deal selling the Nissan and Volkswagen dealerships (over which MBUSA had no power) together with the Mercedes dealership violated MBUSA’s contractual right of first refusal.”\textsuperscript{73}

There was a similar holding in \textit{Volvo Group, N.A., LLC v. Truck Enterprises, Inc.},\textsuperscript{74} a stock sale transaction attempted to sell both Volvo dealerships and other truck lines (Kenworth and Isuzu) to the purchaser. However, the U.S. District Court for the Western District of Virginia held that the transaction improperly impaired Volvo’s ROFR rights. In this regard, it noted:

\textsuperscript{69} Id. at 757.

\textsuperscript{70} See Koch Indust., Inc. v. Sun Co., 918 F.2d 1203, 1212 (5th Cir. 1990); Dyrdal v. Golden Nuggets, Inc., 672 N.W.2d 578, 585 (Minn. Ct. App. 2003), aff’d by 689 N.W.2d 779 (Minn. 2004) (unsigned purchase agreement provided reasonable notice and gave the right holder the opportunity to inquire further); John D. Stump & Assocs. v. Cunningham Mem. Park, 419 S.E.2d 699, 706 (W. Va. 1992) (the owner has an initial duty to make a reasonable disclosure of the third party offer; the holder has a duty to make a reasonable inquiry for any additional information); Roeland v. Trucano, 214 P.3d 343, 348 (Alaska 2009) (holder has a duty to undertake a reasonable investigation of any terms which are unclear).

\textsuperscript{71} See supra note 7.


\textsuperscript{73} Id. at *5.

\textsuperscript{74} No. 7:16-CV-00025, 2016 WL 1479687 (W.D. Va. Apr. 14, 2016).
If Dealers are allowed to go through with the proposed sale of the dealerships to TEC at this time, then Volvo will either lose its right of first refusal or be forced to purchase not only the Volvo portion, but also the Kenworth and Isuzu portions, which, as explained above, Volvo does not appear to have any contractual or statutory right to do. Either way, it is likely that Volvo would be irreparably harmed because it would be compelled to accept a dealer with which it has had no relationship (TEC) or to purchase portions of the dealerships (Kenworth and Isuzu) over which it has no right. Assuming that monetary damages could remedy these harms, it is difficult to see how the appropriate figure could be calculated, given that one harm would likely go well into the future (i.e., a continuing relationship with TEC) and the other would likely give rise to a subsequent legal action (i.e., a suit from Kenworth or Isuzu or both).75

These rulings are consistent with non-automotive case law that a property owner cannot defeat a ROFR by including the burdened property (i.e., the property subject to the ROFR) in a larger package of properties to be sold to a third party. In such cases, the courts have consistently enjoined the transaction in an effort to preserve the ROFR.76 Thus, in *Hinson v. Roberts*,77 the Georgia Supreme Court reversed summary judgment in favor of the property owner who sold the ROFR property together with four other tracts of land. Citing cases from Idaho, New Jersey, and Pennsylvania, the court stated:

> We adopt the principles stated in the foregoing opinions. Thus, the rule we announce is that a preemptive right of first refusal may not be defeated by the offer of a third party to purchase the land in question as part of a package transaction, including one or more additional tracts, even if the purchase price is allocated among the several tracts.

Similarly, in *Radio WEBS, Inc. v. Tele-Media Corp.*,78 the sale to a third party of the ROFR asset (the capital stock of a cable company) was incorporated in a package deal that also included the capital stock of another cable company, an office building, and a personal residence. The Georgia Supreme Court held that the package deal violated the plaintiff's ROFR. In citing numerous cases regarding real property transactions, the court extended the same principle to the sale of a business and held that “to find otherwise would represent defeat of contractual rights of first refusal by inclusion of extraneous assets.”79

Are there any exceptions to this principle? First, it is noteworthy that the *Star* decision involved a state franchise statute (Georgia) that expressly grants a franchisor right of first refusal. Can a dealer ever be justified in structuring a deal that includes other dealerships and other properties? To be sure, the package deal is not uncommon in today’s automobile market. Recent deals

75. Id. at *5.
77. 349 S.E.2d 454, 456 (Ga. 1986).
78. 292 S.E.2d 712, 713 (Ga. 1982).
79. Id. at 715.
have included the sale by the Van Tuyl Group to Berkshire Hathaway of all of its seventy-five dealerships and several real properties and Lithia Motor’s acquisition of DCH Auto Group’s twenty-seven dealerships and real properties. It does not appear that either of these deals was structured to defeat the franchisor’s right of first refusal. Rather the structure was inherent in light of the nature of the deal and was arguably market-driven.

Does the concept of good faith play a role in this context? As noted in Right of First Refusal, at least one higher court has espoused this view. In Crow–Spieker #23 v. Helms Construction and Demolition Company, the Nevada Supreme Court reviewed a trial court ruling that a package real estate deal, including a parcel subject to a ROFR, breached the ROFR. The court ruled that the ROFR is “totally inapplicable” as long as the owner determined in good faith that it is only willing to sell the ROFR parcel as part of a larger transaction. This ruling has been considered a deviation from the many cases supporting the ROFR in packaged deals.

Why the packaged deal case does not explicitly employ the good faith doctrine (with the exception of Crow–Spieker #23) is unclear. However, it would be reasonable, however, to assume that the doctrine of good faith will not be ignored in any case involving the ROFR inasmuch as the implied covenant of good faith and fair dealing is certainly applicable in this arena.

2. Poison Pill Transactions

Interestingly, the concept of good faith has been employed in transactions where the contracting parties include additional terms in the acquisition agreement that make the exercise of a ROFR difficult or undesirable. These are sometimes referred to as “poison pills.”

For example, in David A. Bramble, Inc. v. Thomas, the parties to the sale of a parcel of land subject to the plaintiff’s ROFR included a “no mining” provision. The court reversed the trial court’s ruling that the ROFR was ineffectual since it omitted the “no mining” provision in the exercise notice. The appellate court remanded the case to determine whether the contractual parties’ actions in inserting the objectionable provision were “arbitrary or performed in bad faith” or if there was a “reasonable justification” for the provision.
In contrast, in *Roeland v. Trucano*, the sale transaction, which involved a tract of land subject to a ROFR, entitled the seller to an interest in any future souvenir shops on the land.\(^8\) Obviously, this was a difficult term for the ROFR holder to match. The holder sued the contracting parties, in part, because the transaction breached the implied covenant of good faith and fair dealing.\(^9\) The trial court found for the contracting parties and ruled that the deal was negotiated in good faith and was not designed to cut off the ROFR.\(^1\) In relying upon a prior holding in *West Texas Transmission LP v. Fenron Corp.*,\(^2\) the Arizona Supreme Court confirmed that the ROFR holder had the right to “propose comparable terms to the original offer which are possible for him to meet and which would meet the seller’s corresponding interests.”\(^3\) In support of its holding, the court quoted *West Texas Transmission, LP* and ruled as follows:

> [T]he owner of property subject to a right of first refusal remains master of the conditions under which he will relinquish his interest, as long as those conditions are commercially reasonable, imposed in good faith, and not specifically designed to defeat the preemptive rights. Therefore, where—as here—the right of first refusal does not specify that the third-party offer must be in cash, we give effect to the owner's right to sell his property for whatever he wishes. There was no obligation to provide a cash offer. Roeland and Flamee undertook not inquiries or attempts to negotiate a commercially equivalent offer. Accordingly, they failed to exercise their right of first refusal.\(^4\)

This aspect of an automotive ROFR becomes even more uncertain given that there appears to be no published automotive decisions in the “poison pill” context. This area of law continues to develop, especially given the increased frequency of the exercise of automotive ROFRs. For example, if the acquisition agreement includes special terms that, arguably, the franchisor cannot match, will the deal be allowed under judicial scrutiny?\(^5\) Based upon pre-existing (non-automotive) case law, the focus should be whether the special term was included in good faith or simply a ploy to avoid the ROFR exercise. Unless a specific arrangement in the acquisition agreement is challenged by a franchisor and ultimately addressed in court, the question of whether such a deal will avert a ROFR challenge will remain unclear.

**G. Covenant of Good Faith and Fair Dealing**

The covenant of good faith and fair dealing is a well-established principle in automotive franchise agreements and widely recognized in the common

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89. 214 P.3d 343, 349 (Alaska 2009).
90. Id. at 347.
91. Id. at 351.
92. 907 F.2d 1554 (5th Cir. 1990).
94. Id. at 350.
95. Examples of these include an equity component for the selling dealer in the buying entity and a purchase price based upon the ultimate number of vehicles sold by the buyer (post-closing).
law. The requirement of good faith is codified in the Automobile Dealers’ Franchise Act (ADFA). This Act expressly provides for a cause of action by an automobile dealer against an automobile manufacturer “by reason of the failure of said automobile manufacturer . . . to act in good faith in performing or complying with any of the terms or provisions of the franchise, or in terminating, canceling, or not renewing the franchise with said dealer.”

There are no published decisions successfully challenging an automotive franchisor’s “bad faith” exercise of a ROFR. The fact pattern would present an interesting dynamic in the ROFR area. How would a court balance the franchisor’s clear and well-established preemptive right created by a ROFR provision against both the common law and ADFA doctrines of good faith and fair dealing? Until this issue makes its way into a reported decision, the result will remain unclear.

IV. Conclusion

The automotive ROFR has become the subject matter of much statutory regulation as well as increased judicial scrutiny. This focus is likely to intensify as the utilization of ROFRs by automotive franchisors increases and the deals become more complex. It is certainly a developing and intriguing area of automotive franchise law that warrants special attention by franchisors, franchisees, and contract buyers alike.

## APPENDIX

### Selected Motor Vehicle Franchise Right of First Refusal Statutes

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<thead>
<tr>
<th>State</th>
<th>Statute(s)</th>
<th>Notable Features</th>
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| Arizona   | **ARIZ. REV. STAT. ANN. § 28-4459 (2016)**                                  | • Franchisor must notify franchisee in writing of intent to exercise right of first refusal (ROFR) within 60 days of receipt of completed transfer application and related information  
• Cannot exercise ROFR if proposed transferee is a family member  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises ROFR  
• Franchisor must reimburse transferee for reasonable expenses, including legal fees |
| California| **CAL. VEH. CODE § 11713.3(t) (2016); CAL. BUS. & PROF. CODE § 20028(c) (2016)** | • Franchise agreement must provide ROFR  
• To exercise ROFR, franchisor must provide written notice no later than 45 days after receipt of all information required by the statute  
• Sale must relate to all or substantially all of business assets  
• Cannot exercise ROFR if proposed transferee is a family member  
• Consideration paid by franchisor is to equal or exceed that to be paid by proposed transferee  
• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees |
| Colorado  | **COLO. REV. STAT. § 12-6-127 (2015)**                                      | • Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees |
| Connecticut| **CONN. GEN. STAT. § 42-133cc (2016)**                                     | • Franchisor must notify franchisee in writing of intent to exercise ROFR within 60 days of receipt of proposed transfer and information and documents  
• Cannot exercise ROFR if transferee is a family member  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• Franchisor must assume all duties, obligations, and liabilities contained in the agreement between franchisee and proposed transferee |
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<th>State</th>
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<tr>
<td>Delaware</td>
<td>Del. Code Ann. tit. 6, § 4910(d)</td>
<td>• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees</td>
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<td>• ROFR allowed if in franchise agreement</td>
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<td>• Franchisor must notify franchisee in writing of intent to exercise right of first refusal within 60 days of receipt of completed proposal and all related agreements</td>
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<td>• Cannot exercise ROFR if transferee is a family member</td>
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<td>• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal</td>
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<td>• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees</td>
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<td>• Cannot use ROFR to influence the consideration or influence person to refrain from acquisition</td>
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<td>Florida</td>
<td>No statute, but see Bayview Buick-GMC Truck, Inc. v. General Motors Corp., 597 So. 2d 887 (Fla. Dist. Ct. App. 1992)</td>
<td>• Franchisor’s ROFR held void as against public policy because it violated state bar to manufacturer ownership of dealership.</td>
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<td>• Also, franchisor failed to deny transfer within time limit and via statutory procedure, including filing of complaint with agency</td>
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<td>Georgia</td>
<td>Ga. Code Ann. § 10-1-663.1 (2016)</td>
<td>• Franchisor may exercise ROFR if the proposed sale or transfer is of more than 50 percent of the ownership or assets of the dealership being transferred</td>
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<td>• Franchisor must notify franchisee in writing of intent to exercise right of first refusal within 60 days of receipt of completed written proposal and information and agreements</td>
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<td>• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal</td>
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<td>• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees</td>
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| Illinois| 815 ILL. COMP. STAT. ANN. 710/4 (2016)                                    | • To exercise ROFR, franchisor must provide notice 60 days from receipt of generally used applications forms and all agreements  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises ROFR  
• Franchisor must reimburse prospective transferee for reasonable expenses |
| Indiana | IND. CODE ANN. § 9-32-13-22(c) (Burns 2016)                                | • Franchisor must notify franchisee in writing of intent to exercise right of first refusal within 60 days of receipt of proposed transfer information  
• Franchisor must provide same or better consideration to franchisee  
• Franchisor may exercise ROFR if the proposed sale or transfer is of more than 50 percent of the ownership or assets of the dealership being transferred  
• Franchisor must reimburse franchisee for reasonable expenses, including legal fees  
• Cannot exercise ROFR if proposed transfer is to family member or manager |
| Iowa    | IOWA CODE § 322A.12 pt. 2 (2016)                                           | • Notwithstanding terms of franchise agreement, the transfer of the dealership “shall not make applicable any right of first refusal of the franchiser” |
| Louisiana| LA. REV. STAT. § 32:1267(B) (2016)                                         | • Franchise agreement must have ROFR  
• Franchisor must notify franchisee in writing of intent to exercise right of first refusal within 60 days of receipt of completed proposal and all agreements  
• Cannot exercise ROFR if transferee is a family member  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises ROFR  
• Franchisor must reimburse prospective transferee’s for reasonable expenses, including legal fees  
• Dealer is not liable to any person as a result of the exercise of the ROFR |
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| Maine       | 10 ME. REV. STAT. ANN. tit. 10, § 1174 (2016)                              | • Franchisor can exercise ROFR  
• Franchisor must assume or acquire lease/real property  
• Franchisor must assume all obligations of proposal  
• Franchisor must reimburse prospective transferee’s reasonable expenses  
• Cannot use ROFR in order to influence the consideration or influence person to refrain from acquisition |
| Maryland     | MD. TRANSP. CODE ANN. § 15-211(h) (2016)                                  | • Franchisor may not exercise right of first refusal if the proposed transferee meets manufacturer’s reasonable qualifications, is a member of franchisee’s family, a qualified manager with at least 2 years management experience, or an existing dealer in good standing  
• Franchisor must reimburse prospective franchisee for reasonable expenses, including legal fees |
| Massachusetts| MASS. GEN. LAWS ch. 93B, § 10 (2016)                                      | • Franchisor must notify franchisee in writing of intent to exercise right of first refusal within 45 days of receipt of completed proposal.  
• Franchisor has 30 days after issuing notice of intent to franchisee to exercise the right of refusal  
• Cannot exercise ROFR if transferee is a family member  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• Cannot use ROFR in order to influence the consideration or influence person to refrain from acquisition  
• Franchisor must reimburse prospective transferee for reasonable costs and expenses |
<p>| Michigan     | MICH. COMP. LAWS § 445.1527(g) (2016)                                     | • Requirement that there must be good cause to deny transfer does not include exercise of ROFR                                                                                       |</p>
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| Minnesota    | Minn. Ann. Stat. § 80E.13(j) (2016)            | • In order to exercise ROFR, franchise agreement must provide for ROFR  
• Franchisor may exercise right of first refusal if the proposed sale or transfer is of more than 50 percent of the ownership or assets of the dealership being transferred  
• Franchisor must notify franchisee in writing of intent to exercise right of first refusal within 60 days of receipt of written proposed transfer  
• Cannot exercise if transferee family member  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees |
| Missouri     | Mo. Rev. Stat. § 407.825(7)(c)                  | • Franchise agreement must allow for ROFR  
• Cannot exercise ROFR if proposed transferee is a family member  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees |
| New Mexico   | N.M. Stat. Ann. § 57-16-5 U (2016)             | • It is unlawful to enforce a ROFR by a manufacturer or to require dealer to grant a right or option thereto |
• Franchisor must notify franchisee in writing of intent to exercise right of first refusal and material reasons within 60 days of receipt of completed form and information  
• A right of first refusal may not be exercised if the proposed sale is to a member of the franchisee’s family, a qualified manager, or a trust  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees  
• Cannot use ROFR in order to influence the consideration or influence person to refrain from acquisition |
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<td>• Requires franchisor to assume or acquire lease or real property of dealership in order to exercise ROFR unless otherwise agreed to by franchisor and franchisee&lt;br&gt;• Cannot use ROFR in order to influence the consideration or influence person to refrain from acquisition&lt;br&gt;• Franchisor must reimburse prospective transferee for reasonable expenses, including legal fees</td>
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<td>Oregon</td>
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<td>• ROFR must be in franchise agreement&lt;br&gt;• Franchisor must notify franchisee via certified mail, return receipt requested, of intent to exercise right of first refusal within 60 days of receipt of proposed transfer&lt;br&gt;• ROFR may not be exercised if the proposed sale is to a member of the franchisee’s family, a qualified manager, or a trust&lt;br&gt;• Franchisor may exercise right of first refusal if the proposed sale or transfer is of more than 50 percent of the ownership or assets of the dealership being transferred&lt;br&gt;• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal&lt;br&gt;• Franchisor must reimburse prospective transferee for reasonable expenses, including legal fees</td>
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<td>• Franchisor must notify franchisee of intent to exercise right of first refusal within a statutory period of 60 or 75 day time limitations of § 12(b)(5)&lt;br&gt;• Cannot exercise ROFR if transferee is family member&lt;br&gt;• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal&lt;br&gt;• Provides for franchisor to assume lease of dealership and acquire real property unless franchisor and franchisee otherwise agree&lt;br&gt;• Franchisor must assume all duties, obligations, and liabilities contained in the agreement between franchisee and proposed transferee&lt;br&gt;• Franchisor must reimburse franchisee for reasonable expenses, including legal fees</td>
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<td>Tennessee</td>
<td>TENN. CODE ANN. § 47-25-1505(2)(A) (2016)</td>
<td>• Prohibition against franchisor refusal to renew for purpose of converting dealer’s business into operation by franchisor or its agents/employees does not apply to franchisor exercise of ROFR</td>
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| Vermont  | VT. STAT. ANN. tit. 9, § 4100e (2016)                                        | • ROFR must be in franchise agreement  
• Franchisor must notify franchisee in writing of intent to exercise right of first refusal and material reasons within 60 days  
• A right of first refusal may not be exercised if the proposed sale is to a member of the franchisee’s family, a qualified manager, or a trust  
• Franchisor must reimburse proposed transferee for reasonable expenses, including legal fees  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal |
| Virginia | VA. CODE ANN. § 46.2-1569.1 (2016)                                           | • Franchisor must notify franchisee in writing of intent to exercise right of first refusal within 45 days of receipt of completed proposal  
• Cannot exercise if proposed transfer is to a family member  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• Franchisor must reimburse prospective transferee for reasonable expenses, including legal fees |
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| Washington | WASH. REV. CODE ANN. § 46.96.220 (2016)                                     | • ROFR must be in franchise agreement  
• Franchisor must notify franchisee via certified mail, return receipt requested, of intent to exercise right of first refusal within the lessor of 45 days of receipt of proposed transfer or the time period specified in the franchise agreement  
• Proposed transfer must be at least 50% of the franchise  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• Franchisor may not exercise right of first refusal if proposed transferee was pre-approved, is a family member, or was a manager continuously employed by franchisee for 3 years and is otherwise qualified  
• Franchisor must reimburse prospective transferee for reasonable expenses, including legal fees  
• Requires franchisor to assume lease or acquire real property of dealership  
• Franchisee is not liable to proposed transferee for damages resulting from franchisor’s exercising right of first refusal if disclosed in writing the existence of the ROFR |
| Wisconsin  | WIS. STAT. ANN. § 218.0134(4)(c) (2015-2016)                                | • Franchisor may exercise ROFR but must be in the franchise agreement  
• Franchisee must receive equal or greater compensation to the proposed transfer if franchisor exercises right of first refusal  
• ROFR does not apply if proposed transferee is a family member or a qualified manager for franchisee with 2 years’ experience  
• Franchisor must reimburse franchisee for reasonable expenses, including legal fees |
Regulation Crowdfunding: A Viable Option for the Franchising Industry?

Samuel G. Wieczorek

Since the advent of the Internet, small businesses have sought ways to raise capital by issuing securities to the public at large via Internet solicitations. However, they have typically run into issues with state and federal securities laws that prohibit offering securities unless the security is registered or an exemption applies. The answer that these businesses have traditionally tried to turn to was “crowdfunding,” which generally means using the Internet to solicit potential investors to help fund any number of projects.1 However, in its earliest iterations, to avoid potential securities law violations, most small businesses did not actually issue equity in their companies when seeking funds from the general public over the Internet, instead opting to use services like Kickstarter or Indiegogo to raise funds.2 Congress finally adopted a new exemption that specifically provides for a crowdfunding exemption from federal securities laws, and the Securities and Exchange Commission (SEC) has recently adopted final rules related to crowdfunding, which went into effect on May 16, 2016.

This article examines what impact crowdfunding may have on the franchise industry. It will first provide a brief history of the federal laws governing securities offerings in the United States and Title III of the 2012 Jumpstart Our Business Startups Act (JOBS Act), which first exempted crowdfunded offerings from Section 5 of the Securities Act of 1933 (Securities Act). The article will then explore the actual Regulation Crowdfunding rules issued by the SEC for qualifying for the exemption. Next, the article

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2. Scott Martin & Yuka Hayashi, SEC Opens Way for Wider Pool of Investors to Take Stakes in Startups, WALL ST. J., Oct. 30, 2015 (“Crowdfunding campaigns on Kickstarter and Indiegogo, which don’t accept equity, have helped countless small companies grow. Many have gone on to raise traditional venture funding.”)
will discuss crowdfunding as a method of raising capital for both franchisees and franchisors. The article will also discuss some issues that franchisors should consider before consenting to a franchisee implementing a crowd-funded securities offering. Finally, the article will conclude with some parting thoughts on crowdfunding and the franchise industry.

I. History of Securities Offering and JOBS Act

A. Securities Act of 1933

In the wake of the stock market crash of 1929 and the Great Depression, Congress passed the Securities Act of 1933 on May 27, 1933. The Securities Act has two main objectives. First, it requires that investors receive financial and other important information concerning securities being offered for public sale. Second, it seeks to prohibit deceit, misrepresentations, and other fraud in the sale of securities. At its most basic level, the Securities Act requires that all securities sold in the United States must be registered unless an exemption applies. Some of these exemptions include private offerings to a limited number of persons or institutions; offerings of limited size; intrastate offerings; and securities of municipal, state, and federal governments. With the advent of the Internet, companies and investors have sought ways to increase the ability of small investors to purchase securities in startup companies, while minimizing the regulatory burden and cost of compliance with the Securities Act. Congress sought to bridge this void by enacting an exemption for crowdfunded securities offerings.

B. Title III of the JOBS Act

On April 5, 2012, President Barack Obama signed into law the JOBS Act. A major goal of the JOBS Act is to help provide startups and small businesses with investment capital from small investors by making relatively low dollar offerings of securities, featuring relatively low dollar investments by small investors, less costly and burdensome from a regulatory perspective. To accomplish this goal, Title III of the JOBS Act added new Section 4(a)(6) to the Securities Act, which is the actual crowdfunding exemption. Title III of the JOBS Act further required the SEC to write rules and issue studies on capital formation, disclosure, and registration.

5. 15 U.S.C. § 77e
6. SEC, supra note 4.
8. See, e.g., Crowdfunding: Supplementary Information, 80 Fed. Reg. 71387, 71388 n.2 (Nov. 16, 2015) [hereinafter Supplementary Information] (citing statements by various U.S. Senators in support of allowing small investments in crowdfunded securities by “ordinary” and “average” investors, not just high net worth individuals).
requirements. On October 23, 2013, the SEC proposed rules to implement the new exemption. Nearly 500 professional and trade associations, investor organizations, law firms, investment companies and advisors, broker-dealers, potential funding portals, members of Congress, state securities regulators, government agencies, and other groups and individuals submitted comment letters on the proposed rules. After consideration of these responses, the SEC adopted final crowdfunding rules on October 30, 2015.

C. Regulation Crowdfunding

The final regulations, known as “Regulation Crowdfunding,” which were scheduled to take effect 180 days after their publication in the Federal Register, became effective on May 16, 2016. Regulation Crowdfunding covers five broad topics related to the crowdfunding exemption: (1) the requirements of the exemption itself, (2) the requirements governing issuers of securities in a crowdfunded placement, (3) the requirements of intermediaries to crowdfunded offerings, (4) additional funding portal requirements, and (5) other miscellaneous provisions. The focus of this article will be on the actual requirements of the exemption itself.

II. Regulation Crowdfunding

A. Amounts That Can Be Raised and Limits on Amounts That Investors Can Invest

Subject to certain thresholds, Regulation Crowdfunding lets anyone, regardless of income or net worth, invest in securities-based crowdfunding transactions. This is important because, unlike some other exemptions under the Securities Act, an issuer is not limited to offering securities only to accredited investors. An issuer of securities is permitted to raise a maximum of $1 million in the aggregate through crowdfunded offerings in a twelve-month period. Depending on their income and net worth, individuals can invest in crowdfunded offerings over the course of a twelve-month period as follows:

1) if an individual’s annual income or net worth is less than $100,000, the greater of $2,000 or 5 percent of the lesser of his or her annual income or net worth;

11. Supplementary Information, 80 Fed. Reg., supra note 8, at 71389.
13. Id.
15. 17 C.F.R. § 227.100(a)(1).
2) if both an individual’s annual income and net worth are equal to or greater than $100,000, 10 percent of the lesser of his or her annual income or net worth.\textsuperscript{16}

In addition, during the twelve-month period, the aggregate amount of securities sold to a single investor through all crowdfunded offerings cannot exceed $100,000.\textsuperscript{17} An investor’s net worth and annual income are determined in the same manner as determining an individual’s status as an accredited investor under federal securities laws.\textsuperscript{18} In general, holders of securities purchased through a crowdfunded offering cannot be resold for a period of one year.\textsuperscript{19}

As an example of these limitations, an investor with an annual income of $50,000 a year and $105,000 in net worth would be limited to investing $2,500 in a twelve-month period. By contrast, an investor with an annual income of $1.2 million and net worth of $2 million would be limited to investing $100,000.\textsuperscript{20} The obligation to determine whether an individual meets the annual income and net worth requirements generally falls on the intermediary that the issuer uses to oversee the offering.\textsuperscript{21}

B. Offering Must Be Through a Broker-Dealer or Funding Portal

Title III of the JOBS Act seeks to provide some protection to investors in crowdfunded securities by requiring that crowdfunded offerings take place through either a broker-dealer or a “funding portal.”\textsuperscript{22} A funding portal is a new type of SEC registrant that was created to serve as a crowdfunding intermediary. Funding portals are prohibited in engaging in certain activities, such as offering investment advice or making recommendations; soliciting purchases, sales, or offers to buy securities; compensating promoters; or holding investor funds or securities.\textsuperscript{23} To find a funding portal, an entity that wishes to issue securities through a crowdfunded offering can visit the website of the Financial Industry Regulatory Authority (FINRA), which maintains a list of funding portals that have registered with FINRA.\textsuperscript{24}
C. Bad Actor Disqualification

Regulation Crowdfunding includes a “bad actor” provision that disqualifies offerings if the issuer or the issuer’s “covered persons” have experienced a disqualifying event, such as being convicted of, or subject to court or administrative sanctions for, securities fraud or violations of other specified laws.25 For these purposes, a “covered person” includes the issuer itself and certain predecessors and affiliates; directors, officers, general partners, or managing members of the issuer; beneficial owners of 20 percent or more of the issuer’s outstanding voting equity securities, calculated on the basis of voting power; promoters associated with the issuer; and persons compensated for soliciting investors, including the general partners, directors, officers, or managing members of any such solicitor. In particular, the issuer would be disqualified from selling securities under a crowdfunded offering if a covered person has been convicted of or found guilty of having violated several categories of crimes or regulatory orders, such as conviction of a felony or misdemeanor in connection with the issuance of securities; being subject to a final order of a state securities commission that found a violation of a state law that prohibits fraudulent, manipulative, or deceptive conduct; and SEC disciplinary actions. There is generally a five- or ten-year look-back period for these types of violations.26 However, disqualification will not arise as a result of disqualifying events that occurred before May 16, 2016, the effective date of Regulation Crowdfunding. Matters that existed before the effective date that are within the relevant look-back period and that would otherwise be disqualifying, however, are required to be disclosed in the issuer’s offering statement.27

D. Disclosure Requirements

Although Title III of the JOBS Act and Regulation Crowdfunding is meant to reduce the regulatory burden on issuers of securities through crowdfunded offerings, issuers must still comply with comprehensive disclosure obligations. These disclosures fall into five broad categories: director and officer information, principal shareholder information, the issuer’s business plan and risk factors, a description of the offering, and financial disclosures. In addition, there are ongoing disclosure requirements.

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25. 17 C.F.R. § 227.503.
26. See 17 C.F.R. § 227.503 (The disqualifying events include, but are not limited to, felony and misdemeanor convictions within the last five years in the case of issuers, their predecessors and affiliated issuers; and ten years in the case of other covered persons in connection with the purchase or sale of a security involving the making of a false filing with the SEC.)
1. Form C

An issuer wishing to rely on the crowdfunding exemption afforded by Section 4(a)(6) must file with the SEC certain disclosures and provide these disclosures to prospective investors. The document that an issuer files with the SEC is known as Form C and consists of thirty-one questions covering a variety of topics.\(^{28}\)

The issuer must first disclose background information on each of the issuer’s directors and its officers. The issuer must also disclose background information on each person who is the beneficial owner of 20 percent or more of the issuer’s outstanding voting equity securities, calculated on the basis of voting power.

Following these disclosures, the issuer must describe its business plan and then set forth a standard set of risk factors informing potential investors that they can lose their entire investment, that the SEC has not passed on the merits of the securities being offered nor the information presented in Form C, and that the issuer is relying on an exemption from the Securities Act. There is also a section for the issuer to include its own set of risk factors that may be unique to the offering.

Next, the issuer must describe the offering itself, including the purpose of the offering, how the issuer intends to use the proceeds of the offering, the target offering amount and the deadline to meet it, and how the issuer plans to complete the transaction and deliver the securities to its investors. This section of Form C also describes an investor’s forty-eight hour right to cancel, pursuant to which investors may cancel an investment commitment up to forty-eight hours prior to the deadline identified in the offering.

After this section, the issuer must make certain financial disclosures. The extent of the financial disclosures depend on the size of the offering. For issuers offering $100,000 or less, the issuer must disclose both its financial statements and the amount of total income, taxable income, and total tax as reflected in the issuer’s federal income tax return.\(^{29}\) These disclosures must be certified by the issuer’s principal executive officer.\(^{30}\) However, if the issuer has financial statements that have either been reviewed or audited by an independent public accountant, the issuer must disclose the reviewed or audited financial statements and is not required to disclose the tax return information described earlier or include the signed certification of the issuer’s principal executive officer.\(^{31}\)

If the issuer is offering more than $100,000, but not more than $500,000, the issuer must include financial statements that have been reviewed by an independent accountant. However, if the issuer has financial statements

\(^{28}\) 17 C.F.R. § 239.900.
\(^{29}\) 17 C.F.R. § 227.201(t)(1).
\(^{30}\) 17 C.F.R. § 227.201(t)(1).
\(^{31}\) 17 C.F.R. § 227.201(t)(1).
that have been audited by an independent accountant, it must disclose those audited financial statements instead.\(^\text{32}\)

Finally, if the issuer is offering more than $500,000, and it is the issuer’s first time selling securities in reliance on the crowdfunding exemption, the issuer may disclose financial statements that have been reviewed by an independent accountant. However, once again, if the issuer has audited financial statements, it must use those audited statements in lieu of the reviewed financial statements. If the issuer has previously sold securities in reliance on the crowdfunding exemption, it may only use audited financial statements in its disclosure.\(^\text{33}\)

The instructions to Section 201(t) provide more details on the information that must be included in the required financial statements. In particular, the financial statements must cover the two most recently completed fiscal years or the period(s) since inception, if shorter.\(^\text{34}\) For an offering conducted in the first 120 days of an issuer’s fiscal year, the financial statements provided may be for the two fiscal years before the issuer’s most recently completed fiscal year. However, if the issuer has prepared audited financial statements for the most recently completed fiscal year, it must include those, even if 120 days have not elapsed. If 120 days have elapsed since the end of the issuer’s fiscal year, the audited financial statements must be for the issuer’s two most recently concluded fiscal years.\(^\text{35}\)

2. Ongoing Reporting Requirements

Regulation Crowdfunding requires that an issuer that has sold securities in reliance on the crowdfunding exemption must file an annual report with the SEC no later than 120 days after the close of the issuer’s fiscal year.\(^\text{36}\) In addition, the issuer must post a copy of the annual report on its website.\(^\text{37}\) However, there is no requirement that issuers provide a physical copy to investors because the SEC felt that for an Internet-based offering under Regulation Crowdfunding, most investors should be familiar with obtaining information from the Internet.\(^\text{38}\) Interestingly, issuers are not required to file any intermediate reports, for instance, to disclose material changes.\(^\text{39}\)

With respect to annual financial disclosures, the issuer must provide updated financial statements. However, there is no requirement that the financial statements be audited or reviewed. Instead, it is sufficient if the issuer’s

\(^{32}\) 17 C.F.R. § 227.201(t)(2).
\(^{33}\) 17 C.F.R. § 227.201(t)(3).
\(^{34}\) 17 C.F.R. § 227.201(t), instr. 3.
\(^{35}\) 17 C.F.R. § 227.201(t), instr. 4.
\(^{36}\) 17 C.F.R. § 227.202(a).
\(^{37}\) 17 C.F.R. § 227.202(a).
\(^{38}\) Supplementary Information, 80 Fed. Reg., supra note 8, at 71420.
\(^{39}\) See id. (contending that requiring issuers to submit filings more frequently than annually “would require an allocation of resources to the reporting function of Regulation Crowdfunding issuers that we do not believe is justified in light of the smaller amounts that will be raised pursuant to the exemption”).
principal executive officer signs a statement certifying that the financial statements are true and complete in all material respects. But, if the issuer has had prepared audited or reviewed financial statements, it must disclose those financial statements and cannot rely on the certification of the issuer’s principal executive officer.40

The obligation to prepare and file annual reports continues until the earliest to occur of the following: (1) the issuer is required to file reports under Sections 13(a)41 or 15(d)42 of the Securities Exchange Act of 1934, (2) the issuer has filed at least one annual report and has fewer than 300 holders of record, (3) the issuer has filed at least three annual reports and has total assets that do not exceed $10 million, (4) the issuer or another party purchases or repurchases all of the securities that were issued in reliance on the crowdfunding exemption, or (5) the issuer liquidates or dissolves in accordance with applicable state law.43

III. Franchisee and Franchisor Use of Crowdfunding

A. Franchisees

In the context of the franchise model, a crowdfunded securities offering could work well for franchisees with careful planning. This section explores some ideas for structuring a crowdfunded offering from a franchisee’s perspective.

1. Possible Scenarios for Franchisee Use

The scenarios in which a franchisee could use a crowdfunded offering as a means of raising capital are limitless, but in general would most likely fall within one of several categories. The first category would be for the purchase of a unit franchise, particularly for a franchise that requires a large initial capital outlay, such as a large gym facility or a large restaurant concept with substantial build out costs. Another obvious category would be as a means to avoid taking on debt to finance the purchase of a franchise. A third category would be as a method to expand from one franchise to multiple franchises.

Indeed, for a few reasons, this third category seems to be the most logical place for a franchisee to employ a crowdfunded offering. First, if a franchisee has already operated a single unit successfully and now wants to expand, investors may be more willing to purchase securities from the franchisee that has previously demonstrated its success. Recall that franchisees must make certain financial disclosures with respect to their offering44 so prospective in-

42. Securities Exchange Act of 1934 § 78o(d) (describing periodic and supplementary information that must be filed by brokers and dealers).
43. 17 C.F.R. § 227.202(b).
44. See Part II.D.1.
vestors will be able to examine those financial statements to help them determine a franchisee’s prior level of financial success.45

2. Downsides to Offering Securities

Although there are definite positive aspects to seeking funding via a crowdfunded offering, there are also potential downsides. The most obvious is the cost and expense of compliance with the Securities Act and the crowdfunding exemption. Although the purpose of Regulation Crowdfunding is to reduce the regulatory burden,46 the issuer must still comply with some regulations. And compliance with these regulations would, in all likelihood, entail hiring legal counsel to assist in completing the offering disclosure statement.47 At a minimum, the issuer must engage a funding portal or broker-dealer and in many cases engage an independent accountant to prepare either reviewed or audited financial statements.

Another potential downside to issuing crowdfunded securities is the prospect of hundreds of small investors. This is likely to cause operating burdens with respect to holding shareholder meetings, obtaining quorum for shareholder votes, and incurring expenses involved with keeping shareholders apprised of corporate matters.

The burden of complying with the financial disclosure requirements of Regulation Crowdfunding is another potential downside to seeking capital through a crowdfunded securities offering. As described earlier, any offering above $100,000 requires, at a minimum, reviewed financial statements, and in some cases, fully audited financial statements—an expense that is not typically incurred by a standard franchisee.

As with all public offerings of securities, the would-be issuer needs to consider the possibility of liability for material misstatements and omissions in its offering documents. Section 11 of the Securities Act provides that if a registration statement contains an untrue statement of material fact or if a material fact is omitted, an aggrieved investor can recover the difference between the purchase price and the price at which it is able to dispose of the security.48 The investor is entitled to sue any of a number of individuals involved with the registration statement, including every person who has signed the registration statement; the issuer’s principal officers; each member of the issuer’s board of directors; every person who has consented to being named in the registration statement as a prospective director of the issuer; professionals, such as accountants, engineers, and appraisers, who have consented to being named as having prepared or certified a portion

45. However, see Part IV, which discusses whether disclosing financial statements to prospective investors may violate a franchisee’s confidentiality obligations.
46. Supplementary Information, 80 Fed. Reg., supra note 8, at 71488 n.2.
47. The Office of Management and Budget estimates that the “average burden hours per response” in completing Form C is nearly forty-nine hours. 17 C.F.R. § 239.900.
of the registration statement; and every underwriter. The liability of these individuals is joint and several. These potential extra costs arising from a securities violation are particularly risky for franchisees, which not only have standard overhead costs, but which also have to pay ongoing fees to a franchisor that may be unlikely to grant any forbearance arising from a default resulting from cash flow problems that may arise during such a securities dispute. By contrast, a franchisor would need to consider such cash flow problems arising from a securities dispute as potentially triggering a violation of a loan covenant if it relies on lender funding for its operations.

3. Tips for Issuers

If, despite the risks and possible downsides, a franchisee still wishes to offer securities through a crowdfunded offering, the issuer should bear in mind a few tips. First, Regulation Crowdfunding specifically allows oversubscriptions as long as the issuer does not exceed the $1 million annual limit. There is no maximum oversubscription amount. Allowing for an oversubscription is a good practice because of the ability of investors to rescind their investment within forty-eight hours prior to the deadline identified in the offering. If the issuer allows for an oversubscription, it will need to describe how oversubscribed securities will be allocated.

Issuers also need to be aware of the restriction on their ability to advertise the terms of the offering. In particular, an issuer can issue an advertising notice as long as it directs prospective investors to the intermediary’s platform and includes no more information than: (1) a statement that the offering is being conducted under the crowdfunding exemption of Section 4(a)(6) and the identity of the intermediary through which the offering is being conducted; (2) the terms of the offering; and (3) factual information about the issuer, which is limited to the issuer’s name, address, phone number, and website, an email address for a representative of the issuer, and a brief description of the issuer’s business. The SEC has clarified that brief, informal social media communications about the offering would theoretically be allowed. As an example, the SEC cites a social media post by an issuer that notes that the issuer is conducting an offering and that directs prospective investors to the issuer’s registration materials on the intermediary’s website as likely to be acceptable. Advertising notices do not need to be filed with the SEC.

51. 17 C.F.R. § 227.201(h).
52. See Part II.D.1.
53. 17 C.F.R. § 227.201(h).
54. 17 C.F.R. § 227.204(b).
55. Supplementary Information, 80 Fed. Reg., supra note 8, at 71425.
56. Id.
57. Id.
The final tip to keep in mind in seeking to raise capital from a crowd-funded securities offering is the restrictions on promoter compensation. Regulation Crowdfunding permits compensation to, or a commitment to compensate, directly or indirectly, any person to promote the issuer’s offering through communication channels provided by the intermediary as long as the issuer, or the person acting on the issuer’s behalf, takes reasonable steps to ensure that the person promoting the offering discloses the receipt, or anticipated receipt, of any compensation in connection with the communication. Other than compensation described in the previous sentence, no issuer may compensate any person to promote the issuer’s offering unless the promotion is limited to advertising notices permitted by Rule 204 of Regulation Crowdfunding.

B. Franchisors

Subject to the same drawbacks as a franchisee-initiated crowd-funded offering, a securities offering by a franchisor could make sense in the right circumstances. However, it may not work as well as it would for franchisees. In particular, as described earlier, an issuer of securities is permitted to raise a maximum of $1 million in the aggregate through crowd-funded offerings in a twelve-month period. Depending on the size of the franchise system, this $1 million limitation may be an insufficient amount of capital to make a crowd-funded offering worthwhile.

On the positive side, because a franchisor must already prepare audited financial statements in connection with its FDD, there would be little extra cost involved in using the audited financial statements in a registration statement. In addition, much of the information required in Form C for a crowd-funded offering overlaps with information that must be disclosed in a franchisor’s FDD. As such, the burden of assembling this information may be less onerous than for a franchisee that wishes to offer securities via a crowd-funded offering.

However, franchisors should bear in mind that there is not perfect overlap between the information required by the FDD and Form C and that Form C in some cases requires more information be disclosed than the FDD. As an example, Form C requires the disclosure of all principal shareholders (defined as each person who is the beneficial owner of 20 percent or more of the issuer’s outstanding voting equity securities). Form C also requires disclosure of the material terms of all indebtedness, including the identity of the creditor, outstanding amount, interest rate, maturity date, and other material terms. Some franchisors may be unwilling to disclose this information.

58. See generally 17 C.F.R. § 227.205 (describing restrictions on promoter compensation).
59. 17 C.F.R. § 227.205(a).
60. 17 C.F.R. § 227.205(b).
61. 17 C.F.R. § 227.100(a)(1).
63. 17 C.F.R. § 239.900, at question 24.
addition, some franchisees may argue that this is material information that should have been disclosed in the franchisor’s FDD.64

In structuring a franchise offering, a franchisor would likely want to create a general holding company to issue the shares. The actual franchisor entity would be a subsidiary of the holding company. Other subsidiaries of the holding company could include entities in charge of overseeing operations and employee matters, operating company-owned units, holding intellectual property assets, and overseeing global operations.

IV. Franchisor Considerations in Consenting to Franchisee Crowdfunded Offerings

Assuming a franchisee wishes to raise capital through a crowdfunded securities offering, at a threshold level, it will almost certainly need to obtain the consent of its franchisor pursuant to the “restriction on transfer” provisions of the franchisee’s franchise agreement. In contemplating whether to grant its consent, a franchisor needs to consider several factors.

The first factor that a franchisor will want to consider is any potential liabilities that it could be responsible for in connection with a franchisee’s issuance of securities. The biggest concern in this area surrounds potential secondary liability for a franchisee’s violation of securities law. As discussed earlier, the universe of potential defendants in a Section 11 claim involves all individuals involved with the registration statement, including every person who has signed the registration statement; the issuer’s principal officers; each member of the issuer’s board of directors; every person who has consented to being named in the registration statement as a prospective director of the issuer; every professional, such as accountants, engineers, and appraisers, who has consented to being named as having prepared or certified a portion of the registration statement; and every underwriter.65 For this reason, the franchisor needs to take a careful approach that it does not participate in the franchisee’s preparation of its registration statement. In addition, the standard warnings against exercising too much control over a franchisee’s operations would apply to avoid the possibility of liability under a vicarious liability basis. In fact, an especially cautious franchisor may not want to risk reviewing the registration statement at all even though there may be good reasons to do so, as described below.

Another factor that a franchisor may wish to consider is whether it is worth the risk to the franchise system to allow franchisees to raise capital via a crowdfunded securities offering when there is a risk of purchasers of such securities losing their entire investment if the franchise does not succeed. In other words, will the negative publicity generated by individuals

64. Franchisors should, of course, bear in mind the general restriction on including information in their disclosure documents that is not required or permitted. 16 C.F.R. § 436.6(d).
who have lost their investment in the franchisee’s securities be worth the risk to the franchise system overall? Instead of having just a few principal shareholders who have taken part in an unsuccessful franchise, there is now the prospect of several hundred or even more investors who have lost their investment by investing in a franchisee that has not succeeded. These investors would not be the best ambassadors for the franchise system and are likely to air their grievances about an investment loss online. One possible solution to this risk is by limiting a franchisor’s consent to a crowdfunded offering only to franchisees that have previously shown their success in operating within the franchise system. Nonetheless, the risk to the brand is significant. A franchisor could also face lawsuits from hundreds of owners or investors who are upset with the franchisors’ conduct or believe the system was oversold and they were fraudulently induced to invest. For example, the investors may rely on statements made on the franchisor’s website, and while the franchisee’s principal owner may have disclaimed reliance on representations outside of the FDD, can that disclaimer be imputed to all crowdfund investors?

Finally, as a third factor, and as discussed in more detail below, the franchisor should consider the risks involved with the franchisee’s disclosure obligations in connection with registering the crowdfunded offering. Such risks include disclosing confidential information to franchisee shareholders who may not be bound by confidentiality obligations or disclosing information to shareholders who own competitive businesses.

Assuming the franchisor is comfortable with the risk of assuming secondary liability for a franchisee’s violation of securities law and consents to the franchisee issuing securities, it will need to consider a variety of factors. Among these factors are which shareholders will be required to sign personal guarantees. Most franchise agreements provide that the owners of a franchisee owning a certain threshold percentage interest in the franchisee, or sometimes even all owners, must sign a personal guarantee agreeing to be bound to the franchisee’s monetary and other obligations under the franchise agreement. Accordingly, the franchisor will need to decide whether it will waive this requirement for any shareholders who purchase securities in a franchisee.

As a related factor, the franchisor will need to consider to what extent it will allow dilution of the franchisee’s principal shareholders. In other words, the franchisor may be willing to consent to its franchisee issuing securities as long as the principal shareholders, with whom the franchisor wishes to deal, remain majority owners following the issuance of securities in the franchisee. Therefore, a franchisor may wish to consider conditioning its consent to a franchisee issuance of securities on a maximum level of shareholder dilution.

Another factor to consider is the scope of the financial disclosures that a franchisee must make in its registration statement. As explained earlier, any offering above $100,000 requires, at a minimum, reviewed financial statements and fully audited financial statements in some cases. Is the franchisor going to be willing to allow its franchisees to make these financial disclosures public in a registration statement? Will these financial disclosures provide...
the public insights into unit-level franchise performance? What about the possible disclosure of trade secrets in the form of pricing strategies? Franchisees should consider whether disclosing this information to prospective investors violates their confidentiality obligations to their franchisors since many franchise agreements provide that financial results from the operation of the franchise cannot be disclosed to third parties.

With respect to non-financial disclosures, the franchisor will want to ensure that the franchisee will not be disclosing any confidential information or trade secrets. For instance, will competitors be able to obtain the franchisor’s confidential information and trade secrets by purchasing shares of a franchisee who is obligated to disclose certain information to all shareholders? For this reason, it would be good practice to require the franchisee to provide a draft of its registration statement to the franchisor before making the document public to allow the franchisor the ability to review the information being disclosed. However, the franchisor should exercise caution only to review the proposed registration statement, and not recommend revisions or other changes, so as not inadvertently to fall into the category of a person who helped prepare the registration statement and thereby opening itself up to possible Section 11 liability for misstatements or omissions in the registration statement.66

From the perspective of the franchisor’s disclosure obligations, if the franchisor decides to allow franchisees to offer securities as a routine part of raising capital, the franchisor should consider whether it may need to revise any portions of its FDD. For instance, the cost of compliance issues may be a cost that should be included with the initial investment figures contained within Item 7.67 If the franchisor charges a fee to review, or to have its counsel review, a franchisee’s proposed registration statement, that fee may need to be disclosed in Item 6.68

V. Conclusion

Title III of the JOBS Act and Regulation Crowdfunding have opened up possibilities for businesses to sell securities to unaccredited investors through a less rigorous process than a full securities filing. It may be a good option for franchisees that wish to raise sufficient capital to purchase and develop a franchise without resorting to taking out loans or for franchisees that wish to expand the number of units it owns. For franchisors, the benefits are less clear-cut, particularly in light of the maximum offering amount of $1 million in each twelve-month period. However, notwithstanding these issues, crowdfunding may play a role in the franchise industry, and an understanding of its rules and contours is important for practitioners in franchise law.

66. See Part IV.
67. Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436.5(g).
68. 16 C.F.R. § 436.5(f).
Negotiating Critical Representations and Warranties in Franchise Mergers and Acquisitions—Part II

Andrae J. Marrocco

Franchise systems present a valuable investment proposition for both strategic and financial purchasers. Entrepreneurs seeking out their next business venture, manufacturers in need of a distribution network for their products or services, and competitors looking to take advantage of synergies, economies of scale, expanded offerings, or growing market share—in each case—can achieve those investment goals through the acquisition of a franchise system. Private equity firms are attracted by the robust, diversified, and continuous royalty streams; the proven (often internationally) business model; the potential for organic and rapid growth (without significant capital investment); and the goodwill and strength of an established brand that franchise systems can provide.

As posited in Part I of this article, franchise M&A has become increasingly popular and sophisticated over the past decade, a trend that looks likely to continue. Moreover, franchise M&A transactions involve unique considerations that are relevant from initial strategy discussions, to the letter of intent and due diligence stages, through to the drafting and negotiating of the transaction documents. The terms of an M&A deal are laid out in the cornerstone document commonly referred to as the purchase agreement (irrespective of the underlying stock or asset purchase transaction). This article continues (from Part I) the focus on critical considerations that will ultimately shape the terms of the purchase agreement.

Part I includes a general discussion about representations and warranties, their purpose and use (e.g., in allocating risk), and the current seller-oriented market in which parties find themselves. Specific considerations and repre-
sentations come into play when dealing with particular industries and market segments, such as the franchise sector. Part I develops the notion of a franchise system as a complex web of relationships among suppliers (which provide the necessary inputs for the business); franchisors (which establish and monitor the business model); and franchisees (which deliver the products and services to the consumer). The most intricate part of the web is the unique franchisor-franchisee relationship that is based on a comprehensive interdependence. Special attention must be paid to this complex web of relationships from the outset, and particularly during the due diligence phase of an M&A deal, because a number of issues and deficiencies often surface during proper due diligence of a franchise system.\(^2\) Not only is the franchise business model unique, but in many jurisdictions it is also regulated by specific franchise laws. Strategy and analysis of these matters leads to the inclusion of specific representations and warranties in the purchase agreement to address the issues and deficiencies.

Part II is split into three parts: (1) a discussion of additional best practice principles (continued from Part I) that apply in drafting representations and warranties, (2) an exposition of further select representations and warranties (also continued from Part I) and how they are crafted from the unique considerations that apply in franchise M&A transactions, and (3) further considerations for dealing with foreign jurisdictions and certain matters specific to Canada.

Finally, even though Part I and Part II of this article have been written predominantly from the perspective of a prospective purchaser (negotiating and drafting representations and warranties in the franchise M&A context), the author hopes that sellers will also benefit from the discussion and analysis.

I. General Best Practices

When it comes to drafting representations and warranties in the franchise M&A context (and in some cases generally), a number of best practice principles apply. Continuing from Part I, some of the more critical ones are set out below:

A. What Is a “Franchise Agreement”?

Franchise agreements and “arrangements” are the cornerstone of the franchise system. The representations and warranties dealing with franchise agreements (as detailed in Part I) can be undermined by a narrow or poorly drafted definition of “franchise agreements.” This term should be defined in a broad enough way so as to capture all sorts of permutations of franchising, including joint ventures, partnerships, and alternative licensing arrangements. At the same time, care must be taken to ensure that an expanded def-

inition interacts appropriately with the relevant representations and warranties. An alternative (more detailed) approach is to bifurcate the definition such that “franchise agreements” comprises only those typical agreements, and “franchise arrangements” includes the broader categories of franchise arrangements referred to above. Finally, whichever approach is adopted, the definitions should cover undocumented arrangements (e.g., where one or more franchisees are holding over or where certain arrangements were never documented). Having said that, undocumented arrangements should also be dealt with by other means (e.g., with a condition to closing that they be negotiated and documented).

B. General vs. Specific

There are differing schools of thought on whether representations and warranties should be general (avoiding duplication and verbosity) or whether overlapping and more specific representations and warranties addressing similar subject matter are preferable (striving for better protection). A general catchall “compliance with laws” representation and warranty may, in some cases, be sufficient to address all areas of regulatory compliance. In other cases, (1) the representation and warranty may need to be shaped to reflect particular compliance aspects (e.g., franchise specific legislation in which specific elements of compliance need to be emphasized); (2) negotiated carve outs or qualifiers may be entirely unacceptable for all elements of a general representation and warranty (e.g., a purchaser may resist the application of a materiality qualifier on strict compliance with franchise specific legislation, but may be amenable to such qualification on compliance with all other applicable laws); and (3) additional comfort may be required or desired by a party, and for business reasons it may be important to include a specific representation and warranty separately (e.g., compliance with franchise laws of a particular jurisdiction that has a unique approach to regulation).

C. Watch Overlap and Inconsistency

The corollary of the above is that purchasers should be circumspect and avoid crafting and negotiating overlapping and inconsistent representations and warranties. This scenario can lead to ambiguity and confusion and potentially less protection for the purchaser (i.e., in circumstances where a court is required to interpret the meaning of two conflicting representations and warranties). Such conflict can arise, for example, where purchase agreements include more than one representation and warranty dealing with “compliance with laws,” e.g., general laws, tax laws, real property laws, and franchise laws. Purchasers should ensure that in circumstances of overlap, one provision does not detract from the other through inconsistent qualifiers or other limiting language. Protective language, such as “in addition to and without derogation from section X . . . ,” can be useful, but its utility can be limited where multiple sections deal with the same subject matter. Includ-
ing a contra proferentem provision may also afford some protection for the drafting party, but should not be relied upon to remedy loose drafting.

D. Rectify Before You Close

Certain deficiencies are best rectified either up front before negotiating and signing a purchase agreement or during the interim period (after signing, but prior to closing). Parties should not attempt to force a square peg in a round hole by including in the representations and warranties issues that should be appropriately addressed before finalizing the business deal. For example, with respect to registration of intellectual property, some purchasers will insist that all rectification work be undertaken before entering into purchase agreement negotiations. Alternatively, the rectification work may be included in the purchase agreement as a covenant (requiring the seller to undertake the specific work) with a corresponding condition to closing. Relying on post-closing covenants to undertake such work not only puts the purchaser in a weaker position (e.g., vis-à-vis recourse), but also exposes the purchaser to additional risk and potential liability (e.g., not being able to realize its expansion plans).

E. Sandbagging

Sellers will sometimes look to limit the ability of the purchaser to pursue an indemnity claim for breaches, defects, or liabilities that the purchaser was aware of prior to the closing of the transaction (“anti-sandbagging”). Conversely, purchasers will look to protect themselves from such limitations by including “pro-sandbagging” provisions permitting them to pursue an indemnity claim (post-closing) notwithstanding knowledge of any breach, defect, or liability prior to the closing of the transaction. If a purchaser compromises on this point, the “knowledge” of the purchaser should be carefully defined and limited. For example, some purchasers will agree to an anti-sandbagging provision provided that knowledge of breaches, defects, or liabilities is limited to the “actual” knowledge of specific individuals or classes of individuals, e.g., senior management responsible for managing the business, negotiating the purchase agreement, or both. The onus of proving knowledge in any case can be quite cumbersome. Accordingly, some sellers and purchasers limit the scope of knowledge to the information contained in the data room, which is then maintained post-closing for future reference.

F. Franchise Disclosure Documents

From the perspective of learning about the franchise system, franchise disclosure documents are an integral part of the due diligence undertaken by a prospective franchisee when considering the purchase of a franchise unit. The approach to franchise disclosure documents in the franchise M&A context is significantly different for a number of reasons. First, the purchaser of a franchise system will require much more information about the franchise system than the prescribed information contained in franchise
disclosure documents. For example, the list of court proceedings described in franchise disclosure documents may be a good starting point. However, not all litigation in which a franchisor or its affiliates are involved will necessarily be listed in the franchise disclosure document. Under various provincial franchise statutes in Canada, only certain types of litigation must be disclosed, e.g., litigation regarding allegations of fraud or failure to comply with the statutes. Accordingly, the franchise disclosure document cannot be relied upon to be conclusive on all subject matter contained in it. Second, the veracity and completeness of the franchise disclosure documents may be an issue. Purchasers in fact should conduct due diligence on the franchise disclosure documents including an assessment of the veracity and completeness of statements made; confirmation of jurisdiction specific compliance, e.g., registration in the relevant states; and appropriate delivery to prospective franchisees.

II. Drafting Representations and Warranties

Turning to a review and analysis of the unique critical considerations that should be addressed in acquiring a franchise system, and how representations and warranties can be crafted to address those considerations, it should be noted that:

(1) the unique considerations selected for discussion, while critical from the author’s perspective, are not intended to be exhaustive of all matters that should be addressed;
(2) Part I of this article addresses a further set of unique considerations;
(3) the discussion, analysis, and model representations and warranties are intended to stimulate thought and to provide insight and guidance on the unique considerations that apply to franchise M&A transactions;
(4) in the current seller’s market, purchasers often make numerous compromises on representations and warranties;
(5) although only a handful of critical considerations are discussed, it is intended that the methodology, rationale, and tools of analysis used (and suggestions on how to deal with them) can be extrapolated to others;
(6) the discussion and analysis of representations and warranties apply, for the most part, whether the transaction is an asset or stock transaction;
(7) the discussion and analysis of representations and warranties relate specifically to transactions involving U.S. and Canadian franchise systems (although they may be applicable beyond that), but do address global transactions in certain aspects; and

(8) the focus is on negotiating the representations and warranties (provided by the seller to the purchaser of an entire franchise system) from the purchaser’s perspective.

The value of a franchise system is found in its intangible assets. These assets, discussed further below, are broadly categorized as intellectual property and associated goodwill, key relationships, material contracts, and human capital. In any franchise M&A transaction, the process must reflect an appreciation of, and place a degree of focus on, these assets in the context of the franchise business model. The representations and warranties negotiated into the purchase agreement should be similarly focused.

A. Management and Compliance

Running a successful franchise system involves good management of franchise units and consistent implementation of compliance measures. Purchasers spend a good deal of time conducting due diligence and specifically reviewing and assessing how franchisors identify and deal with non-compliance issues in their system. Franchisee files are a rich source of information that can inform the purchaser as to the conduct and approach the franchisor has taken in this regard. Avoiding full-blown disputes over non-compliance issues is desirable, but a laissez faire approach to enforcing standards weakens the franchise system. For example, if franchise units are late with or dismissive of store upgrades and enhancements, the goodwill and allure of a brand may be weakened for the whole system. This is an area where comprehensive due diligence and appropriate closing conditions with respect to rectification and enforcement of system standards serve the purchaser well.

Management and compliance representations and warranties should be included in the purchase agreement to deal with certain unknown matters, particularly where only a select pool of franchisees has been assessed in due diligence. This representation usually states that franchisees are in substantial compliance with all of the requirements of the franchise system—and that franchisees are operating their franchise businesses in accordance with the franchise (and related) agreements, as well as the operations manual and system standards. The representation typically includes a statement that such standards have been maintained and enforced by the franchisor consistently and in an appropriate manner. If possible, a better approach is to include a representation and warranty that references the franchisor’s policies and procedures and attests to compliance with those particular policies and procedures. Where a franchisor seller seeks to qualify the representation and warranty with certain exceptions (as is customary and advisable for sellers to do), purchasers should attempt to have the seller remedy at least the serious deficiencies. Clearly, if the deficiencies relate to incomplete physical store upgrades, completion is not likely to take place prior to closing.

However, this does not prevent the purchaser from requesting that undertakings and construction contracts form part of the closing conditions (and perhaps that work is commenced prior to closing).

B. Regulatory Compliance

Franchising, in many jurisdictions, is a specifically regulated business activity. Moreover, within jurisdictions, franchisors may operate under a multi-level regulatory scheme. All this serves to make compliance with laws a complex matter for franchisors. Specific franchise and business opportunity laws can also regulate the sale of franchises, the ongoing conduct of franchisors, and the ending of the franchise relationship. In addition to filing, registration, disclosure, and business opportunity laws, a host of other laws apply to franchise systems. Given its complex web of arrangements that, in some cases, may span the globe, the franchisor seller will normally look to qualify, restrict, and limit the general representation regarding compliance with laws. There are potential minefields for unsuspecting sellers that agree to a broad representation and warranty in this regard. Having said that, conventional wisdom would suggest that allocating risk (as it relates to legal compliance) to the seller makes sense, given that it should have appropriate control over its system. For the purchaser, it is important to ensure that the general (compliance with laws) representation and warranty does not interfere with or compromise (or otherwise create ambiguity with respect to) more specific representations and warranties given in respect of franchise laws. Moreover, the following matters should be addressed by the regulatory and compliance representations and warranties:

- Included is the list of jurisdictions (national and international) in which the franchisor offers franchises for sale, or otherwise conducts its franchise business, including the jurisdictions in which filings or registrations are required.
- The franchisor has complied with all applicable franchise laws, including those relating to filings, registrations, updates/revisions, and disclosure, and relevant business relationship laws in all jurisdictions in which it offers, sells, and operates the franchise system, and the purchaser has been provided with copies of all filings and registrations documentation pertaining to such compliance.
- The franchisor has not received any orders, revocations, default notices, or requisitions of any description from, and there are no administrative


6. Interference, ambiguity, or compromise can occur for example in circumstances where the general representation and warranty is qualified by materiality, but a specific representation and warranty on a similar subject matter is not so qualified.
actions or current proceedings with, any administrative or regulatory agency in any jurisdiction (whether or not related to filings or registrations).

- Included is a list of all franchise disclosure documents (and their respective jurisdictions), together with a representation and warranty that the franchisor has provided to the purchaser true and complete copies of all such franchise disclosure documents used by the franchisor over a defined period.

- In jurisdictions where a franchise disclosure document is required, such disclosure documents have been prepared, maintained, updated, and delivered to franchisees strictly in accordance with the franchise laws of that jurisdiction, including with respect to all requisite filings, registrations, updates/revisions etc.

- The franchise disclosure documents and all other advertising and marketing materials used by the franchisor (current and previous within a defined period) do not contain any untrue statements or misrepresentations, and where earnings claims or financial performance representations have been included, they have been calculated on the basis of correct and accurate information.

- Except for the earnings claims or financial performance representations included in franchise disclosure documents, the franchisor has not authorized its representatives to provide any information or documentation that could be construed as such.

C. Disputes

Disputes and court actions have the potential to harm a brand. This is not limited to actions instituted by the franchisee against the franchisor, but also by others in contractual relationships with the franchisor, e.g., suppliers, as well as third parties, e.g., vicarious liability claims. The latter are on the increase as seen in recent joint employer and data breach litigation. Furthermore, disputes and the commencement of litigation may result in copycat actions, a class/group action against the franchisor, or both. A prudent purchaser should therefore take care to conduct searches at all levels of the franchise system with respect to court actions to ensure that all information about any litigation is uncovered. This due diligence requires a number of judgment calls as to the extent of the searches to be conducted across different jurisdictions and different levels within the web of the franchise relationships. It is also advisable to review franchisee files to determine the kinds of issues that may have given rise to disputes but that were either settled with, or abandoned by, franchisees. These considerations should not be limited to existing franchisees, but should extend to former franchisees that recently departed the system that may have claims against the franchisor with respect to the termination, transfer, or otherwise. As discussed in “Franchisee
Satisfaction” in Part I of this article, franchisee associations may also be a valuable source for this kind of information.

Generally, the representations regarding litigation state that all litigation that the franchisor is aware of is listed in a schedule to the purchase agreement. They typically go on to state that the seller is not aware of any other facts that could lead to a court action. The purchaser may request, particularly where the franchisor is also the manufacturer/supplier of certain inputs, that the seller specifically represent that there are no product liability claims, pending or threatened, alleging any defects in the design or manufacture of the products of the seller or any materials used to produce such products. The purchaser may also wish to include specific language stating that there are no pending or threatened actions with respect to the seller’s intellectual property, including copyright and patents. Sellers generally look to include knowledge qualifiers for at least some elements of the litigation representation and warranty to limit their liability. A purchaser may look to broaden the litigation representation and warranty to include other entities, such as master franchisees.

D. Financial and Unit Economics

In any acquisition, obtaining accurate and correct financial statements concerning the target is critical. The financial statements contain much of the information upon which the purchase price is based. The importance of due diligence with respect to financial information cannot be overstated. In the case of a franchise system, the franchisor derives its revenue from multiple layers of business activity, e.g., the franchisor’s direct franchisees, master franchisees and their franchisees, and area developers. Robust unit economics are a strong indicator of the health of a franchise system and are necessary for the ongoing positive financial performance of the franchisor.

In light of the above, the purchaser should ensure that the financial information provided is sufficient to permit it to do the following:

- Gain a clear understanding of the quality of the royalty stream (stress testing), including an appreciation of the nature of the franchisee population.
- Scrutinize two key aspects of franchise unit economics: (1) the turnkey development costs, e.g., franchise fees, build out costs, working capital, inventory, and initial marketing; and (2) the annual cash profits that franchisees generate.

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7. Marrocco, supra note 1, at 121.
8. See supra note 6.
10. Id. at 9.
• Ensure that the financial statements clearly delineate recurring revenue from one-time payments.

• Analyze and form a view as to the likely percentage of upcoming terminations and non-renewals (by either party) of franchise arrangements and model how royalty streams will be affected.

• Take a position on the delinquent franchisees (in consultation with the franchisor seller) to model probabilities of lost revenues.

The representations and warranties regarding financial statements normally state that the seller’s financial statements have been prepared in accordance with consistently applied generally accepted accounting principles and present fairly and accurately the revenues, results, assets, and liabilities of the franchise business. Ideally, and to the extent possible, the financial information included in the latter representation and warranty should include all the information that the purchaser relied on in its valuation assessment. Generally, financial statements will be included in a schedule affixed to the purchase agreement. Where the franchisor operates internationally, there may need to be more specificity as to the particular standards to which the financial statements have been prepared. In addition, the purchaser should also assess as part of its due diligence whether the financial statements provided to prospective franchisees (in the franchise disclosure document) were prepared in compliance with franchise laws (other laws and accounting principles) in the relevant jurisdiction(s).

E. Advertising Fund

In a franchise system, a franchisor will almost always require that its franchisees contribute to one or more marketing and promotional funds. It is not uncommon for such funds to be a contentious part of the franchisor-franchisee relationship. This is because franchisors typically have broad discretion over how to apply the funds, and franchisees often have a clear idea as to how they believe the funds could be utilized to benefit their territory. As such, the purchaser should make itself aware of any issues related to the advertising fund and its management/administration, and should ensure that the funds have been spent consistently with documented policies that comply with the terms of the franchise agreements. Franchisee files, franchisee association correspondence, and minutes of meetings should be closely reviewed to uncover any disputes or concerns that have been raised previously by franchisees on the management of the advertising fund.

In some transactions, the proposed advertising fund due diligence is not possible because of the scale of the transaction, the lack of manpower of the purchaser, or poor record keeping by the franchisor. In such cases, the representations and warranties become especially important. Generally, a representation and warranty on this topic should state that the franchisor has: (1) kept proper records for all monies spent on advertising and marketing (and provided same to the purchaser); (2) the management and administra-
tion of all funds has been conducted in compliance with all relevant agreements and franchise laws; and (3) there are no actual or threatened claims regarding the management and administration of the funds. In addition, representations and warranties, if pertinent, could be included as to the viability of the advertising fund (i.e., that there are sufficient funds to meet ongoing obligations), the franchisor’s ownership of all advertising and marketing materials, and that all arrangements with third parties are in good standing.

III. Canada and Foreign Jurisdictions

When advising clients on international franchise transactions, local counsel are often engaged to advise on the relevant local laws as they relate to franchising as well as other relevant areas of law. Best practices in franchise M&A mandate a similar process. For the purposes of due diligence, engaging with local counsel in a more meaningful way is the recommended (and ultimately the best and most effective) approach rather than having local counsel simply rubber stamp purchase agreements and provide memos on franchise laws in the relevant jurisdiction. Engaging local counsel to undertake the portion of the due diligence that relates to their jurisdiction (e.g., review of franchise agreements for that specific jurisdiction) and assisting with the crafting of certain representations and warranties leads to a more efficient and effective process. The relevant local counsel is best placed, for example, to review the agreements relating to their jurisdiction, especially where franchise laws are enacted.

Canada provides a cogent example of similar yet unique franchise laws that militate in favor of having Canadian counsel participate in due diligence and drafting of the purchase agreement, particularly with respect to representations and warranties. Franchising is provincially regulated in Canada. Currently, only five out of Canada’s ten provinces (and three territories)—Alberta, Manitoba, New Brunswick, Ontario, and Prince Edward Island—have franchise legislation in force. British Columbia’s recently enacted franchise legislation and more recently finalized franchise regulations will come into force on February 1, 2017. Franchise legislation across the provinces is similar, but there are nuances (e.g., with specific disclosure requirements) that must be borne in mind when conducting due diligence. Moreover, when conducting due diligence on the Canadian franchise arrangements of a U.S. (or international) franchise system, the following recent developments demonstrate how knowledge and experience with Canadian franchise law (and Canadian law in general) can provide valuable insight on the due diligence phase and on strategy post-closing of the transaction.

- Ontario recently enacted legislation\(^\text{11}\) to amend its franchise law to permit delivery of a franchise disclosure document by electronic means; previously, such delivery was not permitted. However, practitioners

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11. O. Reg. 581/00: General s. 12.
in the field are still developing the practice of disclosure by electronic means in a way that is consistent with other provisions of the legislation. For example, s. 5(3) of the *Arthur Wishart Act* (Franchise Disclosure), 2000, requires a disclosure document to be delivered as “one document at one time.” This raises questions regarding the new electronic means of disclosure: what happens if one document is too large to be transmitted as one email file? Purchasers require assistance in assessing whether franchise disclosure documents issued by electronic means comply with the legislation.

- The approach to drafting non-competition covenants has shifted in light of the recent case of *MEDIchair LP v DME Medequip Inc.* where the Ontario Court of Appeal refused to enforce a non-competition covenant on the grounds that the franchisor had no intention of continuing to operate in the protected geographic area. The court concluded that there was no “legitimate interest” to protect in the circumstances. Purchasers may want to undertake a specific assessment of the communications between franchisors and their Canadian franchisees to determine whether the franchisors’ rights under non-competition covenants may have been compromised on the basis described above.

- The Canadian approach to system change has been refined as a result of the *Tim Hortons* case, which addressed the franchisor’s right to modify its system. The Ontario Superior Court of Justice found that Tim Hortons had complied with its contractual obligations under the franchise agreement; had acted in good faith by making decisions honestly and reasonably for legitimate business purposes; and had appropriately conducted a consultation process with its franchisees, taking their legitimate interests into consideration. If recent system changes have been implemented in a target system with Canadian franchise units, purchasers will want to assess the manner in which such changes were introduced in light of the Canadian jurisprudence.

- Complex and controversial are the lessons learned from the *Dunkin’ Donuts* case regarding the obligations of a franchisor to its franchisees, and the brand as a whole, and their application to provinces outside of Québec. If a target international system includes Canadian franchise

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15. The court found that by not taking adequate steps to support and protect the Dunkin’ Donuts brand from the influx of Tim Hortons in Québec, the franchisor had fundamentally breached the terms of its franchise arrangement, including implied covenants of good faith. The court said that brand protection is “an ongoing, continuing and successive obligation” of the franchisor. It is important to note, however, that this is a Québec decision and will have varying influences on other Canadian provinces. See Andraya Frith, Éric Préfontaine & Gillian Scott, *La Belle Province: A Practical Business Guide to Key Legal Issues When Franchising in Québec*, 36:2 *Franchise L.J.* 303 (2016).
units, it would be worthwhile assessing the relationship between the franchisor and the Canadian franchises and whether there are any vulnerabilities when it comes to the franchisor’s approach to protecting and supporting the franchise brand in Canada.

• Labor laws and joint employer issues are distinct and in some cases vastly different from the United States. Unlike the United States (where the issue is being developed by the courts), Ontario is currently undergoing a review of its legislation (Labour Relations Act, 1995 and the Employment Standards Act, 2000), and submissions have been made on the approach to joint employer status.¹⁶ As the review of the legislation unfolds and beyond, purchasers will require assistance—and suggestions on how to improve the situation as required—in considering their position vis-à-vis how the target system’s current franchise arrangements with Canadian franchisees stand in light of Canadian joint employer standards.

• A franchisor’s involvement in the resale of franchise units has been scrutinized and best practices modified as a result of a number of recent cases¹⁷ where courts have ruled that franchisors incorrectly relied on the exemption from having to provide a disclosure document (the Resale Exemption) under Ontario law.¹⁸ When conducting due diligence on franchise resales (where franchise units have been sold by one franchisee to another) in Canada over the preceding two years (the maximum statutory rescission period), purchasers of a system will want to ensure that the franchisor either disclosed the incoming franchisee or that it appropriately relied on the Resale Exemption.

In addition to the ever-increasing changes to legislation and common law, local counsel can address other jurisdiction specific matters, such as intellectual property protection and registration, antitrust/competition laws, real estate and environmental law, privacy laws, foreign investment restrictions, and Québec’s civil law system—to name a few. Moreover, to the extent that it is relevant to the context of the transaction (e.g., a U.S. purchaser looking to acquire a Canadian based franchise system), local counsel can assist in negotiating more favorable terms in the purchase agreement based on

¹⁶. Proposed amendments to these laws include a proposal to deem a franchisor a joint employer of its franchisees’ employees for certain purposes.
¹⁸. Under ss. 5(7)(a)(iv) and 5.8(a) and (b) of the Wishart Act, franchisors are exempt from providing disclosure where “the grant of the franchise is not effected by or through the franchisor.” Ontario courts have consistently taken a narrow view of this exception to statutory disclosure obligations. A franchisor will generally be exempt where it is involved only in (1) exercising its right to consent to the transaction and (2) accepting a transfer fee. In cases where the franchisor has taken more than a passive role (e.g., by changing the term of the arrangement) in the assignment process, it is required to abide by the Wishart Act’s disclosure obligations.
their knowledge of what is considered “market” in their jurisdiction. For example, survival periods for representations and warranties tend to be longer in Canada, and Canadian sellers are more likely to agree on a full disclosure representation than sellers in the United States.

In summary, local counsel can assist by identifying the relevant issues in their jurisdiction from the outset of a transaction, comprehensively planning and conducting jurisdiction specific due diligence, and making comments on the purchase agreement in order to manage and allocate risk more effectively.

IV. Conclusion

The sophistication of franchise M&A has evolved significantly over the past decade, and with it the number of franchise attorneys with the corporate M&A proficiency required to competently advise on such transactions. For corporate M&A attorneys, the need to understand the nature of the franchise business model and the unique considerations associated with the complex web of relationships that comprise a franchise system are critical. Knowledge, skill, and experience with respect to both corporate M&A transactions and franchise law are a formidable combination when it comes to advising on franchise M&A transactions, which have developed into a distinct area of law in their own right. From this, it is hoped that more articles, whether academic, analytical, or practical, will be written to increase the body of literature around franchise M&A. Both Part I and Part II of this article provide insight on a more sophisticated approach to franchise M&A by exploring best practices in drafting representations and warranties and focusing on certain key representations and warranties in a franchise M&A purchase agreement. The best practice principles addressed in this article, along with the underlying rationale, tools of analysis, and informal checklists, will assist attorneys in navigating franchise M&A transactions and successfully advising their clients through the entire process.
Expanding business operations into the province of Québec is often overlooked, delayed, or avoided by international franchisors coming to Canada. Although its marked differences from the other Canadian provinces warrant adapting a franchisor’s approach to expansion, with sound legal and business advice and the appropriate upfront investment, Québec can be a very lucrative and rewarding market. This article is designed to introduce international franchisors to some of the unique aspects of franchising in Québec to allow them to assess the investment required to unlock the veritable opportunity the Québec market affords.

I. Business Profile of Québec

A. Population and Geography

Located in the northeastern part of North America, Québec is Canada’s largest province by area and second largest by population. The vast majority of Québec’s 8.3 million inhabitants

reside in cities, the most populous being Montréal, Québec City (the province’s capital), Gatineau, and Sherbrooke.²

Although Québec’s official language is French (the only province in Canada to hold French as its sole official language), approximately eighty other languages are commonly spoken. Additionally, almost half of Québécois speak both French and English, thus contributing to the province’s unique linguistic diversity.³

Québec benefits from a diversified economic landscape, in part because of its unique geographical location. The forestry sector, for instance, is a key economic driver in many of the province’s regions. In particular, pulp and paper production, softwood and hardwood timber products, and forestry management serve as important sources of economic growth and job creation.⁴ Similarly, Québec’s mining industry occupies an important position in the province’s economy. Québec is a worldwide leader in its production of iron, zinc, nickel, silver, and gold in addition to non-metallic minerals.⁵ The economy is dominated by the services sector, which produces about 70 percent of all goods and services.⁶ Other key industries in the province include manufacturing; transportation; and technology, which includes the aerospace, life sciences industry, and renewable energy sectors.⁷ The province’s gross domestic product (GDP) is CAD $363 billion, representing approximately 19 percent of the total GDP of Canada,⁸ and the per capita GDP stands at CAD $44,499.⁹

B. U.S. Business Presence in Québec Generally

The United States is Québec’s largest trading partner for both imports and exports; the province benefits from a considerable American commercial presence.¹⁰ The value of Québec’s total annual exports has grown consis-

5. Id.
6. Id.
7. Id.
tently and now stands at roughly $82 billion.\textsuperscript{11} Nearly 70 percent of those exports go to the United States.\textsuperscript{12} The United States is also Québec’s most significant source of imports, which were valued at $34 billion in 2015, accounting for 38 percent of Québec’s imports for that year.\textsuperscript{13}

Influenced by both the North American and European cultures, Québec attracts American investment in a variety of industries, and American companies, including a number of established franchisors,\textsuperscript{14} enjoy considerable success within the Québec market. However, linguistic requirements do pose certain challenges to English-speaking companies. As addressed in further detail in Part IV, the Québec \textit{Charter} of the French Language regulates the language of commerce and business in Québec.\textsuperscript{15} Section 2 of the \textit{Charter} sets forth the right of every person to have all firms doing business in Québec communicate with him or her in French.\textsuperscript{16} Despite these requirements, major U.S. companies and franchise systems continue to have an ongoing presence in the province, as exemplified by the over 100 American companies with offices in Québec.

\textbf{C. Overview of the Consumer Market and Consumer Tastes}

Québec’s blend of North American and European business and commercial culture uniquely positions the consumers in this market. A 2016 study by Nielsen examining the demographics and shopping habits of French Canadians found some unique differences between Québec consumers and the rest of Canada.\textsuperscript{17} In particular, Québec has a high number of single-member households, 26 percent more than the rest of Canada. The number of single-member households in Québec is increasing and currently represents 34 percent of the province’s population. This is in contrast to the rest of Canada, where single-member households have held steady since 2011 at 26.5 percent.\textsuperscript{18} According to Nielsen, a greater proportion of single-member households is correlated with income spikes in lower brackets in Québec as compared to the rest of Canada.\textsuperscript{19}

In the last year, Québec experienced an increase of 1.9 percent in consumer packaged goods (CPG), lagging behind the rest of Canada. Despite

\begin{footnotesize}
\begin{itemize}
\item 11. Institut de la Statistique Québec, \textit{supra} note 10 at 42.
\item 13. Institut de la Statistique Québec, \textit{supra} note 10, at 42.
\item 14. See, e.g., App. C for international franchises with a presence in Québec.
\item 15. \textit{Charter of the French Language}, CQLR c C-11, s. 2.
\item 16. \textit{Id.} at s. 2.
\item 18. \textit{Id.}
\item 19. Québec has 21% more households with incomes under $20,000 than the rest of Canada, 30% more with incomes ranging from $30,000–$39,000, and 29% more with income ranging from $40,000–$49,000. \textit{Id.}
\end{itemize}
\end{footnotesize}
this, the Nielsen research found that Québec households tend to spend considerably more on household products than the rest of the country. On average, Québécois spent $8,759 per household on CPG products—second to Alberta, where the household spending average was $9,490. Average spending on household products in Ontario was approximately $6,917 per household in 2015.20

In a series of research studies by Headspace Marketing Inc. in 2013, 3,000 respondents were surveyed to identify various consumer sentiments in Québec compared to the rest of Canada. The study found that brand loyalty (defined as a strong resistance to switching a brand) is far more pronounced in Québec than anywhere else.21 Québécois were also found to be more supportive of locally grown brands, making Québec potentially a more difficult market to penetrate.

With Québec displaying such different demographics than the rest of Canada, largely the result of its unique linguistic identity and traditions, many consumer researchers caution retailers and manufacturers to pay particular attention to French consumers’ habits and preferences when entering the Québec market.

Québec Practice Point—A franchisor entering Québec must do its own specific market research with respect to consumer preferences and should not rely solely on general research on North Americans or on English-speaking Canadians.

D. Key Franchises Operating in Québec

The Conseil Québécois de la Franchise (CQF) brings together franchisors and franchisees as well as suppliers of the franchise industry in Québec. According to the CQF, Québec houses over 8,000 franchisees and more than 300 franchisors.22 Québec has several Québec-established franchisors, some unique to its market and others that it has exported to the rest of Canada and beyond. These franchises cross a broad range of sectors from homegrown automotive franchises to those in the telecommunications sector, and most predominantly, those in the food services industry. A number of Québec-based franchises in the food industry, such as Cora, Bâton Rouge, Cacao 70, Eggspectation, Presse Café, Première Moisson, and Rôtisserie St-Hubert, to name a few, have extended their reach beyond the province.

and into other parts of Canada. See Appendix A for a list of examples of Québec-established franchisors.

The following Canadian national brands from diverse sectors also operate in Québec: Beaver Tails, Tim Hortons (food–quick service), M&M Food Market (food–grocery/retail), Mr. Lube (automotive services), and Trade Secrets (retail–cosmetics/beauty), to name a few. See Appendix B for a list of examples of Canadian franchisors with operations in Québec.

Of course, a number of international franchisors of various sectors and origin also operate in Québec, including Midas (automotive services), Kumon Math and Reading Centres (education), Planet Fitness (fitness), McDonald’s (food–quick service), and the UPS Store (printing/copying/shipping). See Appendix C for a list of examples of non-Canadian franchisors operating in the province.

II. Key Business Considerations When Planning Entry to the Québec Market

As with any business expansion, franchisors must devote significant economic and human resources to help ensure the successful launch of their brands in Québec. In addition to doing the homework necessary to understand the unique competition, customs, and consumer tastes found within the province, franchisors are often well-advised to engage a local business consultant or partner who is familiar with the market, has existing relationships with local landlords, and experience operating a business within the French language and civil law environment of Québec.

Even where the franchisor has established franchised operations in other parts of Canada, it is often a good idea to assess whether the same business model and organizational structure is appropriate for expanding into Québec. For example, as part of its initial launch into Canada, a franchisor may have successfully expanded using the direct-unit franchising model and franchise sales and training representatives from its home jurisdiction. However, given the relatively unique aspects of operating a business in Québec, a franchisor may decide that having a local presence, such as an area developer, multi-unit, or master franchisee with existing relationships and business experience in Québec, warrants a different approach.

Regardless of what business model is selected for their Québec expansion, many franchisors see the value in having “boots on the ground” and decide to partner with an area representative or hire an experienced locally based employee to assist with franchise sales and recruitment, site selection and devel-

opment, and initial and ongoing training as well as day-to-day operational support and compliance.

**Québec Practice Point**—Franchisors should assess whether a different franchise model (such as an area developer or master franchisee) is warranted for its Québec expansion. They may also decide to partner with a local area representative to assist with franchise sales and ongoing operational support.

### III. How Québec Law Views the Franchise Relationship

#### A. Adapting the Franchise Agreement for Québec

A franchisor that seeks to establish its business in Québec may be tempted to use its existing Canadian, or even North American, standard form franchise agreement with its Québec franchisees. Although this solution may initially appear more efficient, there is a significant risk that it will, in fact, bring adverse consequences in the long run if the agreement is not adapted for key differences in the Québec legal landscape.

The most significant and overarching factor that differentiates Québec’s legal system from that of the rest of North America (with the partial exception of the State of Louisiana) is that it is governed by a single and comprehensive piece of legislation and not by precedential decision making as in a common law system. The law in Québec stems from the Civil Code of Québec (CCQ).

Although the CCQ provides specific rules with respect to private law contracts, it does not deal specifically with franchise agreements. Franchise agreements in Québec are therefore interpreted in accordance with the general law of contract of the CCQ. This has several immediate and significant practical consequences for franchisors operating in Québec. First, the lack of specific rules (such as the Arthur Wishart Act (Franchise Disclosure), 2000 in Ontario) and the limited case law on franchising may lead in some circumstances to increased legal uncertainty. Franchisors should note that this uncertainty is

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27. Consider the *Dunkin’ Brands Canada Ltd.* case, infra note 105, where the first instance judge found an implied duty from the franchisor to act in good faith to support and enhance the brand. The Court of Appeal refused the argument that this added unforeseen elements to the franchise contract:

In other words, in characterizing the essential obligation of the Franchisor as a duty to protect and enhance the brand, the judge did not assign a new and unintended obligation on the Franchisor, but he drew on the explicit terms, *supplemented by implicit obligations flowing from the nature of the agreement* that, in both cases, reflected the intention of the parties.

*Id.* (emphasis added).
not always resolved in favor of franchisees but, in some cases, makes the outcome difficult to predict. Second, the language of the franchise agreement itself becomes even more important because it is the main source from which courts can draw when defining the parties’ rights and obligations.28

This section of the article reviews certain general provisions of the CCQ relating to commercial contracts, including franchise agreements. As discussed in more detail later, a single-unit franchise agreement will typically be considered a contract of adhesion under the CCQ, thereby triggering a number of other provisions of the CCQ concerning (1) external clauses, (2) illegible or incomprehensible clauses, (3) the interpretation of the agreement, and (4) abusive clauses.29 We provide a brief review of these provisions as well as tips on how to minimize their impact on the franchisor-franchisee relationship.

1. Contracts of Adhesion

Contracts of adhesion are characterized by an inequality of bargaining power, where a stronger party may take advantage of a weaker party.30 The CCQ defines a contract of adhesion as one where “the essential stipulations were imposed or drawn up by one of the parties, on his behalf or upon his instructions, and were not negotiable.”31 The term “essential stipulations” refers to the material terms of a particular contract.32 Importantly, in determining whether a contract is one of adhesion, the weaker contracting party must not have had the opportunity to negotiate certain material terms and cannot simply rely on a failure to attempt to negotiate.33

In Québec, as in some other jurisdictions, franchise agreements are generally found to be contracts of adhesion, with the franchisee as the adhering party.34 The CCQ treats adhering franchisees the same way it treats consumers: both are seen by the legislature as vulnerable parties who require protection from the imbalanced effects of freedom of contract.35

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28. Consider the Uniprix case [paras 66 to 69], infra note 107. Justice Lévesque based his decision on the affiliation contract and wrote that courts must be particularly sensitive to contractual freedom in cases of contracts, such as franchise agreements, that were not addressed by the legislature (such as franchise agreements).


30. Id. at para. 63.

31. Article 1379 CCQ.


35. See Articles 1432, 1435, 1436, and 1437 CCQ.
Whether a particular franchise agreement is a contract of adhesion will depend on the circumstances in which it is entered into by the parties. A franchisor is usually in a position of strength vis-à-vis the prospective franchisee and generally sets the material terms of the agreement (e.g., obligations of the franchisor, obligations of the franchisee, duration of the agreement, grounds for termination, etc.), if only to ensure uniformity among its franchised network. There are cases, such as master franchise, area developer, or multi-unit agreements, where a franchisee has the ability to negotiate and may have more leverage than a single-unit franchisee candidate. In these cases, the franchisor will have stronger arguments that the agreement is not a contract of adhesion. Franchisors may be able to avoid a finding that the franchise agreement is a contract of adhesion by including an express acknowledgment from the franchisee that it had the “ability to negotiate” and the benefit of “independent legal advice,” but the inclusion of such clauses alone will not be determinative of the issue.

2. External Clauses

In the franchise context, an external clause is a contractual stipulation that is separate from the franchise agreement itself (e.g., a reference to compliance with the operating manual or to website terms and conditions), but is deemed to be a material term through an integrating clause (e.g., incorporation by reference clause) in the franchise agreement. Clauses found at the back of the agreement or in a schedule attached to the contract are not considered to be external clauses since they are not separate from the agreement. Common examples of an external clause in franchise matters are the operations manual, a separate document, or set of documents, regularly updated by the franchisor.

Although external clauses are valid in principle, in the case of a contract of adhesion, their validity is conditional upon proof that (1) the clause was expressly brought to the attention of the franchisee, or (2) the franchisee otherwise knew of it. As the Supreme Court of Canada stated in Dell Computer Corp v Union des consommateurs, “[a] contracting party cannot argue that a contract clause is binding unless the other party had a reasonable opportunity to read it. For this, the other party must have had access to it. [A]ccessibility is an implied precondition for setting up the [external] clause against the other party.”

In light of this rule, the franchisor should either give the franchisee a copy of all the documents incorporated by reference in the franchise agreement or

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36. Gagnon, La Franchise au Québec, supra note 34, at 228.37–228.38.
39. Id.
41. Id. at para 98.
reasonable access to such documents prior to entering into the agreement. A franchisor may also want to include in the terms of its franchise agreement a clause containing an acknowledgment by the franchisee that it has received and reviewed the referenced documents.\textsuperscript{42} Such a clause would assist a franchisor in establishing that it had met the requirements of the CCQ on external documents. Otherwise, the franchisor assumes the risk that a Québec court may declare the external clauses null.\textsuperscript{43} In other words, the franchise agreement itself would survive, but the referenced materials, such as the operations manual, would not bind the franchisee.\textsuperscript{44}

**Québec Practice Point**—Prior to entering into the franchise agreement, franchisors must provide the prospective franchisee with copies of or access to all documents referenced in the franchise agreement. The franchise agreement should also include an express acknowledgment from the franchisee that it received and reviewed these external documents.

### 3. Illegible and Incomprehensible Clauses

A clause is found to be illegible when it can be said that a reasonable person would have a hard time deciphering it. Illegibility depends on the quality of presentation, such as the font, the size, and the color of the text.\textsuperscript{45} By contrast, incomprehensibility refers to the substance or content of the clause, which must be understandable to a reasonable franchisee.\textsuperscript{46} Incomprehensibility depends on factors such as style, vocabulary, and length of the clause.\textsuperscript{47} The use of obscure technical terms or ambiguous language risks making a clause incomprehensible.\textsuperscript{48}

Pursuant to the CCQ,\textsuperscript{49} where a clause in a franchise agreement is either illegible or incomprehensible and a franchisee has relied on that clause to its detriment and suffered harm, courts will annul that clause at the franchisee’s request. To avoid this outcome, the franchisor must show that the franchisee was given an adequate explanation of the nature and scope of the clause.\textsuperscript{50} Otherwise, the annulment of one or more clauses of the franchise agreement may have significant and costly consequences for the franchisor.

As discussed in further detail later, a franchisor may be obliged to draft a French version of its franchise agreement for its Québec franchisees. Incomprehensibility is one of the risks of not engaging a legal translation team to assist with translating an existing franchise agreement into French. A literal or otherwise poor translation may lead to ambiguities and lack of clarity,

\textsuperscript{42} Floriani, *A Comparative Analysis*, supra note 26, at 133–34.
\textsuperscript{43} BAUDOUIN, *Les Obligations*, supra note 29, at para. 196.
\textsuperscript{44} Article 1438 CCQ.
\textsuperscript{45} DIDIER LLUELLES & BENOÎT MOORE, *Droit des Obligations* at paras. 1690–92 [hereinafter LLUELLES, *Droit des Obligations*].
\textsuperscript{46} Id. at para. 1696.
\textsuperscript{47} Id. at paras. 1694–99.
\textsuperscript{48} Id. at paras. 1700–07.
\textsuperscript{49} Article 1436 CCQ.
\textsuperscript{50} Id.
rendering certain clauses of the agreement incomprehensible. For instance, certain stock or boilerplate legal terms often found in franchise agreements have no equivalent in the civil law system, and their direct translations have little to no meaning in Québec or to a francophone. The terms “security interest,” “personal property,” and “real property,” to name a few, should be replaced by the civil law terms “hypothec,” “movable property,” and “immovable property,” respectively, while being mindful that these terms are not always perfect equivalents.

Québec Practice Point—Translation of stock phrases into French can lead to issues of incomprehensibility and put the franchisor at risk of having the clauses containing such phrases annulled. A franchisor is well advised to engage the services of a legal translation team and Québec trained-attorneys to oversee the French translation of the franchise agreement and insert the appropriate legal language.

4. Contra Preferentem

Pursuant to the CCQ, where there is any ambiguity in a contract, that ambiguity will be interpreted in favor of the party who did not draft the contract. This is analogous to the common law doctrine of contra preferentem in the instance of contracts of adhesion. Ambiguous terms in franchise agreements will therefore be interpreted in the manner most favorable to the franchisee.

5. Abusive Clauses

Finally, the CCQ empowers the court to annul any abusive clause found in a contract of adhesion. Alternatively, the court may choose, at its discretion, to reduce the obligations that result from the abusive clause.

An abusive clause is defined as “a clause which is excessively and unreasonably detrimental to the . . . adhering party and is therefore contrary to the requirements of good faith; in particular, a clause which so departs from the fundamental obligations arising from the rules normally governing the contract that it changes the nature of the contract.”

A clause will not be found to be abusive merely because it is disadvantageous to one party. The disadvantage must be both so excessive and unreasonable that it fundamentally departs from socially acceptable contractual practices. Exactly what is abusive is hard to predict, considering the courts’

51. LLUELLES, DROIT DES OBLIGATIONS, supra note 45, at para. 1705.
52. Article 1432 CCQ.
54. Article 1437 CCQ.
55. Id.
56. Id.
57. Québec (Procureur général) v Kabakian-Kechichian, 2000 CanLII 7772 (QC CA), at para. 49.
58. BAUDOIN, LES OBLIGATIONS, supra note 29, at para. 144.
The case law contains some examples of abusive clauses. For instance, the Québec Superior Court considered that a collateral assignment of lease was abusive because such lease provided it would be assigned to the franchisor upon breach by the franchisee of any of its obligations under the lease, the franchise agreement, or any other agreement securing the franchise agreement. In other cases, the courts found that a penal clause was abusive because the amount of the penalty was excessive when considered with the royalties payable under the agreement or because the same penalty applied regardless of the nature of the breach.

Whether a clause is excessive can be determined based on either an objective or a subjective test. A clause is objectively excessive when the resulting obligations are virtually impossible to meet, such as an overly aggressive development schedule for a multi-unit or master franchisee, or completely disproportionate in light of the other party’s corresponding obligations. It is subjectively excessive when the difficulties that result from the particular circumstances of the adhering party are taken into account. For instance, a franchisee’s obligation to pay high royalties may not be objectively excessive in light of the franchisor’s corresponding obligations. However, a franchisee who has very little business experience may have opened a franchised store in a particularly difficult and unprofitable market. In this situation, the obligation to pay high royalties, even when the franchisee operates at a loss, may be considered subjectively excessive, and the clause at issue potentially abusive.

Québec Practice Point—Franchisors in Québec are well advised to review certain standard clauses and obligations in its franchise agreement with Québec trained-attorneys to assess whether they are excessive or unreasonable and, where necessary, customize them to specific franchisee situations.

6. Conclusion

Given the high likelihood that their franchise agreements will be held to be contracts of adhesion, franchisors who operate in Québec will need to review and tailor their agreements to manage the risks of having the contract interpreted against them. This means clear, unambiguous, Québec-specific legal terms, and customized terms for unique franchisee situations.

Québec Practice Point—Although the contractual changes required to address the CCQ are important, typically it is possible to make relatively few changes to the

59. Id. at para 147.
62. 3743781 Canada inc. v Multi-marques inc., 2009 QCCS 3663.
63. Québec (Procureur général) v Kabakian-Kechichian, 2000 CanLII 7772 (QC CA), at para 55.
64. Id.
Canadian form of franchise agreement so that the franchisor can use one form of agreement throughout Canada, including in Québec.

B. Franchise Disclosure Requirements in Québec

Unlike in the United States and certain other Canadian provinces, there is no franchise-specific disclosure legislation in Québec. Nonetheless, the general duty of good faith enshrined under the CCQ gives rise to a duty of disclosure in Québec, and the information provided to prospective franchisees prior to their entering into a franchise agreement is the subject of some litigation in Québec. As a result, at least some level of franchise disclosure is required in Québec, but franchisors do not have the benefit of direction from franchise-specific legislation on what must be disclosed. In this section of the article we review the legal considerations that inform franchise disclosure practices in Québec.

Under the Québec civil law, there is a general obligation to act in good faith. Absent a definition in the CCQ, the notion of good faith has been defined in the case law as an objective standard of conduct, corresponding to the behavior that a reasonable person would adopt in similar circumstances. This obligation is a fundamental principle of the civil law of obligations, including the law of contract. Good faith must at all times, that is, during the pre-contractual negotiations, the performance of the contract, and its termination, govern the relations between parties to a commercial contract. This distinguishes the good faith regime in Québec from that in the common law provinces where at common law the duty is owed only by parties to a contract, and there is no definitive duty to negotiate an agreement in good faith.

At the pre-contractual phase, the obligation to act in good faith under Québec civil law translates into a positive obligation to inform (akin to a duty of disclosure). The Supreme Court of Canada has set out three criteria to define the scope of this obligation in practice: “(a) whether the party owing the obligation has actual or presumed knowledge of the information; (b) whether the information is of decisive importance; and (c) whether the party to whom the obligation is owed cannot inform itself, or legitimately relies on the debtor of the obligation.”


67. Articles 6, 7 & 1375 CCQ.

68. BAUDOIN, LES OBBLIGAZIONI, supra note 29, at para. 132.

69. GILBERT, LE DROIT DE LA FRANCHISE, supra note 53, at paras. 188–97.

70. Id. at para. 170.

71. Id. at para. 169.

In the franchise context, the franchisee is generally understood to be a vulnerable party who depends on the franchisor as its primary source of information about the franchise opportunity (e.g., profitability of existing franchised stores, resources of the franchisor, nature and strength of the competition, etc.). As such, the franchisee is entitled to the disclosure of key or material facts about the franchise. This means, in essence, that the duty of good faith in Québec gives rise to a duty of disclosure, which remains an open issue in the common law provinces that has not yet been finally decided by the courts.

Québec Practice Point—Although there is no specific franchise disclosure legislation in Québec, the duty of good faith under the CCQ gives rise to a pre-contractual duty to inform, akin to a duty of disclosure. As a practical matter, many franchisors elect to provide prospective franchisees in Québec with a slightly modified version of their Canadian franchise disclosure document in order to satisfy their civil law duty to inform.

The consequences for failing to disclose key or material facts about the franchise can be as extreme as the annulment of the franchise agreement. Under the CCQ, a franchisee’s pre-contractual erroneous belief about a franchise can arise in two ways: (1) mere errors, and (2) fraud, each of which gives rise to the possible annulment of the franchise agreement.

C. Mere Errors

A franchise agreement may be annulled if the franchisee gave its consent to the franchise agreement in reliance on an error. The reason for the error is immaterial; that is, whether or not it results from the franchisor’s failure to give the relevant information to the franchisee, and may relate to:

1) the nature of the contract (e.g., a franchisee signing a franchise agreement thinking it is a lease agreement);

2) the object of the contract (e.g., franchisees signing a franchise agreement thinking they may operate a restaurant with their own menus, whereas the franchise serves only burgers); or

3) any other material term of the contract on which the franchisee’s consent turned, provided that the franchisee must have voiced the importance of the element in question.

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73. Pascale Cloutier & Marie Hélène Guay, La responsabilité contractuelle et extracontractuelle du franchiseur, in Développements récents en droit de la franchise et des groupements 127 (2008) [hereinafter Cloutier, La responsabilité contractuelle]; GAGNON, LA FRANCHISE AU QUÉBEC, supra note 34, at 228.4.
74. CCQ, article 1399; BAUDOUIN, LES OBLIGATIONS, supra note 29, at para. 170.
75. Articles 1400 and 1407 CCQ.
76. LLUELLES, DROIT DES OBLIGATIONS, supra note 45, at paras. 529 & ff.
77. GILBERT, LE DROIT DE LA FRANCHISE, supra note 34, at 122–23; LLUELLES, DROIT DES OBLIGATIONS, supra note 45, at para, 585; see 9150-0595 Québec inc. v Franchises Cora inc., 2013 QCCA 531, affirming 9150-0595 Québec inc. v Franchises Cora inc., 2011 QCCS 1034.
The court will not, however, annul a franchise agreement if the error is “inexcusable.” Together with the franchisor’s obligation to inform, the franchisee is bound by a corresponding obligation to inquire. Therefore, a franchisee must take into account the information made available to it; ask relevant questions; and take other reasonable steps, e.g., ask for professional advice; and conduct its own due diligence in order to make an informed decision. For example, franchisees who do not read the franchise agreement and ask no questions should not be able to rely on their mistaken belief to obtain the annulment of the franchise agreement. Such a failure to inquire would amount to an inexcusable error.

What constitutes an inexcusable error is based on a comparison between the conduct of the franchisee and that of a reasonable franchisee in similar circumstances. A franchisee that is grossly negligent, reckless, or careless cannot invoke an error in order to annul the contract. This comparison must take into account the personal characteristics of the franchisee. Therefore, a sophisticated franchisee with significant business experience will be held to a higher standard of conduct, and the converse is true for a small, unsophisticated franchisee.

D. Errors Due to Fraud

Errors due to fraud are those caused by the deceitful conduct of the franchisor. They occur when the franchisor willfully misleads the franchisee into signing a franchise agreement, using fraudulent tactics, misrepresentations, or omissions of essential information. The CCQ requires proof that the franchisee’s decision to enter into the agreement flowed from the error caused by the franchisor’s fraudulent conduct. Franchisors should note that good faith is always presumed in Québec.

There are important distinctions between the two types of errors. First, unlike mere errors, errors by fraud are not limited to certain categories. Second, errors due to fraud may not only lead to the annulment of the contract, but also to damages or the reduction of the victim’s obligations.

79. Id. at para. 965.
82. Article 1474 CCQ; Lluelles, Droit des Obligations, supra note 45, at para. 544; Baudouin, Les obligations, supra note 29, at 329.
83. Lluelles, Droit des Obligations, supra note 45, at paras. 546–47.
84. Gilbert, Le Droit de la Franchise, supra note 34, at 121–22.
86. Lluelles, Droit des Obligations, supra note 45, at paras. 613 & ff.
87. Article 1401 CCQ.
88. Lluelles, Droit des Obligations, supra note 45, at para. 647 & ff.
89. Article 2805 CCQ.
90. Lluelles, Droit des Obligations, supra note 45, at para. 608.
91. Article 1407 CCQ; Lluelles, Droit des Obligations, supra note 45, at paras. 674 & ff.
Third, there is no such thing as an inexcusable error by fraud. 92 A franchisor who willfully misled the franchisee cannot invoke the franchisee’s obligation to inquire. 93 The franchisee’s duty to inquire remains relevant, however, in determining whether the franchisor has fulfilled its duty to inform, and whether there has been a misrepresentation in the first place. 94

When considering the franchisor’s duty to inform, courts have often found a franchisor’s omission of material facts from its pre-contractual disclosure to prospective franchisees to constitute fraudulent misrepresentation. 95

Franchisors in Québec (as in many other jurisdictions) often give prospective franchisees financial projections in a pro forma document. The pro forma generally contains information about a franchisee’s expected costs and revenues. 96 Pro formas are undeniably responsible for most of the litigation between franchisors and franchisees in Québec. 97 A franchisor’s willful omission to disclose unfavorable financial information and the presentation of overly optimistic projections have both been found to constitute fraudulent misrepresentations leading to the annulment of the franchise agreement as well as damages. 98 That said, the fact that a franchised store performs less profitably than expected does not necessarily mean that a franchisor made any misrepresentation to the franchisee. By definition, projections may involve a great degree of uncertainty, particularly in situations where there is little or no prior data on franchisees in the same location. In such cases, even where projections diverge significantly from the actual experience, the franchisee will have no recourse, provided that the franchisor acted reasonably in preparing the projections. 99

In their efforts to determine whether pro forma financial information provided to a franchisee complied with the franchisor’s obligation to inform, Québec courts have made eight basic inquiries:

1) Did the franchisor know that the projections were false or incorrect?
2) Did the franchisor otherwise know that it would be impossible for the franchisee to meet the expectations detailed in the projections?
3) Did the franchisor act prudently and reasonably in preparing the projections?

92. Article 1407 CCQ; LLUELLES, DROIT DES OBLIGATIONS, supra note 45, at paras. 674 & ff.
93. GILBERT, LE DROIT DE LA FRANCHISE, supra note 34, at 140.
95. GILBERT, LE DROIT DE LA FRANCHISE, supra note 34, at 136–44.
96. GAGNON, LA FRANCHISE AU QUÉBEC, supra note 34, at 144.34.1,144.34.2.
97. Cloutier, La responsabilité contractuelle, supra note 73, at 129.
4) Did the franchisor make other representations to the franchisee so as to enhance the franchisee’s level of confidence in the projections (e.g., representations with respect to the experience and qualities of the franchisor, the support, and services offered by the franchisor, etc.)?

5) Did the franchisee know that the pro forma contained projections only and did not constitute a guarantee or representations as to the profitability of the enterprise? Does the franchise agreement specifically address the hypothetical nature of the projections?

6) Did the franchisee act prudently in reviewing the projections and did the franchisee take into account other available information that was easily accessible? Did he or she consult with professionals?

7) Did the differences between the projections and the actual results relate to the expected costs or the expected revenues? Expected costs, as opposed to expected revenues, are less unpredictable; courts tend to be less tolerant of inaccurate cost projections.

8) Did the franchisee have business experience or experience relevant to the area of activities of the franchise? Franchisors should be especially careful when dealing with inexperienced and unsophisticated prospective franchisees.100

As such, in preparing and providing pro forma statements to prospective franchisees in Québec, franchisors should:

1) act reasonably in making projections;

2) disclose all relevant data regarding the past performance of any franchised store (assuming that such data is available);

3) include an entire agreement clause in the franchise agreement, making it more difficult for a franchisee to claim that the franchisor made misrepresentations based on statements that are not reflected in the agreement;101 and

4) expressly underline the risks of operating a franchised store and include terms to the effect that the financial projections do not constitute a guarantee or a representation as to the profitability of the store—both in the pro forma and any description of the pro forma in the franchise agreement.102

It is worth noting that although the franchisee is often the vulnerable party in terms of information disclosed, a franchisor may also be the victim of misrepresentations made by a franchisee. For instance, prospective franchisees may mislead a franchisor with respect to their experience or financial

100. GAGNON, LA FRANCHISE AU QUÉBEC, supra note 34, at 144.34.2–144.34.12.
102. Id.
situation. In such cases, the same recourses under the CCQ would be available to the franchisor.

Finally, there may be cases where the franchisor does not comply with its obligation to inform in a way that is harmful to the franchisee, but without meeting the requirements for either types of errors. For the purpose of this article, one should note that there may be a separate recourse in damages available, based on a breach of a party’s general obligation to act in good faith during the pre-contractual negotiations.

Quebec Practice Point—To the extent possible, the majority of the information provided to the franchisee should be in a written format, and franchisors should bring to the attention of the franchisee the correlative exclusions and waivers so as to avoid any unforeseen litigation based on alleged errors, promises, or omissions.

E. Key Franchise Related Judicial Trends in Quebec

In addition to the above discussion of the courts’ review of cases on pro formas, two key cases provide particular and practical insight into the Quebec court’s recent approach to franchising. Both decisions were unfavorable to franchisors.

The first, the Dunkin’ Donuts case, reaffirmed the implied duty of good faith in the franchise agreement as reviewed above. The franchisor’s application for leave to appeal to the Supreme Court of Canada was denied.

The second, the Uniprix case, acknowledged the existence and validity of a perpetual franchise agreement. The Supreme Court of Canada recently granted Uniprix’s application for leave to appeal this decision—and as of the time of writing this article, the appeal had yet to be heard.

1. Dunkin’ Donuts and the Implied Duty of Good Faith

This case was a group action brought against Dunkin’ Brands Canada Ltd. by twenty-one plaintiff Dunkin’ Donuts franchisees that collectively operated thirty-two Dunkin’ Donuts franchises in Quebec. Dunkin’ Donuts was historically a strong brand in Quebec with 210 stores in its heyday in 1998. However, its market share had been slipping as the result of a wave of Tim Hortons franchises flooding the province through the late 1990s and early 2000s.

The plaintiffs claimed that, although they had voiced concerns to Dunkin’ Donuts about rejuvenating the Dunkin’ Donuts brand and business strategy

103. For instance, the error as defined by article 1400 CCQ would usually exclude the error of a franchisee as to the profitability (i.e., the economic value) of the franchise, provided the franchisee has not voiced the determinative character of this element during the course of the negotiations with the franchisor. In a case where the error results from the negligence of the franchisor and not by fraud, the franchisee would be left without recourse. See LLUELLES, DROIT DES OBLIGATIONS, supra note 45, at paras. 568–70.

104. Article 1375 CCQ; see KARIM, LES OBLIGATIONS, supra note 53, at paras. 1001–03; LLUELLES, DROIT DES OBLIGATIONS, supra note 45, at paras. 928 & ff.; BAUDOIN, LES OBLIGATIONS, supra note 29, at paras 304–05.

105. The appeal hearing date in this matter is tentatively set for January 12, 2017.

106. Dunkin’ Brands Canada Ltd. v Bertico inc., 2015 QCCA 624.
in Québec as early as 1996, they found Dunkin’ Donuts to be unsupportive and unresponsive to their concerns.

The plaintiffs brought an action against Dunkin’ Donuts for the formal termination of their leases and franchise agreements together with damages totalling $16.4 million. The claim alleged a repeated and continuous failure by Dunkin’ Donuts between 1995 and 2005 to fulfill its explicit contractual obligations to “protect and enhance” the Dunkin’ Donuts brand in Québec. The plaintiffs’ action was based on breach of contract, namely the franchise agreements between each plaintiff and Dunkin’ Donuts.

The plaintiffs’ claim succeeded in full in first instance and the franchisor appealed the decision on several grounds.

The main thrust of the Court of Appeal’s findings related to the implied terms of the franchise agreements. In this case, the court found that these implied terms included the obligation to undertake reasonable measures to help the franchisees support the brand of the franchise.

Franchisees may take a broader interpretation of certain points made by the court as grounds for expanding the scope of a franchisor’s implicit obligations to a franchisee, especially given that the Supreme Court of Canada, with the dissent of Justice Côté, dismissed the application for leave to appeal. It is important to keep in mind, however, that the implied obligations found by the Court of Appeal, which were central to its decision, arise out of the express language of the Dunkin’ Donuts franchise agreements and the intent of the parties. Notably, the express language in this case was relatively unique in that it referred specifically to protection and enhancement of the brand.

If nothing else, this case reinforces that franchisors, and those who act for them, should be diligent in enforcing the standards contained in their franchise agreements when faced with uncooperative, under-performing, and/or potentially rogue franchisees because the risk of not doing so on the overall franchise system could create a situation like the one in this case and potentially attract the franchisor’s liability.

2. Uniprix Inc. and Perpetuity

The dispute involved the franchisor-appellant, Uniprix Inc., and the franchisee-respondents, which operated a pharmacy under the Uniprix banner (Gosselin Group).

In 1998, Uniprix and the Gosselin Group entered into a contract of affiliation with a five-year term. The contract contained a renewal provision according to which the agreement was to be renewed automatically for an ad-

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107. Importantly, the court made clear that the implied obligation of good faith that results in heightened obligations incumbent on the franchisor was based on article 1434 CCQ (implied terms of the contract) and not the obligation to conduct oneself in good faith pursuant to article 1375 CCQ. See Jennifer Dolman & Alexandre Fallon, Dunkin’ Donuts decision has limited application outside Quebec, Canadian Lawyer, May 4, 2015, http://www.canadianlawyermag.com/5580/Dunkin-Donuts-decision-has-limited-application-outside-Quebec.html.

ditional five years unless the Gosselin Group provided six months’ notice of its intention to leave the banner.

Unlike the Gosselin Group, Uniprix had no ability to end the renewal cycle; it could only terminate the relationship with cause in accordance with specific terms set out in the agreement. Therefore, unless the Gosselin Group decided not to renew the agreement, Uniprix was perpetually bound.

After two automatic renewals, Uniprix notified the Gosselin Group of its intention not to renew the agreement a third time, Gosselin Group contested the notice in court, and succeeded in the first instance.

The majority of the Court of Appeal upheld the judgment of the Superior Court, with Chief Justice Nicole Duval Hesler dissenting. At the core of the dissent was whether the agreement was for a fixed or indeterminate duration. According to Chief Justice Duval Hesler, in spite of the five-year term, the renewal provision rendered the duration of the agreement indeterminate. According to the majority, however, the contract of affiliation had a fixed term of five years. It acknowledged that this interpretation created perpetual obligations for Uniprix, but stated that perpetual obligations are enforceable in Québec civil law.

The Supreme Court of Canada recently granted Uniprix’s application for leave to appeal this decision. Whether or not Canada’s highest appellate court upholds the ruling of the Court of Appeal, the scope of automatic renewal provisions should be expressly limited when drafting a contract so as to avoid being inadvertently bound by perpetual obligations.

Indeed, although enduring commercial relationships are often desirable, perpetual contracts seldom are. An agreement that is mutually profitable for many years may become unprofitable. Long-term contracts, such as franchise or affiliation agreements, should expressly allow the parties to end their relationship in a commercially reasonable manner, for instance, by limiting the number of automatic renewals or by giving both parties the ability to end the renewal cycle subject to a reasonable notice period.

F. Other Key Legal Considerations for Franchisors in Québec

This section provides a high level review of certain other legal considerations for those franchising in Québec.

1. Employment

Québec-specific employment issues will be relevant to those franchisors establishing head offices, subsidiaries, or corporate-owned stores in Québec. Both the CCQ and specialized laws, primarily the Act Respecting Labour Standards (LSA) in a non-unionized context, govern employment. 109 The LSA contains close to 200 provisions and establishes the general rules and

109. Although rare, in some instances hourly workers of franchise networks were able to unionize, particularly given the union friendly laws of Québec. In such a case, the work relations would be governed by the Labour Code, CQLR c C-27.
legal environment in which employees perform their work. The Commission des normes du travail supervises the implementation and application of the LSA. Certain specific language law issues also apply to employers. Although the specifics of employer issues are beyond the scope of this article, it is advisable for those companies doing business in Québec to seek out legal counsel who deal specifically with employment.

2. Tax Issues

Québec-specific tax issues will also be relevant to those franchisors establishing head offices, subsidiaries, or corporate-owned stores in Québec. Although these issues fall outside the scope of this article, franchisors should note that several specific tax considerations must be made in the context of carrying on a business in Québec. Business in Québec is governed by the Québec Taxation Act and its corresponding regulations. Companies doing business and employing individuals in Québec must register with the Minister of Revenue of Québec under the Legal Publicity Act. If a nonresident individual or corporation receives fees for Québec services, the payments are subject to a specific withholding tax. Additionally, certain corresponding forms must be filed with the Minister of Revenue. As a Québec business, a company must make source deductions from employee remuneration and transmit these funds to the Minister of Revenue. Numerous contributions, including to the Commission des normes du travail and the Commission des normes, de l’équité, de la santé et de la sécurité du travail, among others, must be made.

There have been no concrete developments regarding tax initiatives in the context of franchise law in Québec. In recent years, medical specialists and politicians alike at both the federal and provincial levels have proposed taxing high-fat and sugar foods and beverages at higher rates compared to other healthier foods or lowering the tax rates on nutritious foods. However, these initiatives and proposals remain at the early stages of development.

3. Security (Hypothec)

It is beyond of the scope of this article to address in detail the specificities of Québec rules regarding security interests. However, this section provides a very brief overview of some of the differences between the common law and civil law legal systems in Canada with respect to the grant of a security interest over the personal property of the franchisee, often found in franchise agreements.110

Each province and territory in Canada, with the exception of Québec, has enacted a Personal Property Security Act (PPSA), which was largely inspired by Article 9 of the U.S. Uniform Commercial Code.111 PPSAs govern the grant

110. GAGNON, LA FRANCHISE AU QUEBEC, supra note 34, at 301.
of security interests over personal property. They distinguish between entering into a security agreement, the attachment of the security, and its perfection. Although a written security agreement is used in most cases to create a security interest, the creation of the security and its enforceability between the parties depends on the attachment of the security. Its effectiveness against third parties, as well as its priority, depends on its perfection.  

The creation of a security interest is subject to three conditions: (1) the creditor has possession of the collateral or there is an oral or written security agreement; (2) the creditor has given value, that is, sufficient consideration; and (3) the debtor has rights in the collateral. A security interest is perfected when it has attached—in addition to meeting one of the following conditions: (1) the creditor has possession of the collateral or (2) registered a financing statement in the Personal Property Registry. Perfection determines priorities between secured creditors. Importantly, an unperfected security interest continues to be enforceable against certain third parties.

By contrast, there is no PPSA in Québec. The relevant rules are found in the CCQ, which allows a debtor to grant a conventional hypothec (i.e., a security interest) over movable property (i.e., personal property). In civil law, a hypothec is created either by written agreement (i.e., movable hypothec without delivery) or by the creditor taking possession of the property or the title with the consent of the grantor (i.e., movable hypothec with delivery). Although oral security agreements are valid under PPSA legislation, in the case of a hypothec without delivery, the writing is a substantive precondition to the creation of the security.

For a hypothec to be set up against third parties, it must be published in the Register of Personal and Movable Real Rights (RPMRR). Hypothecs rank according to the date and time of their publication. Unlike the failure to perfect a security under PPSA legislation, the failure to publish a hypothec makes it impossible to realize the security, and the creditor will rank as an unsecured creditor. The consequences of this failure may even go beyond the

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112. Id. at 18–19, 240 & ff, 296 & ff.
113. Frank Bennett, Bennett on the PPSA (Ontario) 35 & ff. (3d ed. 2006).
114. Id. at 49 & ff.
116. This is called a “movable hypothec without delivery,” and according to Article 2696 CCQ, such a hypothec must be granted in writing. Unlike under PPSA legislation, an oral hypothec is null.
117. This is called a “movable hypothec with delivery,” governed by articles 2702 and ff. CCQ.
118. Cuming, Personal Property Security Law, supra note 111, at 91.
119. In the case of a movable hypothec with delivery, the hypothec is published by the creditor taking possession and remaining in possession of the property or title (article 2703 CCQ). This is similar to PPSA legislation, allowing the perfecting of a security by the creditor taking possession of the collateral.
120. Articles 2941 & 2945 CCQ.
121. The hypothec is nonetheless valid as between the parties. But in practice, the creditor will not be entitled to exercise its hypothecary rights (i.e., realize its security), such as the taking in payment (i.e., foreclosure) and the sale of the property by the creditor or by judicial authority.
creditor’s ability to realize its security. In the event that the franchisor also obtained a third party guarantee, the failure to publish the hypothec could be used by the guarantor to escape liability.\(^{122}\)

To enforce a movable hypothec in Québec, the creditor has four options, that is, hypothecary rights: (1) the taking possession for purposes of administration (i.e., receivership); (2) the taking in payment (i.e., foreclosure); (3) sale by the creditor; and (4) sale by judicial authority. Each remedy has its own set of rules, which should be carefully considered, since these rules may be more or less advantageous to the franchisor depending on the circumstances. Importantly, like PPSA legislation, the exercise of a hypothecary right requires giving prior notice to the debtor. However, the CCQ requires, in addition, the publication of the notice,\(^{123}\) giving the debtor, as well as any other interested party (e.g., another secured creditor), an opportunity to prevent the first creditor from exercising its right.\(^{124}\)

4. Third Party Guarantees

Franchisors often require guarantees from the franchisees’ directors, officers or shareholders, or from other third parties.\(^{125}\) Like hypothecs, third party guarantees, known as suretyships, are governed by the CCQ, which contains provisions that may affect the franchisor’s situation.\(^{126}\)

Notably, the surety (i.e., guarantor) may terminate the suretyship unilaterally when the suretyship was contracted for a future or indeterminate debt or for an indeterminate period of time.\(^{127}\) Typically, a franchisor obtains a suretyship for all present and future debts of the franchisee for the duration of the franchise relationship. In such a case, the surety is entitled to terminate the suretyship after three years by giving prior notice to the franchisor. Although the surety remains liable for the debt existing at the time of termination,\(^{128}\) this unilateral right of the suretyship may affect the security of the

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\(^{122}\) Article 2365 CCQ. The guarantor who indemnified the creditor would normally be subrogated in the hypothecary rights of the creditor (Article 1656 (3) CCQ), allowing the guarantor to realize the security. If the creditor failed to publish the hypothec, the guarantor could argue that, because of the creditor, the guarantor was now precluded from realizing the security, thereby discharging it to the extent of the resulting prejudice. Third party guarantees, or surety in civil law, are discussed in the next section.

\(^{123}\) CUMING, PERSONAL PROPERTY SECURITY LAW, supra note 111, at 100; Articles 2757 & ff. CCQ. The notice period varies, but is usually from ten to twenty days in the case of a franchisor exercising a hypothecary right against a franchisee, depending on the right that is being exercised.

\(^{124}\) For instance, Article 2761 CCQ allows the debtor or any interested party to defeat the exercise of a hypothecary right by paying the creditor all that is owed in addition to the costs incurred by the creditor.

\(^{125}\) GAGNON, LA FRANCHISE AU QUÉBEC, supra note 34, at 299.

\(^{126}\) Floriani, A Comparative Analysis, supra note 26, at 157–58.

\(^{127}\) Article 2362 CCQ.

\(^{128}\) Article 2364 CCQ.
payments due to the franchisor, since franchise agreements usually last more than three years.

Furthermore, when the suretyship is attached to certain duties, the suretyship will end upon cessation of said duties. When the surety is attached to the duties of a director or an officer, for instance, the suretyship will be terminated when the director or officer steps down, subject to the debts existing at the time of termination.

Considering these rules, a franchisor should require that the surety expressly waives its termination rights in the suretyship agreement. Although such waiver would clearly be effective to prevent a termination upon cessation of the surety’s duties, it remains unclear whether a similar waiver would be effective in the case of the surety’s unilateral right of termination with respect to future or indeterminate debts. It may be wise for a franchisor to include in the franchise agreement a stipulation to the effect that the termination of a surety constitutes an event of default, allowing the franchisor to terminate the agreement unless a new surety is found.

5. Leases

In many cases, the franchisor will lease a commercial space in a building owned by a third party (the principal lease) and sublease this space to the franchisee. This allows the continued operation of the franchise in the same location, despite the termination of the franchise agreement with a particular franchisee. This also puts the franchisor in a dual position—as a tenant in relation to the owner of the premises and a landlord in relation to the franchisee. It is therefore important to consider the regime applicable to leases under the CCQ.

In common law jurisdictions, a lease is considered a property right. Absent a stipulation in the lease, the tenant has discretion to sublease or assign the lease. By contrast, article 1870 CCQ requires the tenant in Québec (1) to give prior notice to its landlord of its intention to assign or sublease and (2) to obtain the landlord’s consent before either subleasing or assigning the lease. Accordingly, a franchisor must first obtain consent of its landlord before subleasing to a franchisee or assigning the lease. The landlord may only refuse for serious reasons within fifteen days of the notification.

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129. The burden falls on the surety to prove that “that the duties he or she performed constituted one of the reasons why the creditor requested the suretyship.” Épiciers Unis Métro-Richelieu Inc., division “Éconogros” v Collin, 2004 CSC 59, at para. 41.
130. Article 2363 CCQ.
131. Article 2364 CCQ.
133. Floriani, A Comparative Analysis, supra note 26, at 158.
134. Id.
135. Gagnon, La franchise au Québec, supra note 34, at 305.
136. Floriani, A Comparative Analysis, supra note 26, at 160.
137. Article 1871 CCQ.
It is also worth considering the consequences of a sale of the leased property. Under the CCQ, the new owner may terminate the principal lease, thereby also terminating the sublease.138 Provided that the lease has a fixed duration, the franchisor may be able to prevent the early termination by publishing the lease in the RPMRR before the sale.139 The publication of the lease is optional, but a franchisor may be liable for damages if its failure to publish the lease causes harm to the franchisee, e.g., if the new owner terminates the principal lease (and the sublease) and thereby prevents the franchisee from operating the franchise in accordance with the franchise agreement.140

The rules of the CCQ also affect the franchisor as landlord of the franchisee. It is important to note that the subleasing franchisor remains liable under the principal lease.141 Meanwhile, an assignment of the sublease by the franchisee to a third party effectively terminates the leasing relationship between the franchisor and the franchisee, thereby discharging the franchisee under the sublease. A franchisor may therefore wish to take advantage of article 1873 CCQ by stipulating in the sublease that the franchisee will remain jointly liable with the assignee.142

IV. French Language Laws—En Français S’il Vous Plaît!

As reviewed above, although a significant portion of Québec’s population understands and speaks English, the official and predominant language of the province is French. A franchisor’s first and perhaps most obvious challenge in doing business in Québec will be navigating through the province’s unique language rules to determine its obligations.

A. Charter of the French Language and Act Respecting the Legal Publicity of Enterprises

In 1977, the National Assembly of Québec adopted the Charter of the French Language143 in order to protect the French language.144 The Charter affirms the status of French as the official language of the province and establishes French as the everyday language of work, business, and commerce.145 It gives every person the right to have all enterprises doing business in Québec communicate with him or her in French, every worker in Québec to carry on his or her activities in French, and every con-

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139. Id.
140. Id.; 9102-5486 Québec inc. v Café suprême Canada inc., 2008 QCCS 4016, at paras. 130–48.
141. The franchisor acting as landlord for all its franchisees may incur significant liability, which may be reflected in the franchisor’s financial statements. *Gagnon, La Franchise au Québec*, supra note 34, at 305.
143. CQLR c C-11.
sumer in Québec the right to be informed and served in French. Any business operating in Québec risks being subject to the Charter, which will affect its operations in various ways.

The first step is to determine whether the Charter is applicable to the franchisor’s business as an “enterprise doing business in Québec.” In conducting this analysis, it is helpful to break this question into its two components: (1) an enterprise and (2) the act of doing business in Québec.

The CCQ broadly defines the notion of an “enterprise” as “[t]he carrying on by one or more persons of an organized economic activity, whether or not it is commercial in nature, consisting of producing, administering or alienating property, or providing a service.” This definition includes any sort of organized economic activity, such as not only those conducted by merchants of goods or services and professionals, but also not-for-profit organizations. Considering the broad scope of the definition, we can safely assume that franchisors and franchisees are both enterprises for the sake of the application of the Charter.

The act of “doing business in Québec” is less easily assessed. An enterprise having its head office, a place of business, or an address in Québec risks being considered to be doing business in Québec. It follows then that the Charter would clearly apply to a Québec franchisee. In the case of the franchisor, however, unless that franchisor establishes its own offices, retail or corporate stores in Québec, or employs people in Québec, the Charter will not necessarily apply. That said, even in those circumstances a franchisor may be deemed to be doing business in Québec if it runs Québec-targeted advertising. This would include having billboards in Québec, advertising in Québec newspapers or on Québec television channels, distributing catalogues in Québec, or having a website targeted at Québec consumers.

In addition, a franchisor may be considered to be doing business in Québec if it is required to register under the Legal Publicity Act (LPA). The goal of the LPA is to protect the public by ensuring it has access through the “enterprise register” to reliable information about the identity of enterprises conducting business in Québec. Thus, it requires any person, including a corporation, such as a franchisor, constituted under the laws of another jurisdiction to register if carrying on activities in Québec. The LPA creates a presumption that a person, such as a corporation, is carrying on activities in Québec if: (1) it has an address, an establishment, a post office box, or the use of a telephone line in Québec; or (2) it performs any activity for profit in Québec.

146. Sections 2, 4 & 5.
147. CCQ, article 1525, al. 3.
148. NICOLE LACASSE, DROIT DE L’ENTREPRISE 45–49 (9th ed. 2015) [hereinafter LACASSE, DROIT DE L’ENTREPRISE].
149. Id. at 227; NABIL N. ANTAKI & CHARLAINE BOUCHARD, I DROIT ET PRATIQUE DE L’ENTREPRISE 316 (3d ed. 2014) [hereinafter ANTAKI, DROIT ET PRATIQUE DE L’ENTREPRISE].
150. Section 21(5) LPA.
151. Section 25 LPA.
The Québec Court of Appeal dealt with the meaning of “carrying on an activity or operating an enterprise in Québec” in *White International Management Inc. c. 9041-8351 Québec Inc.* White International Management Inc., a company based in the Bahamas, had given Gestion Finance Tamalia, based in Québec, the exclusive commercial and distribution rights for Canada to one of its trademarks. Tamalia made use of this trademark by setting up a franchise system with Tamalia acting as franchisor. 9041-8351 Québec Inc., a former franchisee of Tamalia, had continued to use the trademark after the termination of its franchise. White took action against the former franchisee for illegal use of its trademark. The former franchisee alleged that White needed to be registered in Québec in order to file suit and maintain its action.

The Court of Appeal ruled against the former franchisee. There was no evidence of profit. In addition, the court noted that White did not control the services and sale of products commercialized under its trademark. From the facts at hand, it was deemed that only Tamalia exploited the trademark and that White’s action against the former franchisee was only a method of protecting its legal rights to the trademark.

This decision raises concerns regarding the requirements for foreign businesses to register in Québec under the LPA. It is possible, for example, that the outcome would have been different had evidence been provided that the licensing arrangement provided for royalties or fees to be paid to White or that White was doing more than protecting its trademark, such as controlling the sale of merchandise or services rendered in Québec.

Given the fact that firms carrying on “an activity in Québec” (and therefore subject to registration under the LPA) are also considered to be “doing business in Québec” for the purposes of section 2 of the *Charter*, there is a risk that a foreign franchisor, which has no physical presence itself in Québec but merely collects fees from Québec franchisees or exerts control over the merchandise sold in Québec, may be subject to the *Charter*.

Where a franchisor has determined that the *Charter* is applicable (or does not wish to take the risk that it is), it must comply with several obligations regarding the language used in the course of their activities. The sections that follow provide an overview of the main obligations arising from the *Charter*.

**B. Registering a Franchise**

As reviewed earlier, a franchisor or franchisee operating an enterprise in Québec must register under the LPA. The key elements of registering an enterprise are detailed below on Chart 1. With regard to the name of

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153. LPA, sections 21 and 25; *see also* Articles 305 & 306 CCQ. Although corporations have to register, it is not the case of all juridical forms. For instance, an unincorporated person conducting business under his or her real name is not required to register. Similarly, joints ventures do not have to register. ANTAKI, *DROIT ET PRATIQUE DE L’ENTREPRISE*, *supra* note 149, at 326.
the enterprise, a franchisor may register its original English name as the French version of its name, provided the registrant adds a French generic element. For instance, a fictitious franchisor with the name “Shop Better Inc.” could register as “Les Magasins Shop Better Inc.” (which translates as “Shop Better Inc. stores”).

C. Franchise Agreements

Contracts of adhesion, and hence most franchise agreements, are subject to the French language requirements under the Charter in the manner in Chart 2.

Québec Practice Point—Franchisors may contract with their franchisees in English and do not need to create French forms of agreement where both franchisor and franchisee agree to contract in English. In such an instance, franchisors will therefore want to include a clause in any non-French language agreement with a franchisee, in both French and the language of the agreement, clearly stating that both parties agree to the contract being in English.

<table>
<thead>
<tr>
<th>Item</th>
<th>Requirement</th>
<th>Statutory Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Register declaration with the registrar</td>
<td>Must be filed within sixty days after the enterprise begins conducting its activities in Québec</td>
<td>LPA, ss. 32</td>
</tr>
</tbody>
</table>
| Name of enterprise | Must contain:  
—Enterprise name (i.e. corporate name)  
—Any other names it uses in the course of carrying on its activities (i.e., trade names)  
—Additional information may also be required depending on the juridical form of the enterprise | LPA, s. 33; CCQ, Arts. 305 and 306 |
| Updating declaration | The name of the enterprise must be in French or have a declared French version of its name. The latter may be a non-French word as long as it is paired with a generic term in French. | LPA, s. 17(1)* |
| Updating declaration | The enterprise (once properly registered) must ensure that the information contained in the register is up-to-date by filing updating declarations whenever a change occurs as well as annual declarations. | LPA, ss. 41, 45 |

*See also section 27 of the Regulation respecting the application of the Act respecting the legal publicity of sole proprietorships, partnerships and legal persons CQLR c P-45, r 1.
D. Labeling, Advertisements, and Signs

In addition to the name registration requirement and the manner in which the franchise agreement is drafted, another major consequence of the Charter on franchisors wishing to do business in Québec relates to the language used on their products, transactional documents, and advertisement materials.

Chart 3: Labeling, Advertisements, and Signs

<table>
<thead>
<tr>
<th>Item</th>
<th>Applies To</th>
<th>Requirement</th>
<th>Statutory Provision</th>
</tr>
</thead>
<tbody>
<tr>
<td>Packaging and labels</td>
<td>—Writing on a product, on its container, or on its wrapping</td>
<td>Inscription must be in French</td>
<td>Charter, s. 51</td>
</tr>
<tr>
<td></td>
<td>—Any documents or objects supplied with the product (such as directions for use, instruction manuals, and warranty certificates)</td>
<td>Although any French inscription may be accompanied by a translation in one or many other languages, the French inscriptions must be at least as prominent as the other languages.</td>
<td>Charter, s. 51</td>
</tr>
<tr>
<td></td>
<td>—Restaurant menus and wine lists</td>
<td></td>
<td></td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Exception:</strong> Registered trademark for which there is no registered French equivalent or the name of a firm established exclusively outside Québec.</td>
<td>RRLC, s. 7</td>
</tr>
<tr>
<td>Item</td>
<td>Applies To</td>
<td>Requirement</td>
<td>Statutory Provision</td>
</tr>
<tr>
<td>-----------------------------------------</td>
<td>---------------------------------------------------------------------------</td>
<td>-----------------------------------------------------------------------------</td>
<td>---------------------</td>
</tr>
<tr>
<td>Promotional and advertising material</td>
<td>All printed material, such as: catalogues, brochures, folders, commercial directories, and any similar publications</td>
<td>Must be available in French or in a bilingual format</td>
<td>Charter, s. 52</td>
</tr>
<tr>
<td></td>
<td></td>
<td>The French version must be at least as easily accessible as the English version (i.e., for no extra cost) and must be of at least equal quality.</td>
<td>RRLC, s. 10</td>
</tr>
<tr>
<td></td>
<td></td>
<td><strong>Exception</strong>: Registered trademark for which there is no registered French equivalent</td>
<td>RRLC, s. 25(4)</td>
</tr>
<tr>
<td>Public signs, posters, and commercial advertising</td>
<td>All publicly displayed signs and posters, such as billboards, in-store ads, aisle signs, promotional pens, shopping bags, calendars etc.</td>
<td>Must be in French.</td>
<td>Charter, s. 58</td>
</tr>
<tr>
<td></td>
<td></td>
<td>If other languages are used on these signs, the French must be “markedly predominant.”</td>
<td>Charter, s. 58</td>
</tr>
<tr>
<td></td>
<td></td>
<td>**Exceptions to “markedly predominant” rule: large billboards designed to be seen from a public highway or those displayed on or in a public transportation vehicle, registered trademark (without a French version)</td>
<td>RRLC, s. 15 (Billboards), 16, 17 (Public transportation vehicle), s. 25 (4) (Trademarks)</td>
</tr>
<tr>
<td>Transactional Documents</td>
<td>All transactional documents, such as contracts, order forms, invoices, and receipts.</td>
<td>Must be in French or at least bilingual unless the parties expressly agree otherwise.</td>
<td>Charter, ss. 55, 57, 89, 91</td>
</tr>
<tr>
<td>Websites</td>
<td>Websites or online ads intended to be used or seen by Québec customers</td>
<td>Must be in French or at least bilingual.</td>
<td>Not mentioned in the Charter but requirements apply</td>
</tr>
</tbody>
</table>
A franchisor wishing to distribute its products in Québec must therefore translate, often at significant cost, its packaging and labels. The exception to the packaging rule, i.e., a registered trademark without a French equivalent, explains why products with bilingual packages and labels in French and English are often found in Québec with English-only trademarks.154

Similarly, for printed promotional and advertising material, a foreign franchisor distributing the English version of its materials has two options: make a bilingual version of its material for distribution in Québec or translate its material to distribute both a French and an English version.

**Québec Practice Point**—Considering that a franchisor is required to translate its standard promotional material into French, it may be less costly to make bilingual versions of any and all material for distribution across Canada.155

With regard to public signs, the idea behind the “markedly predominant” requirement is to give the French text “a much greater visual impact than the text in the other language.”156 The legislation contains a significant amount of detail as to how such “marked predominance” may be achieved.157

### E. Pending Amendments to Québec Signage Requirements

An important topic for any foreign franchisor wishing to do business in Québec concerns public signage. Franchisors often use a recognized trademark as their name, e.g., Best Buy, Costco, Gap, etc. These trademarks are usually displayed prominently on the front of their stores because stores are mostly recognizable by their trademark. More often than not, these trademarks are in English and they constitute the only inscriptions visible from the outside of the stores.

In Québec, this commercial reality presents a particular challenge. Indeed, section 58 of the *Charter*, by requiring that all public signs and posters be in French,158 seeks to preserve the “visage linguistique” of the province, that is, quite literally the linguistic face of the landscape. Making sure that the linguistic landscape communicates the reality of Québec society, a French-speaking society, is one important way of protecting French language,159 but results in a tension between the objective of the *Charter* and the legitimate protection of trademarks. Recently, this tension has led to a struggle between a group of retailors/franchisors and the *Office de la langue française* (OLF), the public body tasked with ensuring compliance with the *Charter*. This struggle culminated in a legal dispute, and ultimately, resulted

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154. Section 51 also refers specifically to restaurant menus and wine lists, which must be in French or bilingual.
155. The *RRLC* contains several exceptions to section 52, allowing publications exclusively in another language, for instance, where the publications are included in news publications in that language (section 10), or where they are used for a convention, a conference, or similar gatherings intended for a specialized or limited public (section 12).
156. RMP, section 1.
157. See RMP, sections 2, 3 & 4.
158. Subject to the markedly predominant rule, discussed earlier.
in a proposed amendment to the existing signage requirements, as described in more detail later.

For years, the exception to the marked predominance rule for English registered trademarks where there is no registered French equivalent (section 25(4) RRLC) enabled the common practice of franchisors and franchisees identifying their stores by hanging signs with only their English trademarks. In 2011, dissatisfied with this state of affairs, the OLF took the position that trademarks in a foreign language used as business names on signs and posters required the addition of a French generic term or slogan.

The OLF adopted the view that section 27 RRLC, which applies notably to the registration of business and corporate names, also applied to trademarks used as business names on public signage. In 2014, several retailers and franchisors, including Best Buy, Costco, Gap, Old Navy, Walmart, Toys ‘R’ Us, Curves, and Guess, successfully challenged the OLF’s interpretation before the courts.160 In Magasins Best Buy ltée c. Québec (Procureur général),161 the Québec Court of Appeal held that section 25(4) RRLC allows trademarks to appear exclusively in another language on public signs and posters without any French generic terms. This is also true, the court concluded, when an English trademark is used as a business name and displayed on a storefront.

Given this outcome, the Québec government undertook to amend the RRLC to require a “sufficient presence of French” on exterior public signage. On May 4, 2016, it introduced draft regulations and requested feedback from stakeholders.162 The feedback period has now expired, and Québec is awaiting the final version of the new regulations.

Based on the current draft regulations, the new rules, when they come into force, will require that a trademark in a foreign language displayed on a sign or a poster located “outside an immovable” (i.e., outside a building as further defined in the chart below) be accompanied by a “sufficient presence of French.” Of course, this type of phrase is heavily subject to interpretation.

The key elements of this rule as it stands in the current draft regulation are detailed in Chart 4.

The “sufficient presence of French” requirement is indeed premised upon a very broad definition. It reflects the intended flexibility of the new rules, allowing businesses to choose how they wish to ensure the presence of French in a way that fits their circumstances and preserves the integrity of registered trademarks.

According to the draft regulations, virtually any French inscriptions will do. Their sufficiency will depend on the circumstances. Evidently, the “Shop Better” trademark, for instance, may be displayed on the storefront if the same

160. Magasins Best Buy ltée v Québec (Procureur général), 2014 QCCS 1427.
161. Québec (Procureure générale) v Magasins Best Buy ltée, 2015 QCCA 747.
162. Draft Regulation to amend the Regulation respecting the language of commerce and business, (2016) GOQ II, 2477 & ff [hereinafter DR].
sign also contains the generic French terms “Les magasins.” However, it would also be sufficient to display a separate poster, in the front window, describing in French weekly rebates or the services offered, provided that the poster meets the “permanence,” “visibility,” and “same visual field” requirements. The only limitations are listed in the draft regulations, which provide that French indications such as business hours, telephone numbers, addresses, percentages and numbers are not taken into account.163

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163. DR, section 1, subsection 25.5.

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<table>
<thead>
<tr>
<th>Element of Draft Regulation Trademark Rule</th>
<th>Key Points</th>
</tr>
</thead>
<tbody>
<tr>
<td>Located outside an immovable (or building)</td>
<td>—A sign or poster is located “outside an immovable” when it is somehow attached to the outer walls or the roof a building. —The following are examples of what would be deemed to be outside an immovable: any sign or poster intended to be seen from the outside of a building; a sign or poster located outside a commercial space, which is itself located inside a mall or a shopping center; and certain signs or posters found on an independent structure near a building. (DR, s. 1(25.2))</td>
</tr>
<tr>
<td>Sufficient presence of French</td>
<td>—A sufficient presence of French is defined in the draft regulations either as a generic term or description of the products or services offered, a slogan, or any other terms or indications deemed sufficient. (DR, s. 1(25.1)) —The French elements must have the same permanence or durability and the same visibility as the trademark so that both can be easily read simultaneously. (DR, s. 1(25.3)) —The ability to read both the trademark and the French elements at the same time implies that they are legible in the “same visual field.”</td>
</tr>
<tr>
<td>Permanence or Durability</td>
<td>The material or manner in which the sign or poster is attached cannot be easily removed.</td>
</tr>
<tr>
<td>Visibility</td>
<td>The French elements are lighted in a similar way.</td>
</tr>
<tr>
<td>Same visual field</td>
<td>The draft regulations explain how to assess the “same visual field.” Typically, when a trademark is displayed on a sign attached to a storefront bordered by a sidewalk, the assessment is made from the perspective of someone standing on the sidewalk.</td>
</tr>
</tbody>
</table>
Despite its obvious advantages for franchisors, this flexibility creates uncertainty for businesses as well as enforcement challenges for the OLF. It remains to be seen what the final amendments will look like, and how the OLF will apply them in the future. Franchisors and franchisees which are part of franchise system already present in Québec will have three years from the date of the amendments to comply with the new rules, but all new franchises will have to comply with the new rules immediately.

V. Key Resources For Franchisors in Québec

The following organizations and government offices offer a number of excellent resources to help prospective franchisors have a successful entry into the Québec market.

A. Canadian Franchise Association

Founded in 1967, the Canadian Franchise Association (CFA) is a nationwide Canadian organization promoting the interests of its members from the franchise industry, including franchisors, franchisees, service providers, and suppliers. The CFA is the Canadian equivalent of the International Franchise Association. Members of the CFA agree to abide by a code of ethics, which focuses on the relationship between franchisors and franchisees. The CFA offers support and services to its members and constitutes a good source of information on franchising in Canada.

B. Conseil Québécois de la Franchise

Established in 1984, the Conseil national sur le franchisage et le partenariat was replaced in 2004 by the Conseil québécois de la franchise (CQF). The CQF is an industry organization for franchisors, franchisees, service providers, and suppliers in the province. In this way, it is similar to the CFA. It promotes the interests of its members from the franchise sector and offers information and support on franchising in Québec.

C. Office Québécois de la langue française

The OLF, as reviewed above, was established by the Charter. It is tasked with the elaboration and implementation of language policies. It monitors the linguistic situation in the province and promotes the use of French as the language of work, communication, commerce, and business in the civil administration and in enterprises. The OLF is the public body

164. DR, section 2.
in charge of ensuring that businesses conducting activities in Québec comply with their obligations under the Charter regarding the use of French.  

D. Consumer Protection

Like every province and territory, Québec has its own consumer protection legislation. The Consumer Protection Act (CPA) is aimed at protecting consumers in their dealings with merchants of goods and services. The Office de la protection du consommateur (OPC) is the government agency monitoring compliance with the CPA, advocating in favor of consumers, informing and educating consumers, receiving and processing consumer complaints, conducting investigations, and representing consumers in lawsuits against delinquent merchants. The OPC is a good resource for merchants seeking to know more about their obligations under the CPA.

E. Quick Service Restaurants

Restaurants Canada (RC) is a national organization promoting the interests of its members from the restaurant and foodservice industry in Canada, including restaurants, bars, caterers, institutions, and suppliers. Active since 1944, first known as the Canadian Restaurant Association and later the Canadian Restaurant and Foodservices Association, RC provides helpful information and resources.

F. Retail

The Retail Council of Canada (RCC) advocates for the benefit of its members from the Canadian retail industry. It provides services and information specific to the retail sector.

G. Health, Medical, and Fitness

The Recreation and Sports division of the Ministère de l’Éducation et Enseignement supérieur offers several guides and policies to help health and fitness centers adopt best practices.

H. Real Estate

The Organisme d’autoréglementation du courtage immobilier du Québec (OACIQ) is an organization whose main goal is to ensure the protection of the public by overseeing the practice of real estate brokerage in Québec.

169. Section 159.
170. CQLR c P-40.1.
I. Hospitality

The Association Hôtellerie Québec (AHQ) defends the interests of its members from the hospitality industry in Québec, and offers them useful information and resources.176

VI. Conclusion

As with any international expansion, a franchisor’s successful launch into Québec requires an upfront investment of financial and human resources to help assess the local market and consumer tastes. It also entails engaging local business and legal experts to help manoeuvre through the unique statutory and cultural differences between Québec and the franchisor’s home jurisdiction.

As part of its initial planning stage, a franchisor is well-advised to conduct specific market-research on Québec consumer preferences and local brands, and to assess whether a different franchise business model may be warranted for Québec, such as a local master franchisee or area developer for the province. Engaging the services of a French-speaking local area representative or hiring a local employee to assist with franchise sales and ongoing operational support is often recommended.

A franchisor may be tempted to use its existing domestic or even Canadian standard form franchise agreement with its Québec franchisees, but it is important to revise the agreement to address key differences under the Québec civil law regime, including provisions governing contracts of adhesion, as well as other legal considerations unique to Québec, such as French language, taxes, security interests, guarantees, and leases. Although Québec does not have franchise-specific legislation, it is also imperative that the franchisor understand its civil law duties more generally, including its obligation to act in good faith which creates a positive duty to inform that is similar to the statutory duty of disclosure that exists in certain other Canadian provinces.

## APPENDIX A

### EXAMPLES OF HOME GROWN QUÉBEC-ESTABLISHED FRANCHISORS

**Automotives**
- Docteur du Pare-Brise
- Location Pelletier
- Lebeau Vitres d’Autos
- DURO Vitres d’autos

**Cleaning Services**
- Adèle
- Carrébleu entretien ménager
- Ménage-Aide
- Parfait Ménage
- Qualinet
- UrbaiNET Inc.

**Construction**
- Les Scellants Élastek
- Pieux Xtrème Inc

**Fitness Centres**
- Cardio Plein Air
- Énergie Cardio
- Nautilus Plus

**Food–Full Service Restaurants**
- Bar à pâtes Mia Pasta
- Bâton Rouge*
- Cacao 70*
- Chez Cora*
- Dagwoods*
- Eggspectation*
- FF Pizza
- Fromagerie Victoria
- Giorgio Ristorante
- La Cage aux Sports
- La Piazzetta
- Pacini
- Trattoria Di Mikes
- Rôtisserie St-Hubert*

**Food–Quick Service Restaurants**
- Café Vienne
- Franx Supreme
- Habaneros Grill Mexicain
- La Crémière
- M4 Burritos
- Maître Glacier
- Première Moisson*
- Presse Café*
- Sésame
- Sushi Taxi
- Sushi Shop*
- Thaï Express*
- Thaï Zone
- Tiki-Ming*
- Vie & Nam

**Furniture and Appliances**
- Corbeil Électroménager

**Pet Shops**
- Animo Etc.

**Retail–Cosmetics/Beauty**
- Uniprix
- Jean Coutu
- Proxim
- Brunet
- Familiprix

**Telecommunications**
- Le Superclub Vidéotron /
- Microplay

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* Indicates franchises that have expanded operations outside of Québec.
APPENDIX B

EXAMPLES OF CANADIAN FRANCHISORS ESTABLISHED IN QUÉBEC

Automotive Services
Canadian Tire
Mr. Lube

Commercial/Residential Services
Fire-Alert Mobile Extinguishers

Food–Full Service Restaurants
Boston Pizza

Food–Grocery/Retail
M&M Food Market

Food–Quick Service Restaurants
A&W Food Services of Canada
BeaverTails (Queue de Castor)
Bento Sushi
Booster Juice

Cultures
Coffee Culture
Harvey’s
Jugo Juice
Mucho Burrito
Pizza
Second Cup
Tandori
Tim Horton’s
Vanellis
Villa Madina
Yogen Früz

Retail–Cosmetics/Beauty
Trade Secrets
Shoppers Drug Mart
(Pharmaprix)

APPENDIX C

EXAMPLES OF INTERNATIONAL FRANCHISORS ESTABLISHED IN QUÉBEC

Automotive Services
Midas

Cleaning Services
Jan-Pro

Education
Kumon Math & Reading Centres

Financial Services
H&R Block²

Fitness
Anytime Fitness
Planet Fitness

Furniture & Appliances
California Closet Company

Food–Quick Service
Burger King
Dairy Queen
KFC
Little Caesars
McDonald’s
Pizza Hut
Quizno’s
Subway

Printing/Copying/Shipping
The UPS Store

Real Estate
Re/max³

Seniors Services–Home Care
Home Instead

Keeping the Entire Pie and the Dog Fed: Why the Modern instrumentality Test Fails to Reflect the Realities of the Franchisor-Franchisee Relationship

Tyler Jones

The recent struggles of many courts to reconcile modern franchise practices with common law agency and vicarious liability have been well recorded. Consequently, the seeming incompatibility between franchising and traditional agency and vicarious liability approaches has led to an effort to modernize these legal doctrines to better account for the franchise context. Current modernization efforts aim to better protect franchisors via the modern instrumentality test. Summarized, the instrumentality test states that liability for the acts of a franchisee should not pass to the franchisor unless the franchisor controlled the thing, aspect, or instrumentality that caused the harm. In support of their position, proponents of the instrumentality test argue that franchisors do not have sufficient control over franchisees to warrant an application of the traditional day-to-day approach and that what little control they do have is simply to protect their brand or intellectual property.


2. See Wolf & Schepler, supra note 1, at 200–04.


4. See, e.g., id. at 339–42; King, supra note 1, at 437–38. Accordingly, they do not believe that exerting control to protect a brand or intellectual property should be sufficient to pass liability. Id.

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The instrumentality test’s growing popularity, however, has come at the expense of the older “day-to-day” or “right-to-control” test, which focused the analysis on who controlled the day-to-day operations of whatever/whoever caused the harm.\(^5\) Further, the steady trend toward the instrumentality test has not been without considerable debate.\(^6\) Several commentators argue that certain justifications for the instrumentality test do not validate the need for the test.\(^7\) Bearing this in mind, this article addresses the specific question of whether the newer trend—the instrumentality test—accurately reflects the policy being used to justify it. This article argues that the answer is largely “no,” at least in the case of single-unit franchisees. This article identifies several formal and informal controls, other than direct management, utilized by franchisors. The article will show that franchisors’ levels of control are largely comparable to typical employers or other types of principals (when dealing with single-unit franchisees) and that single-unit franchisees hardly have the freedom and control of the franchise necessary to justify solely bearing the brunt of any and all liability. Thus, this article will demonstrate that, in seeking to have the instrumentality test applied to their situation due to allegedly insufficient control, despite having considerable informal controls, proponents of the instrumentality test seek to have their cake and eat it too or, as the expression goes in Greece, they seek keep their entire pie and their dog fed.\(^8\)

This article is divided into four parts. Part I briefly explores the history of agency and franchising and the general principles of its application. Part II specifically focuses the discussion on the purported rationales for the older approach to agency and the instrumentality test. Part III examines to what extent, if any, the purported rationales of the instrumentality test hold up to the reality of the franchising system—whether they are truly justified. Finally, Part IV tries to reconcile the rationales for the instrumentality test (Part II) with the reality of many franchisor-franchisee relationships (Part III). Part IV will also suggest adjustments that might permit the instrumentality test to more efficiently address its purported justification.

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6. Compare Kerl, 682 N.W.2d at 339–42, with Rainey, 998 A.2d at 346–47.
8. Ben Zimmer, ‘Have Your Cake and Eat it Too,’ N.Y. TIMES, Feb. 18, 2011, http://www.nytimes.com/2011/02/20/magazine/20FOB-onlanguage-t.html?_r=0 (“Wolde ye bothe eate your cake, and hauve your cake?”). The concept is catchy but hardly limited to English-American culture. Id. See Also You Can’t Have Your Cake and Eat It, PROJECT GUTENBERG, http://www.gutenberg.us/article/whenb00000264000/you%20can (last visited Feb. 21, 2016). The saying develops the attributes of the cultures that utilize it. For example, a Chinese version goes “[You cannot have] a horse that both runs fast and consumes no feed.” A Danish version says, “you cannot blow and have flour in your mouth.” Id. Greece is no different. Id.
I. Background and Legal Standards

A. Brief History of the Franchising Business Model

As opposed to agency’s roots in continental Europe and Rome, franchising was initially a uniquely English phenomenon. Emerging at least as early as the fourteenth century, franchising was a special privilege conferred by English sovereigns on private parties to perform duties that might typically be exclusive to the public sphere.9 The public duties assigned were usually profitable ones, e.g., tax collecting and tolls.10 A far cry from the explosion of the commercial franchise in the last fifty years, the practice was sparingly used in England and effectively dead after the U.S. Constitution’s prohibition against grants of titles of nobility.11

Despite its apparent death, franchising as a term-of-art lingered, a small but steady flame, until its reemergence with the sewing machine in the nineteenth century.12 In the 1860s, Isaac Singer began to mass produce his sewing machines, but his success had a catch—he could not handle all the requests to fix the machines because there were too many and they were spread too far across the United States.13 Inventing the basis of the modern business franchise model, Singer began to license out the right to fix (and later sell) the machines to regional franchisees.14 Despite this novel, innovative way to allow growth while not succumbing to increasing maintenance costs, the modern franchise model did not catch on and remained the exception, not the rule.15

Although maintained from the Singer-era until the 1950s by the auto industry,16 the prevalence of franchising did not begin to grow noticeably until the 1950s.17 One commentator points to the return of the soldiers from World War II, an unusual excess of unspent paychecks, and the desire to own one’s own business with an experienced advisor in the background as reasons for franchising’s popularity.18 Here the business-format franchise model was born which, briefly summarized, “include[d] not only the product, service, and trademark, but the entire business format itself—a market-

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11. Id.; see also U.S. Const. art. 1, § 9, cl. 8. Although not the same thing, a society with nobility was a system of privileges (not civil codes) for classes of people; the death of one necessarily meant the death of another. See, e.g., William Doyle, The Oxford History of the French Revolution 27–28 (2nd ed. 2002).
12. King, supra note 1, at 422.
14. Id.
15. Id.
16. See King, supra note 1.
18. Id.
ing strategy and plan, operating manuals and standards, quality control, and continuing two-way communication.”

This largely supplanted the earlier product distribution model (in popularity), under which the manufacturer produced the goods and then sold and licensed the right to sell the goods to individual franchisees. This initial surge in the 1950s would eventually see the emergence of such brands as Howard Johnson’s, A&W, and Dairy Queen. The boom would continue through the 1960s to the start of the 1970s when a golden age of franchising would lead to the creation of McDonald’s, Jiffy-Lube, Burger King, and Kentucky Fried Chicken.

This prosperous and largely unregulated era would come to a screeching halt in the 1970s when a combination of a national recession and the exposure of industry-wide poor practices, including recording initial franchise fees as income at the time the franchisor sold the franchise, destroyed public confidence in the unregulated industry. Indeed, this laissez-faire period generated numerous “horror stories” of naive, hardworking, middle-class Americans losing their life savings to fly-by-night franchisors, which were selling defunct or even non-existent franchises. A combination of these events would lead to comparably heavy regulation of the industry by the states and the federal government (specifically, the Federal Trade Commission), typically in the form of pre-sale disclosure requirements to potential franchisees and legislation defining proper conduct for the franchise relationship, if established. Despite the fact that the last thirty to forty years have been characterized by increasing duties on franchisors, and while national recessions have caused peaks and valleys in the growth, franchising as an industry has remained a powerful mainstay in the U.S. economy by producing almost $1 trillion worth of economic output.

B. A Brief Overview of Agency

Like so many of our oldest legal traditions, the law of agency spans back over a millennium and a half to Roman Code. The Roman Code likely laid

20. See id. at 24.
21. Id. at 24–25.
22. Id. at 25.
23. Id. at 26.
24. Id. In fairness, and as pointed out by the author, it is unclear exactly how substantiated the majority of these horror stories were; however, the rub is that the stories existed in the first place and their existence, as pointed out by the author, is what helped to push much of the regulation efforts forward. Id. at 26–28.
25. Id. at 27–28.
27. The origins of respondeat superior are contested and there is some dispute exactly where the doctrine originated. See David Benjamin Oppenheimer, Exacerbating the Exasperating: Title VII Liability of Employers for Sexual Harassment Committed by Their Supervisors, 81 CORNELL L. REV. 66, 78 n.48 (1995).
the foundation for English common law traditions, which created much of the early predecessor theories for older American practices. As defined by the Restatement, “Agency is the fiduciary relationship that arises when one person [(a ‘principal’)] manifests assent to another person [(an ‘agent’)] that the agent shall act on the principal’s behalf and subject to the principal’s control, and the agent manifests assent or otherwise consents so to act.” Agency encompasses a variety of legal concepts, often grouped together under the umbrella term “agency,” which can refer to instances third parties conduct business for another, sign agreements for another, and even share responsibility. As one commentator puts it, “[i]t would be difficult to function in a modern economy for more than a few hours without interacting with an agent. . . . I willingly hand money to a stranger I meet in a store and carry away goods without questioning whether a sale has occurred.”

It is also worth noting that vicarious liability and respondeat superior are dis-

Reflecting the differing social strata of the time, Roman practice allowed various types of claims against principals for the actions of their agents based on the situation and the social class of the agent. David Johnston, The Development of Law in Classical and Early Medieval Europe: Limiting Liability: Roman Law and the Civil Law Tradition, 70 CHI.-KENT L. REV. 1515, 1517–24 (1995). For example, under Actio Institoria and Excercitoria when a principal’s agent became liable for a contract entered into with a third party, the third party would bring a claim against the principal if the agent was a slave or the third party’s preference if the agent was a freeman. Id. at 1517–18. Additionally, under Actio de Peculio, a claim was based not on contractual agreement but on relation of the agent (in this case a person under the power to the paterfamilias or head of household—typically a slave, wife, or child) to the paterfamilias and was limited by the possessions of the paterfamilias. Id. at 1521–22. Perhaps unsurprisingly, like in our modern application, Roman practice limited the liability of the principal where the agent had acted outside the scope of his authority or where the principal had given express notice to a third party concerning the limited authority of his agent. Id. at 1517–18.

28. See WINTON S. CHURCHILL, THE BIRTH OF BRITAIN: A HISTORY OF ENGLISH-SPEAKING PEOPLES 30–59 (Barnes & Noble, Inc. 2005) (1956). This is perhaps as a result of Roman occupation of Britannia Superior or as an importation of customs by German (primarily Saxon) migrants and invaders. Id. For the sake of this brief overview, it is not critical.

29. At some point, an early precursor of today’s principal-agent liability found its way into the English common law where it appeared at least as early as the fourteenth century in the court of Edward I (1272–1307). Rhett B. Franklin, Pouring New Wine into an Old Bottle: A Recommendation for Determining Liability of an Employer Under Respondeat Superior, 39 S.D. L. REV. 570, 574 n.29 (1994). See also South Carolina Ins. Co. v. James C. Greene & Co., 348 S.E.2d 617, 621–22 (S.C. Ct. App. 1964). Admittedly, this older version applied only to a master’s direct command to a servant to commit a tort (i.e., the master’s tort); it was not until the late seventeenth century that a shift from the traditional understanding to one of “implied command” of a master occurred. Franklin, supra, at 574–75. This modern shift was in accordance with the rationale that “the enterprise liability theory allocates the risk of the servant’s negligence to the master, not because [the master] is at fault, but because he is normally in a better position than the servant to respond in damages.” South Carolina Ins. Co., 348 S.E.2d at 622. However, because many legal theorists and jurists found the legal fiction of a master’s implied command to his servant to impute liability too abstract, late eighteenth and early nineteenth century English courts would drop the fiction in favor of modern enterprise liability. Franklin, supra (citing South Carolina Ins. Co., 348 S.E.2d 617). It is from this foundation that modern American agency law would stem.

30. RESTATEMENT (THIRD) OF AGENCY § 1.01 (2006).

tinct theories from agency as a whole, although they are very close cousins and often confused with agency.32

It is difficult to find a starting point to summarize agency. This may be because there is no consensus among jurists and commentators as to agency’s underlying purpose—assuming, of course, that there is a singular purpose.33 Still, the best place to begin may be to gain a simple understanding of who is defined as an agent because any underlying theory of agency still depends on the existence of some kind of master-servant relationship, employer-employee relationship, or a manifestation of such a relationship.34

In general, courts distinguish between agents and independent contractors.35 While both entities are typically in a contract with or have an understanding with the alleged principal, the independent contractor’s actions pursuant to a contract/understanding will not be attributed to the principal while the agent’s actions will be.36 As explained by the Illinois Supreme Court, the traditional rationale for this is because:

[T]he principal does not supervise the details of the independent contractor’s work and therefore is not in a good position to prevent negligent performance. . . . The independent contractor commits himself to providing a specified output, and the principal monitors the contractor’s performance not by monitoring inputs—i.e., supervising the contractor—but by inspecting the contractually specified output to make sure it conforms to the specifications.37

32. They are very close cousins in part because they share many of the same terms-of-art (such as independent contractor) and are often applied in very similar scenarios. In South Carolina Insurance Co. v. James C. Greene & Co., 348 S.E.2d 617, 624 (S.C. Ct. App. 1964), the court discussed one such distinction in the family tree of agency that allows the principal to be liable for the agent, although through different legal mechanisms.

The doctrine of respondeat superior is often confused with the power of an agent to bind his principal to a third party. . . . In a true agency situation, the principal is liable vicie the agent by reason of his consent to be bound. An agent contracting with the authority of his principal binds him to the same extent as if the principal personally made the contract. The principal’s liability to the third party is contractual and direct. In contrast, under the doctrine of respondeat superior, the principal is liable in addition to the agent, not by reason of his consent to be liable, but by operation of law. . . . Liability to the third party is delictual and derivative.

See also Restatement (Third) of Agency § 2.04 (2006).

33. Compare Dalley, supra note 31 (“Stated briefly, the purpose of agency law is to restore the status quo after a person chooses to use an agent.”) and NCP Litig. Trust v. KPMG LLP, 901 A.2d 871, 879 (N.J. 2006) (“[T]he purpose of the doctrine is the same—to protect innocent third parties with whom an agent deals on the principal’s behalf.”) with Bennett v. Industrial Comm’n, 726 P.2d 427, 430, n.2 (Utah 1986) (“The purpose of agency law [is] to define the limits of a master’s vicarious liability for a servant’s misdeeds . . .”) with Daniel Allen & Mindy Haverson, An Alternative Approach to Vicarious Liability for International Accounting Firm Networks, 15 Stan. J.L. Bus. & Fin. 426, 440 (“The purpose of vicarious liability in agency law is to place the burden of liability on the party that is in the best position to avoid that liability.”).

34. King, supra note 1, at 429.
36. Id.
37. Id. at 278 (citing In re Berry Publ’g Servs., Inc., 231 B.R. 676, 682 (Bankr. N.D. Ill. 1999)).
To determine if a party is an agent or an independent contractor, courts typically utilize some form of the “control test” to determine who was in control and thus who is the most culpable or in the best position to bear the risk. If it is determined that the alleged principal had sufficient control, it is said that a master-servant relationship forms, and the next question becomes determining if that agent had the authority to act for his or her principal. This element is typically divided into actual authority and apparent authority.

There are two diverging approaches for what the control test should look like in a franchising setting. The first and newer branch is the instrumentality test. The second and older branch might be better titled the right-to-control or “day-to-day” test because of its focus on who retains the discretion for day-to-day decisions or the “details of performance.” For an example of an application of the latter test, consider *Humble Oil & Refining Co. v. Martin*, where an injured party sued the Humble Oil Company for negligence. The plaintiff was struck by a car that rolled away from the filling station, owned by W.T. Schneider, due to the negligence of a filling station employee. Humble Oil licensed Schneider to sell Humble’s product but claimed that he was an independent contractor, pointing to the facts that Schneider was considered the boss by employees and he directed and paid them; he did not consider Humble to be his boss; and language in the agreement where Humble expressly repudiated any authority over Schneider’s employees. However, the Texas Supreme Court found a master-servant relationship because Humble ultimately retained control and Schneider lacked day-to-day discretion over the business.

For example, the court noted that Humble controlled the hours of operation; Humble could make unspecified demands of Schneider that had to be

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39. *Id.* at 430.

40. Some commentators prefer the more politically correct term of employer-employee relationship, instead of master-servant relationship. See, e.g., Richard R. Carlson, *Why the Law Can’t Tell an Employee When It Sees One and How It Ought to Stop Trying*, 22 BERKELEY J. EMP. & LAB. L. 295, 302–04 (2001). The two phrases are synonymous; however, this article will opt for the “master-servant” usage because of the potential confusion in associating this doctrine solely with formal employment.

41. *See* RESTATEMENT (THIRD) OF AGENCY § 2.01 (Introductory Note (2006)), which also notes that respondeat superior is a distinct theory, dealing more specifically with the employment context. *See RESTATEMENT (THIRD) OF AGENCY* § 2.04.

42. *See infra* Part I.C.


44. 222 S.W.2d 995 (Tex. 1949).

45. *Id.* at 997.

46. *Id.*

47. *Humble Oil & Refining Co.*, 222 S.W.2d at 998.
followed; Schneider was obligated to submit reports; and Humble could unilaterally terminate the relationship at will.48

After some form of the control test is satisfied, one still needs to demonstrate that the agent had the principal’s authority in order to attribute the agent’s actions to the principal.49 One type of authority, actual authority, describes the circumstances where the agent, by virtue of the principal’s express “manifestations” or by the agent’s reasonable belief based on those “manifestations” undertakes some act on behalf of the principal.50 It is a “consensual, fiduciary relationship in which the agent acts on the principal’s behalf, subject to the principal’s control.”51 The focus of the analysis tends to turn on the agent’s interpretation and belief regarding the principal’s manifestation.52 If the agent’s act caused liability of some sort, the principal could be liable if the act was in accordance, even in part, with those express manifestations to the agent.53

On the other hand, apparent authority (also sometimes referred to as apparent agency) denotes situations where a principal’s manifestations to a third party concerning the agent’s authority reasonably lead the third party to conclude that the agent has authority to bind the principal.54 Critically, the alleged agent need not be an actual agent of the principal; rather, the alleged agent may be an independent third party, which, by the principal’s manifestations to the injured party, is believed to have had the supposed authority at issue.55 Analysis of apparent authority then, unlike actual authority, turns on the third party’s interpretation of the principal’s manifestation56 and the third party’s reasonable reliance on that manifestation to his or her detriment.57

To better illustrate these types of authority, consider *Fidelity National Title Insurance Company v. Mussman*, where the Mussmans entered into an agreement with ITC to procure escrow services in anticipation of the sale of the Mussmans’ property.58 ITC was an agent of Fidelity and by virtue of a written agreement was empowered to “countersign and issue title insurance commitments. . . .” But the written agreement also expressly prohibited

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48. *Id.*
49. See Restatement (Third) of Agency §§ 2.01 cmt. c., 2.03 cmt. c (2006). The Restatement lists two manners in which authority might come: actual and apparent. See Restatement (Third) of Agency §§ 2.01–2.03 (2006). Note that some courts distinguish between actual, apparent, and “inherent” authority. See, e.g., Cange v. Stotler & Co., 826 F.2d 581, 591 n.7 (7th Cir. 1987).
50. See Restatement (Third) of Agency §§ 2.01–2.02 (2006). Note that some define this latter category as implied authority. See, e.g., Thomas v. Immigration & Naturalization Serv., 35 F.3d 1332, 1339–40 (9th Cir. 1994).
ITC from performing escrow services. At no point did the Mussmans ever interact with Fidelity directly. After it was discovered that the owners of ITC were operating a Ponzi scheme and the Mussmans were unable to recoup their lost fees from ITC, the Mussmans instituted an action against Fidelity under a traditional theory of agency. The trial court granted the Mussmans’ motion for summary judgment as a matter of law and Fidelity appealed. The Indiana Court of Appeals determined that ITC did not act with actual or apparent authority; thus Fidelity was not liable for ITC’s acts. Giving significant weight to the express prohibition in the agreement, the court reasoned that there was no actual authority because ITC could not reasonably interpret the agreement and the prohibition as authorizing powers to provide escrow services. The court reasoned that there was no apparent authority because there had been no direct manifestations to the Mussmans, at least to the extent to support such a theory.

Thus, in summary form, modern agency generally requires a master-servant relationship between the principal and the agent and for the agent to be acting within the actual or apparent authority that the agent or the third party believes he or she has. For vicarious liability, the test is rephrased simply to ask if the party causing the injury was an employee or an independent contractor and whether he or she was acting within the scope of his or her duties. Although it has evolved considerably since the days of the Roman Empire, the general principles guiding agency and vicarious liability have remain largely untouched.

C. Applying Agency Principles and Vicarious Liability in a Franchise Setting

Applying traditional agency and vicarious liability principles to the franchising context has proven to be a difficult problem. The route utilizing actual agency or a theory of vicarious liability fails for a single, crucial reason, although some courts have been able to overcome this pitfall. Stated simply, the reason is that franchisees usually qualify as independent contractors and not agents or employees because franchise agreements typically vest many of the day-to-day operations of the business in the franchisee, while retaining the necessary protections to manage the franchisor’s

59. Id. at 1162–63.
60. Id. at 1165.
61. Id. at 1163–64.
62. Id. at 1169.
63. Id. at 1165–68.
64. Id. at 1165, 1169.
66. See Emerson, supra note 1, at 620 n.31.
brand. As such, the necessary master-servant or employer-employee relationship between the franchisee and franchisor is typically not present.

Perhaps for this reason, the traditional control or day-to-day test has waned in popularity. Of course, the other likely reason for the demise of the day-to-day test is because of the instrumentality test. Under this approach, and as mentioned earlier, some courts, most notably the Wisconsin Supreme Court, have argued that steps taken to assure brand protection and quality assurance by franchisors are not the same as steps taken to control the daily operations of the business. To emphasize this belief, the court employs a test that requires the proponent of a claim demonstrate that, in order to establish franchisor liability, “the franchisor has control or a right of control over the daily operation of the specific aspect of the franchise’s business that is alleged to have caused the harm.” For example, in Kerl v. Dennis Rasmussen, Inc., an employee at an Arby’s franchise left work without permission and proceeded to murder his ex-girlfriend’s boyfriend and severely injure his ex-girlfriend. The deceased’s estate and the girlfriend brought suit against the Arby’s franchisor and the franchisee, Dennis Rasmussen, Inc. (DRI), for DRI’s alleged negligent supervision of its workers. Noting that the franchise agreement provided only for quality assurance checks, operational standards, and inspection rights, the court reasoned that this was not indicative of any kind of control—for the purposes of a master-servant relationship—over DRI’s conduct or standards for its employees. To borrow the language of the court, Arby’s did not control, at least in its franchise agreement, the “specific aspect” or “instrumentality” of the business that caused the harm, in this case direct supervision of the franchisee’s employees.

While some commentators have been quick to extol the impact of this opinion and many jurisdictions have adopted the approach in name or

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67. See Wolf & Schepler, supra note 1; see also Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328 (Wis. 2004).
68. See Emerson, supra note 1, at 620–22. As an aside, even if the agency relationship can be established, a minority of franchisors has been able to escape liability by disclaiming any direct or express manifestations to the agent to perform the alleged harmful act(s). See id. at 623 n.43. Admittedly though, this is a relative minor issue when compared to the ordeal of establishing the necessary master-servant relationship.
69. See Wolf & Schepler, supra note 1, at 197–200.
70. See, e.g., Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328 (Wis. 2004).
71. Wolf & Schepler, supra note 1, at 202–03.
72. Kerl, 682 N.W.2d at 331–32.
73. Id.
74. Id. at 332.
75. Id. at 332–33.
76. Id. at 338–39.
77. Id. at 331–32.
78. Wolf & Schepler, supra note 1, at 203–04 (stating “[r]educing the instances in which franchisors can be held vicariously liable for the acts of their franchisees is a necessary step in continuing the explosive growth that franchising has experienced in the last two decades”).
form,\textsuperscript{79} it has not been universally accepted in all jurisdictions.\textsuperscript{80} Further, some jurisdictions have either not decided the issue or are still actively struggling to precisely define their approach.\textsuperscript{81} Overall then, although some courts now consider this the majority rule,\textsuperscript{82} that declaration may prove to be somewhat premature if undecided jurisdictions fall on the other side of the fence.

The apparent authority approach has not been without its issues either. Typically, the manifestation relied on by the third party to link the “agent” franchisee to the “principal” franchisor has been the signage or branding at the store, e.g., the McDonald’s arches or the Pizza Hut red roof.\textsuperscript{83} However, this appears to contradict the traditional principle that it must be the principal’s manifestation, not the alleged-agent’s, which creates the reliance.\textsuperscript{84} Many commentators have criticized the inconsistency of this common law approach with the larger guarantees of the Lanham Act,\textsuperscript{85} which they insist was enacted to afford franchisors adequate control to protect their trademarks.\textsuperscript{86} As Professor Joseph King notes, franchisors face a “dilemma” in “trying to protect and preserve the integrity of their trademark


\textsuperscript{80} See, e.g., Rainey v. Langen, 998 A.2d 342, 349 (Me. 2010) (declining to adopt the instrumentality test); People v. JTH Tax, Inc., 151 Cal. Rptr. 3d 728, 746–48 (Cal. App. 2013) (recognizing that, while franchisors may exercise control over their trademark without making a franchisee an agent, the determinative question becomes “the right to control the means or manner in which the result is achieved”); Wolf & Schepler, supra note 1, at 211–13; see also Estate of Anderson v. Denny's Inc., 987 F. Supp. 2d 1113, 1151–57 (D.N.M. 2013) (noting that, while applying New Mexico law, certain acts related to protecting a brand will not be demonstrative of sufficient “day-to-day” control, although expressing doubts as to the consistency at which similar facts in precedent were applied).

\textsuperscript{81} See, e.g., Wolf & Schepler, supra note 1, at 208–13 (discussing California’s hesitance in applying the instrumentality test and recent decisions that seemingly kept the door open to the traditional control test).

\textsuperscript{82} Gray v. McDonald’s USA, LLC, 874 F. Supp. 2d 743, 752 (W.D. Tenn. 2012) (“The preeminent test for holding a franchisor liable for the tortious conduct of its franchisee is whether the franchisor control[s] or ha[s] the right to control the daily conduct or operation of the particular ‘instrumentality’ or aspect of the franchisee’s business that is alleged to have caused the harm.”).

\textsuperscript{83} Emerson, supra note 1, at 626.

\textsuperscript{84} RESTATEMENT (THIRD) OF AGENCY § 3.03 cmt. b (2006).


\textsuperscript{86} Wolf & Schepler, supra note 1, at 198; Emerson, supra note 1, at 626–27; see also 15 U.S.C. § 1127 (2015) (“The intent of this Act [is to make actionable] the deceptive and misleading use of marks . . . to prevent fraud and deception and to provide rights and remedies . . . ”).
and commercial reputation. Others disagree with this proposition and note that protection under the Lanham Act does not mean the absence of any liability for the acts of a franchisee. As noted by Professor Harvey Gelb,

Reference by the [Kerl] court to Lanham Act requirements as some kind of excuse or reason to protect franchisors from vicarious tort liability resulting from franchisee behavior is inappropriate. Persons in business may be subject to a variety of regulations causing the level of control they exercise over employees or others to increase. Why should Lanham Act requirements be construed in some perverse way to undermine vicarious liability principles?

These problems aside, the apparent agency approach is also under increasing pressure from the common knowledge doctrine. In brief, the common knowledge doctrine is the idea that the majority of the public understands that franchises are usually independently owned and operated; consequently, they understand that the franchisor is in no way liable for the actions of the franchisee and that they cannot reasonably rely on any manifestations of the franchisor. The common knowledge doctrine has been a fairly recent legal phenomenon of the last fifty years, with one commentator linking its growing judicial popularity to the discomfort many courts have with applying apparent agency to a situation where the franchisee has made all the relevant manifestations. This estimation of common perception has proven to be troublesome for judges to accurately gauge, however, because at least one study has demonstrated that a large portion of the general public struggled to correctly identify specific franchising practices and their legal consequences.

II. Rationales

A. Rationales for the Day-to-Day Control Test

“Vicarious liability is a severe exception to the basic principle that one is only responsible for [his or her] own acts . . .” Still, despite this apparently
stern rule, the policy reasons and rationales behind the traditional common law day-to-day control test seem adequately compelling.

To begin, courts have applied the control test for the simple reasons of control and fault (culpability model). This theory is epitomized by asking “who best had control to prevent the harm from occurring?” Under the culpability model, the person who had the best ability or most control to prevent the harm is most at fault and should be the one to bear the burden of rectifying the wrong. Further, this policy reason is strongly linked, if not indistinguishable, from deterrence theory. However, some commentators have been less than enthused about this rationale. Yet, these appear to be exceptions, not the rule.

Another popular justification for the control test is some conceptualization of spreading the loss or enterprise liability. As the theory goes, members of a common goal or enterprise should equally bear the burden created by their actions, i.e., the agent would not have caused the damage had he or she not been acting on behalf of the principal. This also forces the principal to account for potential liability and forces it to internalize more of the risk it had put solely on the shoulders of the agent. Perhaps not as intuitive as the culpability and deterrence models, some commentators have crit-

96. See Wolf & Schepler, supra note 1, at 197–98.
97. Id.
98. Neyers, supra note 95, at 293. Most common, although not exclusive to a criminal law context, deterrence theory is the idea that a punishment or result can be utilized to shape the conduct of actors; it often presumes that actors are reasonable and will engage in some kind of calculus prior to engaging in an act. See, e.g., Atkins v. Virginia, 536 U.S. 304, 320 (2002) (“The theory of deterrence in capital sentencing is predicated upon the notion that the increased severity of the punishment will inhibit criminal actors from carrying out murderous conduct.”); Dobson v. Camden, 705 F.2d 759, 769–70 (5th Cir. 1983) (“[D]eterrence is concerned with establishing a rule to shape future conduct. A potential tortfeasor’s actions will probably not be shaped by considerations of whether the injured party will be compensated nearly as much as they will be shaped by considerations of whether the tortfeasor will have to pay.”), different results reached on reh’g, 725 F.2d 1003 (1984). The theory is not without its detractors however. See, e.g., Tison v. Ariz., 481 U.S. 137, 180 (1987) (“[Constitutional limits to the State’s power to punish] must be defined with care, not simply because the death penalty is involved, but because the social purposes that the Court has said justify the death penalty—retribution and deterrence—are justifications that possess inadequate self-limiting principles . . . under a theory of deterrence the state may justify such punishments as ‘boiling people in oil; a slow and painful death may be thought more of a deterrent to crime than a quick and painless one.’” (Brennan, J., dissenting) (citing Herbert L. Packer, Making the Punishment Fit the Crime, 77 HARV. L. REV. 1071, 1076 (1964))).
99. As one notes, “Control has never per se been a ground for imposing vicarious liability, e.g., a parent is not liable for the torts of his children, a superior servant is not liable for the torts of subordinate servants, schoolteachers are not liable for the torts of their pupils and so forth.” Neyers, supra note 95 at 291 (citing S. ATIYAH, VICARIOUS LIABILITY IN THE LAW OF TORTS 22 (1967)).
101. Id.
102. Neyers, supra note 95, at 296–97.
icized this justification as not adequately explaining why vicarious liability is used where loss cannot be spread appropriately, as in the cases of charities or where an employer cannot get adequate insurance coverage. But again, these counterarguments appear to be finite exceptions to an approach that generally is supported in the majority of instances where it is applied.

To illustrate these rationales, consider *Ramos v. International Fidelity Insurance Company*. In *Ramos*, a local bail bondsman (Fiore) was charging double the statutory limit for bond premiums and, in some instances, not putting them into the proper escrow accounts before setting up the transfer to get the bond from the International Fidelity Insurance Company (IFIC). Although Fiore was an agent for IFIC and empowered only to enter into bail bonds contracts on behalf of IFIC, IFIC had no knowledge of his fraudulent and questionable practices. Fiore died and numerous outstanding bonds were left unsatisfied because the funds were absent from the escrow account and he had not paid them to the appropriate courts. Although IFIC would pay back the courts for the money owed, it managed to negotiate for a reduced amount on each bond by as much as half in some cases.

Collectively, the various customers of Fiore sought the return of their collateral from Fiore’s overcharging. IFIC refused, however, claiming first that Fiore, although an agent-in-fact, was not acting to benefit IFIC and second that IFIC had no knowledge of Fiore’s actions. The Massachusetts Court of Appeals disagreed. The court noted that putting Fiore in a position where he could initiate bonds on its behalf was a direct manifestation from IFIC to the customer-plaintiffs that Fiore was empowered to enter into such exorbitant rates (i.e., a theory of apparent authority). Additionally, IFIC’s actual knowledge of his acts was irrelevant to the apparent authority theory.

Both enumerated policy rationales demonstrate why imputing liability to IFIC was proper. First, IFIC was in the best position to control Fiore’s behavior and supervise his practices because he was their agent. He needed IFIC for the issuance of the insurance on the bonds and thus would have needed to capitulate to any reasonable demand IFIC made regarding his pol-

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103. *Id.*
104. *See, e.g.,* Mary M. v. City of Los Angeles, 814 P.2d 1341, 1349–50 (Cal. 1991) (reasoning in part that the City of Los Angeles could bear the cost of taking steps to prevent its officers from committing sexual assaults and that this would not detract from the services provided by police, unlike with public school teachers).
106. *Id.* at 739.
107. *Id.*
108. *Id.*
109. *Id.* at 739–40.
111. *Id.* at 741–42.
112. *Id.* at 742.
113. *Id.* (citing Kansallis Fin. v. Fern, 659 N.E.2d 731, 738 (Mass. 1996)).
114. *See id.* at 739–42; *see also* Wolf & Schepler, *supra* note 1, at 197–98.
icies or practices. As such, IFIC was in the best position to prevent the harm to the plaintiffs and was culpable for its agent’s actions. Secondly, IFIC and Fiore both benefitted from their common enterprise: IFIC received business from Fiore, and Fiore benefitted from having a nationally recognized principal backing him. Because they both benefitted, it would be unsatisfying to hold just Fiore accountable; rather, it was proper for IFIC to bear some of the risk for the common, beneficial enterprise. Such a judgment forced IFIC to internalize the risk of not supervising its agents and better distributed risk between principal and agent. Thus, as noted earlier and as demonstrated by Ramos, courts still largely rely on culpability and loss spreading models in justifying the use of the control test to impose vicarious liability.

Although other reasons have been proposed for the traditional application of vicarious liability, this article focuses on culpability and enterprise liability justifications because they appear to be the main platforms from which instrumentality test advocates also justify their position.

B. Rationales for the Instrumentality Test

As previously noted, the instrumentality test does not impose vicarious liability on a franchisor for its franchisee’s torts unless “the franchisor has control or a right of control over the daily operation of the specific aspect of the franchise’s business that is alleged to have caused the harm . . .”. As with the traditional test, justifications for the instrumentality test are based primarily on culpability or enterprise justifications, although these are not the only rationales.

Beginning with the culpability model, the first thing many advocates point to is the fact that the franchise model is completely distinct from employment and agency in general; notably, the typical franchisor exerts no more control over a franchisee than it needs to in order to protect its intellectual property. The control itself, the argument goes, is statutorily protected by the Lanham Act and a franchisor should not be held culpable for utilizing a statutory right. In an effort to tie additional controls to protecting the

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115. See Ramos, 34 N.E.3d at 739–42. See also Wolf & Schepler, supra note 1, at 197–98.
116. See Ramos, 34 N.E.3d at 739–42.
117. See id.; see also Keating, supra note 100.
118. See Ramos, 34 N.E.3d at 739–42.
119. See id.
120. See, e.g., Neyers, supra note 95, at 292–301 (discussing other theories, including victim compensation, mixed policy, and employee-focused enterprise liability).
122. Kerl, 682 N.W.2d at 331–32.
123. See, e.g., Wolf & Schepler, supra note 1, at 204 (noting that the adverse economic impact of imposing the traditional test on franchisors would likely harm the industry and the economy as a whole).
124. Kerl, 682 N.W.2d at 337–39; see also Depianti, 990 N.E.2d at 1063–64.
125. Id.
brand, advocates of the instrumentality test take a seemingly generous view of what actions are considered protecting statutory branding rights, at least for the purpose of the Lanham Act, e.g., “operational requirements,”126 mandated inspections of franchisees,127 how to conduct marketing,128 premises maintenance,129 and much more. Yet despite all these controls on seemingly important aspects of how to run one’s business, the Kerl court insists:

[T]he existence of these contractual requirements does not mean that franchisors have a role in managing the day-to-day operations of their franchisees. To the contrary, the imposition of quality and operational requirements by contract suggests that the franchisor does not intervene in the daily operation and management of the independent business of the franchisee.130

Applying this approach then, the franchisor is not in the best position to control the franchisee’s actions (and thus not culpable) simply because the franchisor announces in the franchise agreement that it does not have control over the franchise’s daily operation and thus washes its hands of the drawbacks of promoting its brand, while still reaping the benefits of increased brand visibility.131 Ultimately, at least in the minds of instrumentality test advocates, the culpability model justifies this test because franchisors lack the control that would have allowed them to prevent the harm from occurring.

Enterprise liability justifications are very similar. According to instrumentality test advocates, the franchisor and the franchisee cannot be considered to be a part of the same venture and thus should not be held liable because both do not benefit in the same way.132 As it goes, the franchisor’s benefits differ from those of the franchisee’s—the franchisor gets increased brand exposure and perhaps some royalties.133 The franchisee, on the other hand, gets the traditional benefits of increased profits.134 As the Kerl court sees it, these are two distinct businesses with two distinct benefits and goals based on an equal exchange via contract.135 However, such an interpretation seems attenuated. Is it fair to draw two distinct interests where the situation

126. Presumably the courts are speaking about general policies in maintaining the store: the hours, the goods and/or services provided, etc. See Kerl v. Rasmussen, 682 N.W.2d 328, 337–41 (Wis. 2004).
127. See, e.g., id. at 338.
128. Id. at 337–39.
129. See, e.g., Ketterling v. Burger King Corp., 272 P.3d 527, 533 (Idaho 2013) (finding that in a standard slip-and-fall incident a franchisor manual directing a franchisee to clear snow, salt pavement, and set up caution signs was insufficient control over franchisee to impute liability, in part because the manual noted that the franchisee retained day-to-day control over the business).
130. Kerl, 682 N.W.2d at 338 (emphasis added).
131. See generally Wolf & Schepler, supra note 1, at 200–04.
132. See id.
133. See id.
134. See id.
135. Kerl v. Rasmussen, 682 N.W.2d 328, 337 (Wis. 2004) (“As we have noted, a franchise is a commercial arrangement between two [distinct] businesses which authorizes the franchisee to use the franchisor’s intellectual property and brand identity, marketing experience, and operational methods.”).
might be more clearly characterized as a simple for-profit venture? Surely, both parties are interested in the deal because it will help increase their respective profits. Brand exposure is not a goal, in and of itself; rather, it serves to better expose an otherwise uninformed public about the product or service so that they will buy the product or service.\footnote{136 See, e.g., The Importance of Brand Awareness, Small Bus. (Jan. 28, 2013), http://www.smallbusinesscan.com/the-importance-of-brand-awareness/ (last visited Mar. 12, 2016).}

Summing up the justifications, advocates of the instrumentality test typically emphasize the distinction of the control and the benefits between franchisors and franchisees. Doing so validates why it would be inequitable to attribute a “distinct” franchisee’s acts to a franchisor. Franchisors emphasize the importance of their statutory rights to grow their brand and protect it from liability for doing so. They commonly emphasize that the typical powers retained by the franchisor do not vest the franchisor with any control and still wholly maintain the franchisee as an independent business. Most important, they emphasize the need for the instrumentality test because of the relatively weaker control that franchisors have over franchisees, as compared to a typical agency or employment scenario.

III. Applying the Rationales to Reality

A. Franchisor Control

The typical franchisor has a plethora of ways to maintain control of its franchise brand, most involving direct or indirect controls over the franchisee.\footnote{137 See Gillian K. Hadfield, Problematic Relations: Franchising and the Law of Incomplete Contracts, 42 Stan. L. Rev. 927, 951–52 (1990); Gelb, supra note 7, at 223. The question of control is discussed at greater length below.} However, it is important to first note what an average franchisee looks like. According to a 2007 study, 82 percent of all franchisees were single-unit operators: this means that these were investors with all of their capital, for this particular investment, tied to a single franchise.\footnote{138 Peter C. Lagarias & Robert S. Boulter, The Modern Reality of the Controlling Franchisor: The Case for More, Not Less, Franchise Protections, 29 Franchise L.J. 139, 144 (2010).} While there is substantial debate about how sophisticated these single-unit operators are,\footnote{139 Compare id. with Killion, supra note 17, at 29–30.} it appears that at best these are as sophisticated as the franchisors they deal with and, at worst, they are less sophisticated and sometimes completely inexperienced in the very basics of conducting business.\footnote{140 Lagarias & Boulter, supra note 138, at 144.} However, as noted by Professor Robert Emerson, even if franchisees were adequately sophisticated, the psychology of these types of investors tends to overvalue the viability of a given project:\footnote{141 Robert W. Emerson, Assessing Awuah v. Coverall North America, Inc.: The Franchisee as a Dependent Contractor, 19 Stan. J.L. Bus. & Fin. 203, 220–24 (2014).}

[F]ranchisees are often untested, raw recruits, whose business decisions are based on selective perception bias. . . . Most franchisees’ inexperience in business,
coupled with the tendency to over-estimate their own abilities, often leads franchisees to ignore relevant information regarding their purchase and its terms. . . . [Some even forgo seeking independent counsel to review their agreements and] after the initial investment has been made and the franchised enterprise launched, a franchisee’s post-purchase rationalization and neglect of probability can trap her in a foolish, long-term investment. The franchise turns into a money pit for a once gullible, perhaps now regretful franchisee.142

With this picture in mind, what kind of controls do franchisors typically exert over franchisees? Of course, there are the standard formal, contractual controls. As outlined by the Federal Trade Commission, these often include site approval,143 design and appearance standards,144 restrictions on goods and services provided, restrictions on methods of operation,145 and restrictions on “sales areas.”146 In addition, monthly or annual fees typically must be paid to maintain the franchise; these usually come in the form of royalties or joint advertising fees.147 Often, a failure to abide by any of these numerous terms will cost franchisees control of their franchise and the loss of their investment.148

Besides these formal controls, however, there are significant informal controls. As outlined by Professor Hadfield, because the nature of the franchisee’s investment is primarily a sunk cost,149 the franchise agreement gifts the franchisor with immense leverage over the franchisee.150 Stated a different way, because so much of the franchisee’s money is tied up in an unsalvageable asset, franchisees often must bend over backwards, even to unrea-

142. Id. at 223.


144. Id. Design and appearance standards often concern a particular look that a franchise must exhibit, often to promote the franchisor’s brand.

145. Id. These restrictions go to the heart of the franchisee’s procedures: hours, uniforms, advertising, special discounted pricing, bookkeeping procedures, etc.

146. Id. These clauses typically restrict the geographic area where franchisees may expand their franchise. Of note, these clauses may not prevent franchisor-owned stores from expanding into territory owned by the franchisee. Id. As stated by the FTC:

If you have an “exclusive” or “protected” territory, it may prevent the franchisor and other franchisees from opening competing outlets . . . but it may not protect you from all competition by the franchisor. For example, the franchisor may have the right to offer the same goods or services in your sales area through its own website, catalogs, other retailers or competing outlets of a different company-owned franchise.

Id.

147. Id.


149. Sunk Cost, BUS. DICTIONARY, http://www.businessdictionary.com/definition/sunk-cost.html#ixzz40FRMYY00 (last visited Mar. 16, 2016) (defining a “sunk cost” as money already spent and permanently lost; sunk costs are past opportunity costs that are partially or totally irretrievable and, therefore, should be considered irrelevant to future decision making).

150. Hadfield, supra note 137.
sonable behavior by the franchisor, to ensure that their investment does not evaporate. Unfortunately, franchisees’ desperation to preserve their investment can be exploited by franchisors that become conscious of this fact. As explained by Professor Gillian Hadfield:

The incentive that causes a business with sunk costs to stay in operation despite losses makes franchisees vulnerable to franchisor behavior known as “opportunism.” Because the franchisee will continue to operate even if it is not recovering its sunk investment, the franchisor can make decisions that induce such losses without the franchisee going out of business.153

This riposte of the lack of control argument is also joined by Professor Gelb, who notes,

[T]he Kerl opinion did not deal with the realities of the control relationship between a franchisor and franchisee. . . . Evidence of such realities may demonstrate a level of control by the franchisor far greater than the documents indicate. De facto control may arise in some situations from franchisee reluctance to defy franchisor recommendations.154

For example then, if a franchisor were to decide to increase the price of a bushel of lettuce by a dollar a bushel, for no good reason other than to increase its revenues, many of its single-unit franchisees would have no effective relief but to grit their teeth and bear it, unless the franchisee wished to risk losing the franchise and thus its entire investment.155 While it is true that some states try to protect against such improprieties, such statutes appear to provide only nominal protection to a cash-strapped single-unit franchisee, which lacks the funds to fight an unjust franchisor action in court. Furthermore, even assuming a franchisee has the funds, this does not undercut the points above concerning its reluctance (at least in the case of a single-unit operator) to contest such an action. Ultimately, franchisors, at least in dealing with a single-unit operator, often levy powerful informal controls over franchisees because of the nature of the franchisee’s investment.

151. Id.; see also Lagarias & Boulter, supra note 138, at 145; Instructional Sys., Inc. v. Computer Curriculum Corp., 614 A.2d 124, 140 (N.J. 1992) (noting “[o]nce a business has made substantial franchise-specific investments it loses all or virtually all of its original bargaining power regarding continuation of the franchise”).
152. Hadfield, supra note 137.
153. Id. at 952.
154. Gelb, supra note 7, at 223.
155. See id.; see also Phil Wahba, McDonald’s Says Its Wage Hikes Are Improving Service, FORTUNE, http://fortune.com/2016/03/09/mcdonalds-wages/ (last visited Mar. 16, 2016) (noting that in the wake of franchisor calls for increased hourly wages, franchisees, which pay hourly workers, have begrudgingly acquiesced, although not without considerable “friction”).
156. See, e.g., REV. CODE WASH. § 19.100.180 (requiring that any mandatory purchases from vendors be “reasonably necessary”); HAW. REV. STAT. ANN. § 482E-6 (requiring the parties to deal in “good faith”); OR. REV. STAT. ANN. § 650.210 (prohibiting a franchisor from requiring a franchisee to purchase goods from a specific source unless such a decision is “reasonably necessary for a lawful purpose justified on business grounds, and [does] not substantially affect competition”).
157. Hadfield, supra note 137, at 952; Gelb, supra note 7, at 223.
Besides controls over franchisees, franchisors also implement other means to more directly control their brand.\textsuperscript{158} Perhaps most notably, recent research has determined that franchisors actively maintain a set percentage of company-owned stores.\textsuperscript{159} This control is maintained by increasing (opening) or decreasing (closing) company-owned stores in proportion to the number of franchisee-owned stores being operated.\textsuperscript{160} In general, the study found a positive correlation between the profitability of a brand\textsuperscript{161} and the percentage of (franchisor) company-owned stores.\textsuperscript{162} Besides suggesting a considerable gap in trust between experienced franchisors and their franchisees,\textsuperscript{163} the correlation demonstrates that most franchisors maintain enough control to keep their brand profitable, regardless of the actions of their franchisees.\textsuperscript{164} Thus, the supposed need for control over operations procedures in order to maintain a franchisor’s brand appears to be more a way to sneak in excess control over franchisee dealings than a necessary element of protecting franchisor brands.\textsuperscript{165}

B. Employer Control

In relation to a basic employment scenario, employers do not enjoy the same kind of powerful, informal leverage as a franchisor. In a classic at-will employment scenario, the employer has the option to terminate an employee, but the employee typically does not have personal property at stake.\textsuperscript{166} Unlike typical franchisees, who have invested tens of thousands, if not hundreds of thousands of dollars in their businesses, the average employee does not have to invest a significant sum just to get the right to work for the employer.\textsuperscript{167} Indeed, besides the threat of losing one’s job,

\textsuperscript{158} This is not to suggest that franchisors are not allowed or should not be allowed to protect their brand, as stipulated under the Lanham Act. However, perfectly legitimate rights can easily bleed into a grey area where liberal interpretation of brand protection ends and day-to-day control begins. The point of this section is to demonstrate that franchisors have effective brand-control protections outside of their contractual ones, which often bleed into that grey area.
\textsuperscript{160} Id. at 136–39.
\textsuperscript{161} Id. at 148. “Brand profitability” was large determinant on how much a given franchise spent on media advertising.
\textsuperscript{162} Id. at 146.
\textsuperscript{163} Id. at 139–40. The authors hypothesize that this could be on account of a fear of “franchisee free-riding,” where a franchisee does not assist the franchisor in growing the brand and takes all meaningful steps to improve bottom line results, regardless of their effect on the brand itself. This view is inconsistent with the theoretical underpinnings of the instrumentality test. If the franchisor and the franchisee are two distinct businesses with two distinct interests, it would not be the franchisee’s duties to maintain the brand, but the franchisor’s, because that is the only asset which the average franchisor would typically maintain control over (in addition to powers related to maintaining it). Franchisee free-riding seems to imply that it would be the average franchisee’s duty.
\textsuperscript{164} See id.
\textsuperscript{165} See id.
\textsuperscript{166} Hadfield, supra note 137, at 931.
\textsuperscript{167} See id. at 930–32.
there is often relatively little that an employer can utilize to control an employee. 168

The argument that employers have more control than franchisors may have more credence for many career-oriented employees, those who are likely to stay at their position as long as possible. However, they typically face issues with non-compete clauses and general health and retirement benefits that can constrain them from leaving. Non-compete clauses 169 could effectively preclude specialized employees in a limited market from finding any employment, not just employment with a competitor. 170 Thus, these clauses can magnify the influence of a termination threat. 171 Still, as of a recent study, only an estimated 12.3 percent of all employees were under a non-compete and the vast majority were in highly technical, specialized fields such as information technology and programming. 172 Moreover, while non-competes have been growing in other less advanced or technical industries, 173 most employees do not have such leverage against them. 174 This is also not to mention the fact that most franchise agreements also have some form of non-compete, 175 creating a large discrepancy in the flexibility in which franchisees and employees have in conducting their behavior.

Employment benefits can also give some employers leverage over their employees in the sense that employees may not be able to find as generous health insurance plans or expansive coverage. But this argument has lost its sting in recent years for two reasons. First, the Affordable Care Act (ACA) has closed the pre-existing condition loophole in many benefit plans. 176 Prior to the ACA, if an employee developed a serious heart condition while working for her current employer, she might feel trapped because of the chance that her new company’s health care insurer might not accept

168. See, e.g., Carlson, supra note 40 at 361–62 (giving examples of “controlling” employers who otherwise cannot control other aspects of their employees’ duties such as productivity and focused use of work-time).

169. Cristin T. Kist, Blocked Airwaves: Using Legislation to Make Non-Compete Clauses Unenforceable the Broadcast Industry and the Potential Effects of Proposed Legislation in Pennsylvania, 13 VILL. SPORTS & ENT. L.J. 391, 393 (2006) (“Non-compete clauses are agreements which employers include in employment contracts to ensure that for a period of time after the employee leaves the employer, s/he will not work for a competitor in certain positions.”).

170. Martha Lagace, The Power of the Non-Compete Clause, HARVARD BUS. SCH. (Feb. 26, 2007), http://hbswk.hbs.edu/item/the-power-of-the-noncompete-clause. The author notes that, in certain fields, a non-compete acts like a monopoly over a burgeoning area can specifically foreclose any opportunities in that area, outside of that company.

171. Id.


173. Id.

174. Id.


her. With the ACA in place, the health care provider cannot deny her coverage on the basis of her pre-existing condition and the employee is free to search for a new job. Second, a recent study by the Society for Human Resource Management determined that employees are generally not knowledgeable about their benefits. According to the study, only 9 percent of human resources officials believed that their employees were very knowledgeable about their benefits package and only 22 percent believed that their communication process was sufficient to fully inform their employees. Thus, the argument that benefits act a significant control by employers over employees appears blunted by the fact that most employees are not sufficiently well informed to realize if any such leverage is even present.

Summing up, it appears that at the very least, franchisees are under as much pressure, if not more, than typical employees. While most employees essentially just face the prospects of losing a job, which can be replaced, the franchisee faces the prospect of losing a major investment and all related investments, which cannot be retrieved. Considering that the majority of franchisees are still single-unit operators and that the franchise represents perhaps the majority of their net worth and portfolio, it is unsurprising that franchisees accept many of the abuses of franchisors that an employee would not tolerate with an employer.

C. Common Enterprise (Joint Venture)

Unlike control, the enterprise justifications for treating franchisors differently may hold some weight. As noted by Black’s Law Dictionary, a joint venture is “a business undertaking by two or more persons engaged in a single defined project. [It requires:] an expressed or implied agreement; a common purpose . . . ; shared profits and losses; and each member’s equal voice in controlling the project.” Although a joint venture does not speak to any specific legal form (i.e., a joint venture might refer to a partnership, LLC, or corporation), this article utilizes the term briefly to demonstrate that a


178. Pre-Existing Conditions, supra note 176.

179. SHRM is the principal licensing and continuing education provider for the human resource industry.


181. Id.

182. Hadfield, supra note 137.

183. Lagarias & Boulter, supra note 138.

184. See id. at 145; Hadfield, supra note 137.

185. Joint Venture, BLACK’S LAW DICTIONARY (10th ed. 2014). This is sometimes used interchangeably with joint enterprise, although Black’s Law Dictionary gives the impression that joint enterprise is more commonly used for criminal or tort discussions. See Joint Enterprise, BLACK’S LAW DICTIONARY (10th ed. 2014). For the purpose of this article, the distinction is negligible.
theory of enterprise liability struggles to justify imputing vicarious liability in a franchise setting. Because a franchisee would utilize a franchisor’s intellectual property, the franchisee must have an agreement with the franchisor to obtain permission for its use.186 Although some commentators emphasize that the franchisor and the franchisee have different purposes,187 this seems to fly in the face of the basic generalization that the purpose for the relationship is so that both entities can profit from the agreement.188 Regardless, this is not the element that causes the most problems.

It becomes more difficult to label a franchisor-franchisee relationship as a joint venture or joint enterprise because of the differing levels of influence and the differences in the profits and losses. Needless to say, franchisees do not have the same level of control or input as franchisors.189 Further, it is hard to characterize a franchisee’s losses in the same terms as a franchisor's: when a franchise fails, the franchisee loses its franchise fee(s), business investments, and business income. The franchisor, which, at best, is making a royalty fee of some kind and suffers no immediate financial hit; any loss is usually more related to the potential damage to the franchise's brand and future sale of franchises.190

For these reasons, it is difficult to utilize enterprise liability to justify holding a franchisor liable for a franchisee’s acts.191 Most simply, franchisors and franchisees, while sharing an agreement and a common goal, differ in the liability they bear from the same loss and the input they have in decisions. As such, it is hard to consider them a common enterprise or joint venture.

IV. Amalgamation

The prime motivations for the creation of the instrumentality test do not sync with reality. For starters, there is no standard franchising contract—for the purpose of making a generalization—much less a standard that does or

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187. See generally Wolf & Schepler, supra note 1, at 200–04.
189. See supra Part I.C.; see also Lagarias & Boulter, supra note 138, at 144–45 (noting the one-sidedness and lack of power to negotiate terms characteristic in most franchise agreements).
190. Admittedly, this same risk distribution is also paired with a comparable amount of upside. Franchisors, while having less to lose, will typically only receive a set percentage return on investment while, at least in theory, a franchisee’s profits are only limited by the market, although their risk is much greater.
191. Consider also the corporate subsidiary, which does not normally impute its liability to its parent corporation. In this instance, although the relationship is defined by a common pursuit of profit and an agreement (like franchising), the subsidiary and the parent differ markedly when considering the levels of input and the different losses each would suffer. United States v. Bestfoods, 524 U.S. 51, 61 (1998); Bowoto v. ChevronTexaco Corp., 312 F. Supp. 2d 1229, 1238–39 (N.D. Cal. 2004); see also Martin, supra note 204; Henry W. Ballantine, Separate Entity of Parent and Subsidiary Corporations, 14 CALIF. L. REV. 12 (1925), http://scholarship.law.berkeley.edu/cgi/viewcontent.cgi?article=3941&context=californialawreview.
does not favor liability, as noted by Professor Gelb, “[t]he [Kerl] court’s willingness to generalize about franchise agreements in order to create a restrictive vicarious liability approach in favor of franchisors is inappropriately speculative. Courts should examine the terms of such agreements on a case by case basis rather than trumpeting a purported commonly found standard.”

Even assuming the Kerl decision’s reasoning, however, the culpability rationale fails because typical franchisors have substantial formal and informal controls over their franchisees—or at least as much as any typical employment scenario—to justify exposure to liability akin to principals in an average employment scenario. Moreover, franchisors maintain direct control over their brands, and empirical data suggests that the Lanham Act justification to maintain some control to protect the brand is overemphasized. Although it is true that the franchisor and franchisee’s businesses are too distinct to call them a common enterprise, this does not justify the issue created by applying different tests—one in an employment scenario and one in a franchise setting—to what is, at best, the same level of control by franchisors and employers over their subordinates. Further, distinctions between two business relations or forms are not per se a bar against being held liable for the other’s wrong as the concepts of veil-piercing, lender liability, and substantive consolidation can well attest.

Considering these arguments, it does not make sense to apply the traditional day-to-day test to a textbook employment scenario, where the controls over employees are relatively weak, as opposed to the more flexible and forgiving instrumentality test to a franchising scenario, where the informal controls tend to greatly constrain franchisee behavior. A single-unit franchisee, deeply in debt and reliant on a franchisor for a return on its investment and for a future income will rarely risk going against its franchisor’s wishes and interests. It acts less on its own volition and more under intense pressure or on an anticipatory belief of its franchisor’s preference. What is vital is a readjustment of the realities to the rationales behind the tests. Either the in-

192. Gelb, supra note 7, at 223.
193. See supra Part III.A. and Part III.B.
194. Id.
195. See, e.g., Pro Tanks Leasing v. Midwest Propane & Refined Fuels, LLC, 988 F. Supp. 2d 772 (W.D. Ky. 2013). Piercing the corporate veil or ignoring the corporate fiction is a term of art which refers to a court’s refusal to acknowledge the distinction between a corporation and another entity because, typically, of an abuse of the corporate form like fraud. Id.
196. See, e.g., Pearson v. Component Tech. Corp., 247 F.3d 471 (3d Cir. 2001). Lender liability refers to situations “where third parties seek to impose liability on major lenders on the theory that the lenders have so controlled the borrowing corporation that the corporation was functionally being run by the lenders, or solely for the lenders’ benefit, to the detriment of other creditors.” Id. at 492.
197. See, e.g., In re Stone & Webster, 286 B.R. 532 (Bankr. D. Del. 2002). As noted by the bankruptcy court, “[c]onsolidation of the estates of separate debtors may sometimes be appropriate, as when the affairs of an individual and a corporation owned or controlled by that individual are so intermingled that the court cannot separate their assets and liabilities.” Id. at 540.
198. See, e.g., Wahba, supra note 155.
strumentality test should be applied more broadly to most, if not all, agency and vicarious liability scenarios or franchisors’ levels of exposure to liability should be brought up to the levels of other principals.

As one option to address this problem, courts could simply apply the more stringent instrumentality test to all vicarious liability scenarios. Recall that employees and franchisees are, at best, under the same kinds of pressures to conform their actions to their employer/principal’s desires and very often franchisees are under much greater pressures to do so. Because typical agents and employees have potentially less motivation to stay within the constraints set by their principal than do franchisees, it might make more sense to extend the expanded protections of the instrumentality test to all agency scenarios.

But utilizing this possibility seems a poor choice for two reasons. First, what it aims to control (rogue actual agents who accumulate liability for their principal with no intention of acting to benefit their principal) is already easily monitored by “scope of authority” basics. Secondly, it seems impractical to attempt to modify centuries of common law precedent and countless jurisdictions to a higher standard.

Perhaps more appropriately, the better choice seems to be to recall the instrumentality test and return to the traditional control test. This would remove the double standard provided to franchisors and acknowledge that the purported reasons for the instrumentality test do not hold water. This approach would be simple to apply because jurisdictions applying the instrumentality test still utilize the control test in more traditional agency scenarios. Additionally, it would not require a complete rewriting of the common law.

Either way, to continue promoting the instrumentality test for the reason of a relative lack of control is fallacious. The facts do not support it. Franchisors have more than adequate control over their franchisees and franchise brand. As such, these reasons cannot justify utilizing the instrumentality test.

V. Conclusion

Advocates of the instrumentality test seek “to keep their entire pie and their dog fed.” They want to extend protections to franchisors, as if the franchisors had little to no ability to shape their franchisee’s behaviors, while ignoring the fact that franchisors have as much—if not significantly more—leverage than most employers and other types of principals. The crucial policy reason for agency liability, i.e., to hold those most culpable accountable, fails when we ignore those who could have easily prevented the wrong. For example, why should the franchisee be held solely liable for not installing

199. See supra Part III.A and Part III.B.
additional safety measures, which would decrease risk but increase expenses, when there are intense pressures from the franchisor to continue along the more dangerous but cheaper route? Ultimately, although readjusting the tests to fall within what reconciles the policy with the reality is unlikely,\textsuperscript{201} as long as courts continue to promote the use of the instrumentality test, they must realize that they are seeking to achieve two mutually exclusive, or at least two incompatible, ends.

\textsuperscript{201} See supra Part V.
ARBITRATION

A franchisor filed a statement of claim with the American Arbitration Association asserting that its franchisee and the franchisee’s principal breached the parties’ franchise or area development agreements, both of which contained mandatory arbitration provisions. The franchisee’s principal filed suit in the U.S. District Court for the District of New Hampshire, seeking a declaratory judgment that he was not bound by the arbitration provisions because he was not a party in his personal capacity to either of the agreements. The court agreed, finding that the principal had signed the franchise agreement in his capacity as an authorized representative of the franchisee entity, not in his personal capacity. Additionally, there was no evidence that the franchisee’s principal had personally guaranteed the franchisee’s obligations. Therefore, the court held that the franchisee’s principal was not bound by the arbitration provisions.

A franchisee of four Subway stores subleased from Subway Real Estate Corp. fell behind on rent. The franchisor (DAI) initiated an arbitration against the franchisee and, because she failed to appear at the final arbitration hearing, four arbitration awards were entered against her. The relief granted included termination of the franchise agreements; a requirement that she de-identify the stores; and payment of past due royalties, other fees, and

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the arbitration costs. The franchisee then filed a complaint in the New Jersey Chancery Court asking the court to enjoin the enforcement of the arbitration awards and termination of the franchise agreements on the ground that the arbitration awards violated the New Jersey Franchise Practices Act (NJFPA).

The Chancery Court issued a preliminary injunction enjoining enforcement of the arbitration awards. The franchisor then filed a complaint in the U.S. District Court for the District of New Jersey seeking a preliminary injunction preventing the franchisee from operating the franchised stores and asserted a claim for trademark infringement. The franchisee filed affirmative defenses and a counterclaim asserting that the arbitration clause was unconscionable and, therefore, unenforceable. At some point, the franchisee filed a petition for relief in the U.S. Bankruptcy Court for the District of New Jersey and the Subway entities filed a motion to dismiss the franchisee’s claims.

The bankruptcy court held that the franchisee’s reliance on the NJFPA and the injunction issued by the Chancery Court were misplaced because the Federal Arbitration Act precluded resorting to a state court for matters that the parties agreed to arbitrate. Accordingly, because the NJFPA was preempted, the court vacated the preliminary injunction issued by the Chancery Court. It further held that the arbitration clause was not unconscionable because the franchisee was educated in business matters and had several other food franchises to choose from if she disagreed with the terms of the arbitration provision, and there was no evidence that the agreements were presented to her on an “as is” basis.

**BANKRUPTCY**


A group of more than forty franchisees of Vision 21 Ace Hardware sought to file both a third and fourth amended complaint against the franchisor, alleging that the franchisor fraudulently induced them to purchase their franchises by knowingly providing manipulated and inflated sales projections and false historical performance numbers. The plaintiffs also moved to add a number of plaintiffs to the case, including trustees that represent the bankruptcy estates of franchisees named as plaintiffs in a prior proposed complaint. Ace objected to the proposed pleadings.

The U.S. District Court for the Northern District of Illinois held that the shareholders of the franchise entities that entered into agreements with Ace did not have standing to sue Ace and could not be added.

Although the franchisor argued that the claims of six other franchisees were barred by res judicata because their claims were compulsory counter-
claims to breach of contract suits previously brought by the franchisor, the

court held that the complaint did not show that the six franchisees could
have or did discover their fraud claims during the pendency of the franchi-
sor’s original lawsuits and, as such, they were not now barred from bringing
those claims.

The court based its determination on the shareholder- standing rule,
which the court characterized as a general principle of U.S. corporate law
and Illinois law. Under this rule a shareholder of a corporation does not
have an individual right of action against a third party for damages indirectly
resulting to the shareholder because of injury to the corporation.

**CHOICE OF FORUM**

*Cambria Co. LLC v. Renaissance Marble & Tile, Inc.*, Bus. Franchise

The U.S. District Court for the District of Minnesota upheld the common
law principle of freedom of contract and rejected Renaissance Marble & Tile
Inc.’s argument that a provision of Iowa franchise law (Iowa Code § 523H.3)
invalidated the forum selection clause and waiver to object or defend found
in the venue provision in the parties’ dealership agreement.

The dealership agreement between dealer Cambria Co. LLC and Renais-
sance, an Iowa-based manufacturer of kitchen countertops, specified that the
laws of the State of Minnesota were to govern the contract and included a pro-
vision whereby both parties expressly agreed not to raise any objections or
defenses with regards to the agreed-upon forum. In January 2016, Cambria
commenced proceedings in Minnesota state court against Renaissance in
the contractually stipulated Le Sueur County, alleging that Renaissance had
breached the agreement by failing to pay outstanding amounts. Cambria
brought a motion to remand pursuant to the contract’s forum selection clause
in response to Renaissance’s removal of the case from Le Sueur County to the
U.S. District Court for the District of Minnesota.

Although Renaissance did not deny the enforceability of the forum selec-
tion clause, it argued Iowa’s franchise law invalidated the clause. According
to the Iowa Code, proceedings may be commenced “wherever jurisdiction
over the parties or subject matter exists, even if the agreement limits actions
or proceedings to a designated jurisdiction.”

Granting Cambria’s motion and remanding the case to Le Sueur County,
the court held that Iowa law did not apply to the dispute because the contract
clearly stated that it was to be governed by the laws of the State of Minnes-
to. Accordingly, Iowa law could not invalidate the forum selection clause.
Furthermore, the court found the waiver provision to be a clear and unequiv-
ocal waiver of Renaissance’s right to remove, which effectively prohibited
objections relating to venue.
Franchisee Cluck–U Chicken, Inc. and its guarantor (plaintiffs) filed suit against franchisor Cluck–U Corp. and its president (defendants) in the U.S. District Court for the Middle District of Florida. In response, the defendants filed a motion to transfer the action to the U.S. District Court for the District of Maryland under 28 U.S.C. § 1404(a).

The court first considered the defendants’ argument that the forum selection clauses in the franchise agreement and guaranty required the parties to litigate in the District of Maryland. The court disagreed, finding that the forum selection in the franchise agreement “includes no words of command and no words of exclusion” and was, therefore, permissive, rather than mandatory, because it authorized litigation in Prince George’s County, Maryland, but did prohibit litigation elsewhere. The court also noted that the parties consented to jurisdiction and venue in state court and not federal district court.

The court found that the forum selection clause in the guaranty was a “hybrid clause” because it provided for permissive jurisdiction in a forum that was mandatory upon the party being sued. In other words, a party can sue in any appropriate jurisdiction, but a party that is sued in the identified forum cannot transfer the action.

Because the forum selection clauses were permissive, the court then considered whether the interests of justice and convenience of the parties and witnesses warranted a transfer. The defendants argued that its staff and witnesses were all based in Maryland. However, the court held that the significance of the convenience of the witness is “diminished” when such witnesses are employees of a party and the party can make them available for trial. The defendants also argued that its records were in Maryland. The court was unpersuaded by this argument because the records were electronically available and could be easily transferred to Florida. The court gave little weight to the defendants’ next argument—that there was pending litigation between the parties in Maryland (initiated by the defendants)—because the Maryland action was filed after the plaintiffs had filed their case in Florida. Finally, the defendants argued that the parties’ franchise agreement was negotiated and “finalized” in Maryland. The court rejected this argument, observing that the defendants failed to explain the importance of litigating the dispute where the parties negotiated and signed the agreement.

Having dispensed with the defendants’ arguments, the court then noted several things that the defendants had not done to advance their motion, including identifying any witnesses unwilling to attend a trial in Florida or arguing any “imbalance” in the parties’ respective abilities to pursue the litigation in Florida. Accordingly, the court denied the motion to transfer.
CHOICE OF LAW

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

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

CONTRACT ISSUES

After a period of negotiations with a franchisor (Cyclebar Franchising), a franchisee signed a franchise agreement. The franchisor did not countersign the agreement and, two days after the franchisee signed, informed the franchisee that it would not be granted a franchise and that the franchisor would refund the fees the franchisee had paid. The prospective franchisee filed a complaint in the U.S. District Court for the Eastern District of Kentucky, alleging claims for breach of contract, promissory estoppel, breach of warranty, misrepresentation, violations of Kentucky’s Consumer Protection Act, deceptive trade practices based on a violation of the FTC Franchise Rule, and punitive damages.

The court dismissed the prospective franchisee’s claims. Because the franchisor had not signed the franchise agreement, the breach of contract claim was barred by the statute of frauds. The court also held that the doctrine of promissory estoppel could not be used to enforce an agreement that is otherwise unenforceable based on the statute of frauds. Additionally, there was no warranty because there was no contract and the prospective franchisee did not offer any theory for relief based on a breach of warranty under Kentucky’s Uniform Commercial Code. The prospective franchisee’s fraud claim did not satisfy the particularity requirements because it failed to allege damages stemming from reliance on any misrepresentations. The Kentucky Consumer Protection Act claim also failed because that statute provided a cause of action only to individuals who purchased or leased goods for personal, family, or household purposes. Finally, the deceptive trade practices claim based on violations of the FTC Franchise Rule was dismissed because the rule does not create a private right of action; the claim for punitive damages was rejected because it was not a separate cause of action.
This case is discussed under the topic heading “Statutory Claims.”

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

A car dealer sued the manufacturer in Michigan state court for fraud and breach of the duty of good faith and fair dealing for not expanding and improving the Lancia vehicle line. The distribution agreement, however, contained a clause permitting the manufacturer to alter, modify, stop production of, or withdraw from the market for all vehicles or derivative vehicles under the contract. The distributor relied on the manufacturer’s representations that the particular line would be expanded and improved and claimed that absent those representations, it would not have entered into the agreement to distribute Lancia products. In ruling on the defendant’s motion for summary judgment, the lower court dismissed several counts in the distributor’s complaint. Upon appeal, the Michigan Court of Appeals considered only the dismissal of the distributor’s fraud and breach of the duty of good faith and fair dealing claims. The court found that the distribution agreement included an integration clause that nullified any alleged misrepresentation that the Lancia product line would be expanded and developed. The appeals court also ruled that the express terms of the agreement involved in this case gave the manufacturer the right to take the actions of which the distribution complained. For that reason there was no implied duty of good faith and the appeals court upheld the lower case ruling.

The U.S. District Court for the Northern District of Illinois struck seven of the defendant’s eight affirmative defenses to the plaintiff’s claim for breach of contract, but declined to strike the defense that the parties’ alleged agreement violated the statute of frauds.

Plaintiff Maurice Sporting Goods, Inc. and defendant BB Holdings, Inc., d/b/a Buck Bomb, were in a business relationship pursuant to which Maurice sold Buck Bomb products to retailers. After approximately eight years, Buck Bomb began selling its products directly to Maurice-supplied retailers. The parties chose to formally end their relationship and entered into a written agreement via email pursuant to which Maurice would return all Buck Bomb products in its inventory if Buck Bomb had previously provided an invoice for the product (the buyback agreement). Maurice brought an action against Buck Bomb for failing to pay $88,932.66 under the agreement.
In the alternative, Maurice alleged breach of oral contract and unjust enrichment.

In response, Buck Bomb pleaded eleven affirmative defenses, three of which were withdrawn, wherein it admitted the facts alleged but asserted alternative reasons why it was not liable. Maurice brought a motion to strike the defenses pursuant to Federal Rule of Civil Procedure 12(f). The court confirmed that affirmative defenses are assessed under the Twombly–Iqbal “plausibility” pleading standard and individually assessed the sufficiency of each defense as pleaded.

Buck Bomb’s first affirmative defense, asserting that its breach of the buyback agreement was excused due to Maurice’s prior breach of the parties’ alleged distribution agreement, was struck without prejudice on the ground Buck Bomb had failed to plead any allegations that plausibly suggested the existence of an enforceable distribution agreement beyond the “ongoing business relationship” between the parties.

The court struck Buck Bomb’s defense that Maurice failed to mitigate damages because Buck Bomb’s allegations related to behavior occurring prior to Buck Bomb’s failure to pay for the product buyback. As such, the allegations did not support a mitigation defense.

The court also struck Buck Bomb’s defense that Maurice contributed to its own alleged damages by making misrepresentations about Buck Bomb and its own business practices and status, on the basis that Buck Bomb had not asserted any factual allegations to support the defense.

The court struck an unclean hands defense because Buck Bomb failed to plead any facts establishing essential elements of the defense, including bad faith behavior and a connection between the alleged misconduct and the transaction in question. The court struck defenses of estoppel and waiver on the same grounds, finding the pleadings lacked reference to the essential elements of the defenses and failed to disclose any facts that could plausibly suggest the existence of a distribution agreement or actions constituting waiver.

Buck Bomb also asserted that the buyback agreement was void on the basis that its execution was obtained through Maurice’s illegal actions. The court struck this defense without prejudice on the basis that no facts supporting the allegations of illegality were pleaded.

However, the court declined to strike Buck Bomb’s final affirmative defense, which asserted that the alleged agreement between the parties violated the statute of frauds. The court found that the factual basis for this defense was inferable from Buck Bomb’s pleadings. Maurice had claimed damages arising from Buck Bomb’s breach of the written buyback agreement or, in the alternative, breach of oral contract and unjust enrichment. However, the Illinois statute of frauds provides that “a contract for the sale of goods for the price of $500 or more is not enforceable “unless there is some writing sufficient to indicate that a contract for sale has been made between the parties. . . .” As such, the court concluded that if Maurice’s written contract ar-
argument were to fail, the statute of frauds defense may be available in relation to the arguments advanced in the alternative. Furthermore, Buck Bomb had denied material elements of the written agreement on the basis of insufficient knowledge.


The U.S. District Court for the Eastern District of Louisiana considered several motions to dismiss in a case involving a contractual dispute among three entities—TSP Institute, Neill Corp., and TSP Consulting—all of which shared a common owner, Thomas Petrillo. In doing so, the court confirmed that although directors and officers of a corporation owe a fiduciary duty to the corporation and its shareholders, the duty owed between contractual parties is not fiduciary in nature.

Two of the involved entities, Neill Corp. and TSP Institute, shared a long-term distributorship agreement with Aveda to sell and market Aveda beauty products. The agreement with Aveda was a crucial part of Neill Corp.’s business. In order to leverage Petrillo’s industry expertise, Neill Corp. entered into a consulting agreement with TSP Institute, which shifted daily operational control of the Neill Corp. entities to Petrillo. Neill Corp. brought a claim against TSP Consulting alleging that Petrillo, as TSP Consulting’s sole member/employee, had attempted to usurp control of Neill Corp.’s distributorship agreement with Aveda through the consulting agreement. In response, TSP Consulting argued that Neill Corp. was merely trying to justify premature termination of the consulting agreement.

Keeping in mind the standard for avoiding dismissal in a Federal Rule of Civil Procedure 12(b)(6) motion, namely, that the complaint must state a valid claim for relief, the court addressed various motions to dismiss arising from counterclaims and third party claims. With respect to the motion to dismiss filed by TSP Consulting and Thomas Petrillo, the court granted the motion as to claims for breach of fiduciary duty by TSP Consulting. The court held that although contracts must be performed in good faith, this standard does not reach that of a fiduciary duty. In contrast, the court denied the motion to dismiss the claims of a breach of fiduciary duty by Petrillo individually because corporate officers and directors owe a fiduciary duty to their corporations and shareholders.

The court further considered a motion to dismiss related to a third party demand filed by TSP Consulting against a principal of TSP Consulting. Because the principal had not signed the consulting agreement in his personal capacity, but had apparently done so for a side letter, the principal’s motion to dismiss was granted with respect of the consulting agreement and denied as to the side letter. The court denied the remaining motions to dismiss, which related to requests for declaratory relief for breach of contract and repudiation, for tortious interference with contract, and for conversion against Petrillo personally.
The U.S. District Court for the Western District of Missouri held that a franchisor was not liable to one of its master franchisees for allegedly violating the Texas Business Opportunity Act and breaching the parties’ master franchise agreement (MFA). Although the franchisor had failed to provide the master franchisee with a Uniform Franchise Offering Circular (UFOC), the franchisor’s failure did not cause the master franchisee to sustain any damages.

Dr. Vinyl & Associates owned and franchised the Dr. Vinyl brand, a business that repaired vinyl and other materials. In addition to selling franchises directly to individuals, Dr. Vinyl also sold master franchises pursuant to which master franchisees would sell new franchises and promote existing franchises but would not perform actual repair services. In 2004, Restored Images Consulting, LLC, a limited liability company of third party-defendant Christopher Collins, signed an MFA with Dr. Vinyl. Among other things, the MFA required Restored Images to sell five franchises per year for five years. In turn, the MFA required Dr. Vinyl to pay Restored Images $10,000 for each franchise it sold. Dr. Vinyl was also required to provide a UFOC for the offer of Dr. Vinyl franchises.

Restored Images brought various claims against Dr. Vinyl, including that Dr. Vinyl breached the MFA by refusing to pay Restored Images a commission for selling a franchise and that Dr. Vinyl breached both the Texas Business Opportunity Act and the MFA by failing to provide a UFOC. Dr. Vinyl also brought various claims against Restored Images and Collins. Ultimately, the only party to prevail was Restored Images, which was awarded $10,000 in unpaid commissions.

In considering Restored Images’ claims regarding the failure to provide a UFOC, the court assumed, without deciding, that Dr. Vinyl’s failure to provide the UFOC constituted a breach of the MFA. However, the court found there was no evidence that not receiving a UFOC prevented Restored Images from promoting, selling, or growing franchises. As such, Restored Images did not require any sum of money to make it whole for the assumed breach of the MFA. Restored Images had also sought lost profits resulting
from Dr. Vinyl’s failure to provide a UFOC. Again, Restored Images’ lack of evidence was fatal to its claim as there was no evidence that it had a reasonable chance of completing a franchise sale but for the lack of a UFOC.

With respect to Restored Images’ claim to recover an unpaid commission, the court found the MFA required Dr. Vinyl to pay Restored Images $10,000 for each franchise sold, and Restored Images had, in fact, sold one franchise. Notably, in order to sustain its claim against Dr. Vinyl for unpaid commissions, Restored Images had to establish that it had performed its obligations under the contract. Dr. Vinyl argued that Restored Images had failed to satisfy its obligation to sell franchisees. Ultimately, the court held that Dr. Vinyl had waived this contractual provision because it had not enforced the franchise-selling requirement for over nine years nor had it terminated the MFA for non-performance. Because this section of the contract was waived, the court concluded that Restored Images had performed its obligations under the contract and found in Restored Images’ favor on its claim for unpaid commissions. The court awarded damages in the amount of $10,000, placing Restored Image in the position it would have been had Dr. Vinyl performed under the MFA.


Several truck dealers, some of which sold both Volvo and Kenilworth trucks, entered into a stock purchase agreement with Transportation Equipment Company, Inc. (TEC) to sell all of their dealerships. Volvo, however, desired to exercise its rights of first refusal to purchase just the Volvo portions of the dual dealerships. The dealers agreed that Volvo had a right of first refusal, but insisted that if Volvo wanted to exercise its rights, it had to stand in the shoes of TEC and buy all of the dealerships for at least the price set forth in the stock purchase agreement.

Volvo filed a motion in the U.S. District Court for the Western District of Virginia to enjoin the proposed sale until the scope of its right of first refusal could be determined. The court issued the requested injunction because the dealership agreement provided that a bona fide offer giving rise to the right of first refusal may not contain proposed sales terms that are commingled with other assets of the dealer. Thus, Volvo was likely to succeed on its claim that its right of first refusal was valid and that the dealers were required to honor Volvo’s rights by providing Volvo with information regarding the value of just the Volvo portions of the dual dealerships.

In finding that Volvo was likely to succeed on the merits of its claims, the court relied on a case in which the plaintiff had a right of first refusal to purchase a seventeen-acre tract of land. The plaintiff contracted with a buyer to sell the seventeen-acre tract along with another 1.9-acre parcel. There, the court was not persuaded by the plaintiff’s argument that the packaged nature of the sale defeated the right of first refusal and held that specific performance in favor of the plaintiff was appropriate. The court also held that
Volvo would likely suffer irreparable harm if the proposed sale was consummated because Volvo would lose its right of first refusal or be forced to purchase the Kenilworth and other portions of the dual dealerships. Additionally, the court found that harm to dealers from the injunction requested was minimal because they could continue to own and operate the dealerships.

DAMAGES


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


The U.S. District Court for the District of New Jersey entered a default judgment against a franchisee and its individual guarantors following their failure to defend an action for outstanding fees and liquidated damages after the franchisor terminated the license agreement for nonpayment.

Ramada Worldwide Inc. (RWI) entered into a license agreement with APS Corp. for the operation of a 134-room Ramada guest lodging facility. The agreement provided that RWI could terminate the license agreement with notice if APS failed to pay amounts due to RWI under the agreement or if APS failed to remedy any other default of its obligations or warranties under the agreement. In addition, the agreement provided for liquidated damages upon termination in the amount of $1,000 for each room in the facility. APS repeatedly failed to meet its financial obligations under the agreement, ultimately owing $168,416.92 in outstanding fees. RWI terminated the license agreement and sought to recover the amounts outstanding, its costs, and $134,000 in liquidated damages against APS and its guarantors. The defendants failed to defend the action, and RWI sought a default judgment.

In granting the requested default judgment, the court determined that the defendants had breached the license agreement and guarantees by failing to meet their financial obligations to RWI. The court found that RWI had performed its contractual obligations under the agreement, had properly pleaded the elements of a breach of contract claim, and put forward unchallenged facts that constituted a legitimate cause of action.

The court further found that RWI would suffer prejudice if the default judgment was denied because it had already waited nearly four years since the breach to receive the fees it was owed as well as the attorney fees and court costs. It found that APS and the individual defendants had not presented any factors or arguments to suggest they had a litigable defense for the breaches and that it was not clear if their failure to litigate was the result
of willful or bad faith conduct. Accordingly, the court determined that a de-
fault judgment was appropriate and entered judgment against APS and the
individual guarantors.

2016)
This case is discussed under the topic heading “Contract Issues.”

DEFINITION OF FRANCHISE

Lofgren v. Airtrona Canada, Bus. Franchise Guide (CCH) ¶ 15,776,
The U.S. District Court for the Eastern District of Michigan declined to
amend its judgment holding an agreement to provide equipment and training
in exchange for a fee constituted a franchise agreement under the Michigan
Franchise Investment Law (MFIL). Plaintiff Brian Lofgren entered into an
agreement with Airtrona Canada that enabled him to operate a used car de-
odorizing business. Two years later, he purchased upgraded equipment
from Airtrona. The business failed and Lofgren sought rescission under the
MFIL, claiming his arrangement with Airtrona was a franchise agreement
under the MFIL. At trial, the court concluded, among other things, that Air-
trona’s agreement to provide Lofgren with equipment and training to operate
his business in exchange for a fee constituted a franchise agreement under the MFIL, that
Airtrona had breached its disclosure obligations, and that Lofgren was entitled
to rescission. Although there was no formal written franchise contract, the
court found that Lofgren’s payment to Airtrona of more than the bona fide
wholesale price of the equipment he purchased could be considered an indi-
rect franchise fee for purposes of the MFIL. Airtrona and its principal Sam
Barbeiro moved for the court to amend its findings.

The defendants argued that the court had erred in finding that the parties’
arrangement constituted a franchise agreement because it failed to satisfy the
requirement that the claimed franchisee was granted the right to engage in of-
fering, selling, or distributing goods or services under a marketing plan or sys-
tem prescribed by the franchisor. The court rejected arguments from Airtrona
that the parties had begun working prior to entering into the agreement and it
had already granted Lofgren the right to use its marks. The court similarly re-
jected Airtrona’s arguments that it had erred by finding Lofgren was required
to pay a franchise fee under the agreement, finding (in obiter due to proce-
dural consideration) that the additional fee imposed by the agreement was
“for the right to enter into a business under a franchise agreement.”

The defendants also contended rescission was not a proper remedy be-
cause the failure to provide Lofgren with a disclosure statement was merely
a technical violation of the MFIL because Lofgren “knew everything that
would have been contained in the disclosure.” The court disagreed, finding the plain language of the MFIL did not require a substantial breach or intent to deceive in order to invoke the remedy of rescission. The court further found that the defendants had made no new arguments and declined to amend its judgment.

**DISCRIMINATION**


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

**ETHICS**

*Sanford v. Maid–Rite Corp.*, Bus. Franchise Guide (CCH) ¶ 15,742, 816 F.3d 546 (8th Cir. 2016)*

A franchisor’s counsel moved to withdraw from a case after the franchisor failed to pay its legal fees and provide certain information related to its defense. After first determining that the district court’s order was the appropriate subject for an interlocutory appeal, the Eighth Circuit held that the U.S. District Court for the District of Minnesota abused its discretion in denying the firm’s motion to withdraw.

The appeals courts found that the firm met the Minnesota Rules of Professional Conduct requirements to withdraw because the defendants refused to pay and failed to provide information important to the defense, which constituted a substantial failure to fulfill an obligation to the lawyer. The firm also provided the defendants with notice of at least four weeks prior to filing its motion to withdraw, over six months prior to the close of discovery, and one year from the earliest possible trial date. Additionally, there were no immediate deadlines in the case and the defendants therefore had sufficient time to secure new counsel. Finally, there was no prejudice to the parties and the plaintiffs did not oppose the firm’s motion to withdraw.

**EXPERTS**


Denying Spencer Franchise Services of Georgia, Inc.’s motion in limine to exclude expert testimony, the U.S. District Court for the Eastern District of Louisiana clarified evidentiary requirements relating to expert qualifica-

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* Mr. Ginsburg and his firm represented the plaintiff in this matter.
tions and the content of expert reports in the franchise context. At issue was a contractual provision that allegedly mischaracterized an obligation of the franchisee as one of the franchisor. The court concluded that, as a matter of law, the contractual provision contained a typo and entered summary judgment in favor of the franchisor, Wow Café and Wingery Franchising Account, LLC. The Fifth Circuit reversed the lower court’s decision and remanded the case to the district court for a fact finder to determine whether the parties had made an error. On remand, Spencer filed a motion to exclude expert testimony during trial preparations.

Spencer argued that Wow’s expert, who had an accounting background, lacked the appropriate qualifications to testify about the franchise industry or Spencer’s franchising expert’s report. In particular, Spencer argued the expert lacked academic or professional credentials in franchising, publications in franchising journals, and knowledge or expertise in operations and economics of the industry. In opposition, Wow argued that its witness was qualified as an expert in business valuation and that an expert’s lack of specialization in franchise issues should affect only the weight of his testimony, rather than its admissibility. The court agreed with Wow, holding that the Federal Rule of Evidence 702 does not mandate that an expert be “highly” qualified and that a lack of specialization should go to weight of the evidence, rather than admissibility. The court also noted that the district courts in the Fifth Circuit had previously concluded that specialization in the underlying field is unnecessary for business valuation experts. On this basis, the court held the expert was properly qualified, notwithstanding a lack of specialized expertise in franchising.

The court further rejected arguments that Wow’s expert’s testimony was unreliable because his report lacked sufficient facts or data to support its conclusions, failed to use reliable principles and methods, and was irrelevant because it would not assist the trier of fact. Noting that Wow’s expert had reviewed the underlying contracts, Spencer’s expert report, and other relevant reports constituting “sufficient facts or data” and that business valuation is not a “common-sense subject” for a jury, the court held that the expert’s testimony would help the trier of fact in evaluating the opinions of Spencer’s expert. Further, the court rejected arguments that Wow’s expert report did not contain a “complete statement of all opinions the witness will express and the basis and reasons for them,” holding that a statement of opinions is not rendered incomplete in the case of expert witnesses not expressing their own opinions.

FRAUD


This case arose out of a franchisor’s alleged inability to provide a functioning website to its franchisees for purposes of selling products. Plaintiff and
counter–defendant Country Visions, Inc. (CVI) is the franchisor of Apricot Lane franchises. Two of its franchisees, North Beach, Inc. and CC Young & Associates, LLC, created e-commerce websites for their respective businesses. CVI approached North Beach and Young about operating a website that would sell products for all Apricot Lane franchisees. During the course of the parties’ discussions, CVI provided North Beach and Young with a pro forma setting forth the projected revenues and profits that could be generated from operating the CVI website. North Beach and Young subsequently formed defendant and counter–claimant Midsouth LLC, which entered into an agreement with CVI to operate the CVI website. The parties’ relationship soured and litigation in the U.S. District Court for the Eastern District of California ensued. Midsouth asserted counterclaims against CVI and its CEO, Kenneth Peterson, for fraud, negligent misrepresentation, unjust enrichment, and unfair business practices pursuant to California Business & Professions Code § 17200. CVI and Peterson (counter–defendants) filed a Federal Rule of Civil Procedure 12(b)(6) motion to dismiss Midsouth’s claims. The Eastern District of California granted in part and denied part the motion.

As a threshold matter, the court first addressed the scope and enforceability of the choice of law provision in the parties’ agreement, which provided that the agreement “will be governed and construed in all respects by the laws of the State of California. . . .” CVI argued that the choice of law provision was “narrow” and did not encompass Midsouth’s tort claims. Relying on a California Supreme Court case involving a similar choice of law clause, the court found that Midsouth’s tort claims were embraced by the choice of law provision. The court next considered whether the provision was enforceable, i.e., “whether the chosen state has a substantial relationship to the parties or their transaction, or . . . whether there is any other reasonable basis for the parties’ choice of law.” Because CVI was incorporated in and has its principal place of business in California, the court found there was a substantial relationship between the parties and the state and that California law would be applied. The court then turned to the substance of counter–defendants’ Rule 12(b)(6) motion.

With respect to Midsouth’s fraud and negligent misrepresentation claims, counter–defendants argued that the pro forma was a non–actionable statement of opinion under California law. The parties agreed that speculative statements about potential profits are non–actionable opinions and that there is a potential exception to this rule if the declarant holds himself out as being “specially qualified.” CVI argued that Midsouth had not attempted to establish the applicability of this exception, given its allegations that CVI had been unable to operate a website. The court disagreed, finding that Midsouth’s allegation that CVI had specialized knowledge regarding its franchisees, including their sales revenues, satisfied the exception. Accordingly, the court denied the motion as to the fraud claims.
The court next addressed Midsouth’s unjust enrichment claim, which counter–defendants argued should be dismissed because there is no such claim under California law. Although the court agreed that there is no stand-alone claim for unjust enrichment, it noted that a court may construe such a claim as a “quasi–contract claim seeking restitution.” The court found that the allegations in Midsouth’s complaint fit within the quasi–contract theory seeking restitution and, therefore, denied counter–defendants’ motion.

Finally, the court addressed Midsouth’s unfair business practices claim seeking injunctive relief. Counter–defendants argued that Midsouth was not entitled to injunctive relief because it had not alleged “threatened future harm or [a] continuing violation.” The court agreed, finding that Midsouth’s allegation that “it will continue to be damaged” was conclusory and not supported by any allegation of ongoing injury. Therefore, the court granted counter–defendants’ motion as to the unfair business practices claim.

In a multi–million dollar class action, the U.S. District Court for the Eastern District of Michigan granted and denied in part motions to dismiss the plaintiffs’ eleven asserted claims. The plaintiffs, a group of affected creditors, alleged that weight loss shake retailer ViSalus, Inc., along with several other associated individuals and entities, violated or conspired to violate the Racketeer Influenced and Corrupt Organizations Act (RICO), federal securities laws, the Michigan Consumer Protection Act, the Michigan Franchise Investment Law (MFIL), and Michigan common law.

The plaintiffs claimed that they were induced at ViSalus-hosted events into paying to enroll in the ViSalus program, which allegedly misled consumers to enroll in its weight loss system to earn commissions by recruiting other consumers. The plaintiffs alleged that the system, which was pitched as a viable and attractive “business opportunity,” amounted to a fraudulent pyramid scheme and that they lost all of the money paid to ViSalus.

The court allowed actions to proceed against the company and its co-founders for mail or wire fraud under RICO Section 1962(c) as well as conspiracy under § 1962(d) against several distributors of ViSalus’ materials. In addition, it held the plaintiffs had sufficiently pleaded ViSalus’ role in creating, structuring, funding, and controlling the scheme to proceed with claims under Rule 10b–5b of the Securities Exchange Act of 1934.

The plaintiffs claimed the defendants violated Section 5 of the MFIL, having employed a “device, scheme, or artifice to defraud” in connection with the filing, offer, sale, or purchase of any franchise by engaging in a scheme to sign them up for the ViSalus program. The court found, however, that Section 5 was limited to persons who offer or sell a franchise and did not contain its own private right of action authorizing a private plaintiff to sue for its violation; only Section 31, which authorizes a private civil action
against a person who sell or offers a franchise in violation of Section 5, authorized such an action. Because ViSalus was the only defendant that offered or sold an alleged franchise to the plaintiffs, the Section 5 claim failed as to all the other defendants.


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


The Texas Court of Appeals upheld a finding of fraud in the inducement and negligent misrepresentation based on Mercedes–Benz USA’s failure to disclose that it intended to allow the addition of a new dealership in the McAllen area prior to its approval of a prospective dealer’s takeover of an existing dealership and relocation to the same area. Although the judgment was upheld, a punitive damages award was reduced from $115 million to $600,000.

Carduco, Inc. bought the assets of an existing Mercedes dealer with the intent to move the dealership to McAllen. There was evidence the previous dealer had received permission from Mercedes to relocate to McAllen, and Mercedes was aware of Carduco’s intent to do the same. The court found that Mercedes intentionally did not inform Carduco about Mercedes’ approval of a new dealership in the same area, that Mercedes knew the region could only support one dealership, and that Mercedes intentionally reassigned affluent areas to the new McAllen dealership. The court found that this was done in malice with an intent to negatively affect Carduco’s business. Two months following execution of the dealer agreement, Mercedes appointed a new dealership to McAllen and rejected Carduco’s relocation request.

The court rejected Mercedes’ arguments that Carduco had agreed in the dealer agreement that it was not relying on any oral representations outside the contract. The court noted that the jury had found Carduco was fraudulently induced into entering into both the asset purchase agreement and dealer agreement. Because only the dealer agreement contained an alleged disclaimer of reliance, Mercedes had not shown that Carduco “clearly and unequivocally” disclaimed reliance on the oral representations. The court also rejected Mercedes’ argument that there was no duty to disclose because there was evidence that Mercedes led Carduco into believing it was authorized to relocate to McAllen. The court found the evidence at trial was sufficient to support findings of malice and fraud and upheld the trial court’s judgment. However, the damages award was found to be unconstitutionally excessive and disproportionate to the severity of the offence and was therefore reduced.

The Fifth Circuit upheld a lower court decision summarily dismissing a franchisee’s counterclaims. Yumilicious Franchise, L.L.C. sued Why Not LLC and others for breach of the parties’ franchise agreement after Why Not closed one of its stores in South Carolina without notice and stopped paying royalties. Why Not counterclaimed for breach of contract, fraud, negligent misrepresentation, and violations of the Texas Deceptive Trade Practices Act and FTC Franchise Rule on the grounds that Yumilicious’ failure to disclose start-up costs constituted deceptive trade practices. The counterclaims were summarily dismissed on the grounds that the franchisee had failed to set forth a cause of action.

During negotiations, Yumilicious had made oral representations to Why Not that it was in negotiations to create a national supply chain that would make it economical to supply stores in South Carolina. These negotiations ultimately failed. The court held that this did not make Yumilicious’ initial representations false. Accordingly, the representations could not form the basis for a negligent misrepresentation claim. The court noted that Why Not had not alleged Yumilicious knew any details about the start-up costs, financial performance, or other items discussed in the FDD that it allegedly failed to disclose and that there could be no liability for a failure to disclose unknown costs. The court similarly rejected allegations that Why Not was fraudulently induced to enter into the franchise agreement by the CEO of Yumilicious, finding Why Not had failed to introduce evidence that Yumilicious made false statements or material omissions. The court accordingly upheld the lower court’s summary dismissal. In its decision, the court commented on the frivolity of the counterclaims, observing that the “saccharine swirl of counterclaims suggests that litigants, like fro-yo fans, should seek quality over quantity.”

INJUNCTIVE RELIEF


James Dunlap was a longtime franchisee of AAMCO Transmissions, Inc. After the expiration of his franchise agreement, Dunlap continued to operate his repair center using the AAMCO marks. AAMCO filed suit in the U.S. District Court for the Eastern District of Pennsylvania seeking to enjoin Dunlap’s continued use of the AAMCO name and signage. In response, Dunlap argued that the franchise agreement had not terminated. After discovery and a hearing, the district court found that the agreement had terminated and issued a preliminary injunction. The lawsuit was stayed pending arbitration, after which the arbitrator found that the franchise agreement had expired. Dunlap did not appeal the arbitrator’s ruling.
Thereafter, AAMCO filed a motion in the district court to convert the preliminary injunction into a permanent injunction. After a hearing, the district court granted AAMCO’s motion. In doing so, the court considered the traditional four injunctive relief factors. As to the first factor that the moving party succeeded on the merits, the court found that AAMCO had prevailed on its claims and the arbitrator’s ruling that the franchise agreement had expired was binding. With respect to the second factor, whether the moving party would suffer irreparable harm absent the requested injunctive relief, the court found that AAMCO’s business reputation and goodwill might be harmed in the event Dunlap’s customers were unsatisfied with his services. With regard to the third factor, whether the granting of a permanent injunction would result in even greater harm to the defendant, the court found that requiring Dunlap to “de-identify” and not hold himself out to the public as an AAMCO franchisee would not harm him. Finally, the court found that “the injunction would be in the public interest” because the public would benefit from the injunction in that it would prevent customer confusion and deception.

Dunlap appealed to the Third Circuit. In a per curiam opinion, the Third Circuit upheld the district court, finding that it had not abused its discretion; without explanation, the district court “essentially” embraced the lower court’s reasoning and findings.

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

The U.S. District Court for the Western District of Missouri granted H&R Block’s motion to enjoin a former franchisee from operating a competing tax service. Block terminated the franchisee after the franchisee failed to pay royalties and other sums owed. Upon termination, the franchisee was obligated to deliver its client list and records to Block, discontinue using Block’s trademarks, return all franchise materials, and execute documents to assign its business phone numbers to Block. The agreement also contained a post-termination covenant not to compete that prohibited the franchisee from operating a competitive business within a 25-mile radius of the formerly franchised territory.

The court held that Block had met its burden of showing a likelihood of success on the merits because the franchisee’s failure to pay fees was good cause for termination and the franchisee had breached its post-termination obligations. The court also held that Block would suffer irreparable harm absent a preliminary injunction because the operation of a competing tax service would inhibit its ability to refinance the territory. The court further held that the balance of harms weighed in Block’s favor because it would suf-
fer irreparable harm absent an injunction, while the franchisee’s harm could be remedied by an award of damages if it was ultimately determined that the injunction was wrongfully issued. Finally, the court held that the public interest was served by granting an injunction because of the benefits of enforcing reasonable noncompetition covenants and preserving the enforceability of contractual relationships.


The U.S. District Court for the District of Connecticut refused to grant injunctive relief to a group of Wireless Zone cellular franchisees. Thirty-five of the forty-two plaintiff franchisees moved for an injunction with respect to their claims against the franchisor, Automotive Technologies, Inc. (ATI), for breach of contract, unjust enrichment, and unfair trading practices.

At issue was a change to ATI’s business model, including the imposition of a new five percent royalty payable to ATI and withholding of that royalty from payments due from ATI to franchisees. The plaintiffs moved to enjoin ATI from implementing and withholding the royalty. The court determined the franchisees had failed to demonstrate they would suffer irreparable harm if the injunction was not granted. Specifically, the franchisees did not appear to be at risk of substantially losing all of their respective businesses because the payments at issue constituted approximately two percent of their gross revenues.

In rendering its judgment, the court made it clear that parties seeking interlocutory injunctions must meet a very high threshold. The court noted that preliminary injunctions are rarely granted in breach of contract actions unless damages are difficult to measure or there is a risk of loss of goodwill, reputation, or business opportunities. The court found that neither circumstance was present and therefore denied the franchisees’ motion.


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


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


In this case, the U.S. District Court for the Western District of Washington considered whether to enforce a covenant not to compete against a former distributor of Organo Gold Int’l, Inc., a multi-level marketing (MLM) company that sells ganoderma-based coffee products. Defendant Luis Ventura had prior experience in the MLM industry and began working with Organo
as an independent distributor in 2009. Several years after he began working with Organo, Ventura and his wife signed an independent distributor application that included a covenant not to “participate in any other opportunity that directly competed with Organo Gold in offering ganoderma-based products” for a twelve-month period after terminating his relationship with Organo. Organo’s policies and procedures also prohibited any distributor from “competing with [Organo] or any of its affiliates by soliciting existing customers of the Company to any ganoderma or healthy beverage business similar to the Company in a multi-level marketing setting or its equivalent, for a period of twelve (12) months” after the termination of the distribution relationship.

Ventura’s relationship with Organo terminated in February 2016 and he went to work for Total Life Changes, LLC (TLC), another MLM company, which sells a variety of products, including coffee infused with ganoderma. Ventura discussed TLC with Organo distributors and allegedly attempted to recruit them to join TLC. In response, Organo filed a complaint against the Venturas and their company, L&A Ventura, and sought a temporary restraining order against L&A Ventura based on its breach of contract and tortious interference claims.

The court first addressed Organo’s breach of contract claim and whether it was likely to succeed on the merits. L&A Ventura raised a series of procedural arguments: (1) Organo had failed to participate in a pre-dispute mediation as required by the relevant documents, (2) the noncompete clauses were not supported by adequate consideration, and (3) the clauses were unreasonable under Washington law. The court found that the policies clarified that Organo was entitled to seek injunctive relief before initiating an arbitration and therefore it was not required to first participate in a mediation. The court next found that the noncompete clauses were supported by independent consideration because, among other things, they were part of agreements that were renewed on an annual basis and a “fixed term of employment” constitutes independent consideration under Washington law. The court found that the policies clarified that Organo was entitled to seek injunctive relief before initiating an arbitration and therefore it was not required to first participate in a mediation. The court had little difficulty finding that the noncompete clause in the policies was necessary and reasonable because it was limited to protecting use of Organo’s “most valuable assets,” i.e., its customer base. The court ultimately concluded that the noncompete clauses in the distributor application were also reasonably necessary, finding that Ventura’s “insight into [Organo’s] employer guidelines may unfairly advantage him in recruiting for a competing MLM firm.” The court then considered the scope of the noncompete clauses. The court quickly found that the duration (twelve months) and geographic scope (nationwide) of the clauses were reasonable given the nature of the MLM business. Finally, the court was unpersuaded by Ventura’s argument that the noncompete clauses were overly broad in that they prevented him from “directly competing” and encompassed both the ganoderma and “healthy beverage” business, focusing on the differences in scope and application of the clauses.
With respect to the merits of Organo’s breach of contract claim, the court found that Ventura had breached the distributor application by soliciting other Organo distributors to join him at TLC and because TLC sells products made with ganoderma. As to Organo’s tortious interference claim, the court found that Organo had not shown that it was likely to succeed on this claim because it had not established that the alleged interference was “wrongful” and that L&A Ventura was “motivated by an improper purpose.”

The court next turned to L&A Ventura’s arguments that Organo had not established the requisite irreparable harm. The court rejected L&A Ventura’s argument that Organo had unreasonably delayed in seeking injunctive relief because the “delay” was only six weeks. The court was equally unpersuaded by L&A Ventura’s argument that Organo had suffered only monetary damages, finding that the potential loss of distributors resulting from Ventura’s solicitation “may cripple Organo’s viability as a going concern” because of the nature of the MLM business model. The court also found that there was evidence suggesting significant distributor attrition following Ventura’s communications with Organo distributors. Accordingly, the court found that Organo had demonstrated irreparable harm.

The court found the balance of the equities favored Organo because the potential consequences to Organo absent the injunction were significant, Ventura was still permitted to work in the MLM industry provided it did not involve ganoderma-based products, and the injunction was for only one year. Finally, the court held that the public interest in enforcing “reasonable and necessary non-compete agreements” would be served by issuing the requested injunction.

Finally, the court turned to the issue of whether Organo should post a bond and, if so, the amount. Organo argued that no bond was required, although L&A Ventura argued that a bond in the “realm” of $1 million was warranted. Because the court had some doubts as to the “substantive merits” of Organo’s claims and believed the defendants would suffer some harm as a result of the injunction, the court concluded that a $100,000 bond was appropriate.

This case is discussed under the topic heading “Injunctive Relief.”

JURISDICTION

The First Circuit overturned a district court decision dismissing a franchisor’s action against its franchisee for lack of in personam jurisdiction, finding it had specific jurisdiction based on the franchisee’s ties to Massachusetts.
Alpenrose Dairy, Inc. entered into a franchise agreement and a series of renewals over several decades with Baskin–Robbins Franchising LLC for franchises in Washington, Oregon, Montana, and Idaho. During the course of the parties’ relationship, Baskin–Robbins moved its headquarters from California to Massachusetts. Following a dispute over whether Alpenrose had properly exercised its renewal right leading up to the expiration of the final agreement, Baskin–Robbins filed suit in the U.S. District Court for the District of Massachusetts for a judicial declaration that Alpenrose’s rights as a franchisee would terminate upon expiry of the agreement. Alpenrose moved to dismiss the suit for lack of personal jurisdiction, arguing the proper venue was Washington. The district court dismissed the case and Baskin–Robbins appealed to the First Circuit, asserting that there was specific jurisdiction permitting the court to hear the case because it “relates sufficiently to, or arises from, a significant subset of contacts between the defendant and the forum.”

In reversing the district court’s decision, the First Circuit considered a three-part test for determining if there is in personam jurisdiction: (1) whether the claim “directly arise[s] out of, or relate[s] to, the defendant’s forum state activities; (2) whether the defendant’s in-state contacts represent a purposeful availment of the privilege of conducting activities in the forum state, thereby invoking the benefits and protections of that state’s laws and making the defendant’s involuntary presence before the state’s courts foreseeable; and (3) whether the exercise of jurisdiction is reasonable.”

Regarding the first condition, the court found that a series of letters pertaining to the non-renewal and expiration of the franchise agreement that were sent to Baskin–Robbins’ offices in Massachusetts had set the controversy in motion, thus creating a sufficient nexus to the forum.

With respect to the second condition, the court found—on the basis of fourteen years of contacts between Alpenrose and Baskin–Robbins’ Massachusetts offices as well as a constant reciprocal flow of payments between the parties—that Alpenrose deliberately targeted the Massachusetts economy and should have reasonably foreseen the involvement of a Massachusetts court in the event a controversy developed.

Finally, the court found the exercise of jurisdiction was reasonable after analyzing five factors: (1) the defendant’s burden of appearing in the forum state, (2) the forum state’s interest in adjudicating the dispute, (3) the plaintiff’s interest in obtaining convenient and effective relief, (4) the judicial system’s interest in obtaining the most effective resolution of the controversy, and (5) the common interests of all sovereigns in promoting substantive social policies. In particular, the court found that the parties were of substantial means and accustomed to cross–country travel for business and, as such, would struggle to establish the inconvenience required to meet the first factor. As to the second and third factors, the court found the state generally has an interest in providing its residents with a convenient forum for redressing injuries by out-of-state actors. Finding that the third
and fourth factors were neutral, the court held that this condition was satisfied and Massachusetts was an appropriate forum. In regards to the fifth factor, the court concluded that although a Washington statute would determine any compensation owed to Alpenrose in connection with the expiration of the agreement, a federal court sitting in Massachusetts is fully capable of applying Washington law and, therefore, Washington’s interest in the matter does not trump that of Massachusetts.


In this case, the U.S. District Court for Western District of Oklahoma considered whether it had personal jurisdiction over one of the owners of a franchisee of Express Services, Inc. and a company owned by the other owner of the franchisee. Express is an Oklahoma-based company that provides staffing, recruiting, and human resources services to customers through its network of franchisees. Southern Staffing, Inc. is a Georgia corporation owned by Don and Emily King. In 1998, Express and Southern entered into a franchise agreement under which Southern operated an Express franchise in Georgia. The franchise agreement, which included a forum selection clause, was signed by Mr. King on behalf of Southern. Express and Mr. King subsequently entered into a developer agreement pursuant to which Mr. King agreed to develop franchisee prospects on behalf of Express and consult/advice existing Express franchisees. A few years later, Express and Southern signed an amendment to the franchise agreement, extending the term of the franchise agreement for an additional five years. At the same time, both the Kings signed a guarantee that was part of the amendment. Generally coterminous with the franchise and developer agreements, Express was providing services to Impact Outsourcing Solutions, which was partially owned by Mr. King. Ms. King had no ownership interest and was not an officer or director of Impact. In 2011, Mr. King, on behalf of Southern, solicited Express about a “collaborative business relationship” in Oklahoma that did not come to fruition.

The parties’ relationship deteriorated and Express filed suit against Southern, the Kings, and Impact alleging that Mr. King (1) used Express’s confidential information obtained during the course of the parties’ discussions regarding the potential collaborative business relationship to solicit Express’s clients and “steer” its employees to Impact, (2) used Express’s intellectual property, and (3) otherwise breached the franchise agreement and developer agreement. Although Southern and Mr. King agreed they were bound by the forum selection clause in the franchise agreement and consented to jurisdiction, Ms. King and Impact argued that the court lacked personal jurisdiction as to them.

With respect to Ms. King, the primary issue was whether she had consented to jurisdiction by signing the guarantee that was part of the amendment. Express argued that the franchise agreement, including the forum
selection clause, was incorporated by reference in the amendment. Applying Oklahoma’s three-prong test for determining whether a contract incorporates an extrinsic document by reference, the court held that it did. First, the court found that the amendment made “clear reference” to the extrinsic document, i.e., the franchise agreement. Second, the court found that the “identity and location” of the extrinsic document was “ascertainable beyond a doubt.” Third, the court found that Ms. King had knowledge of and consented to the incorporation even though she did not recall signing the guarantee or agreeing to be bound by the forum selection clause in the franchise agreement.

Ms. King also argued that enforcing the forum selection as to her would be “unfair and unreasonable” for a variety of reasons, including that she (1) was not a party to and did not negotiate the franchise agreement, (2) did not negotiate the forum selection clause, and (3) had a policy of refusing to sign agreements between Southern and Express. The court rejected these arguments, noting that Ms. King had a fifty percent ownership interest in Southern, signed the guarantee, was “aware” of the franchise agreement, and had “bargaining power” with respect to transactions between the parties as evidenced by the fact that she did not sign other agreements and documents relevant to the parties’ business relationship.

The court then turned to the issue of whether it had personal jurisdiction over Impact. Express argued that the court had specific jurisdiction over Impact and therefore was required to establish Impact had “purposefully directed its activities at residents” of Oklahoma and that its “injury arose from those purposefully directed activities.” With respect to the purposeful direction factor, the court found Express was essentially arguing that Impact committed an intentional act that was “expressly aimed” at Oklahoma simply because Express has its principal place of business in Oklahoma. Following the U.S. Supreme Court’s holding in *Walden v. Fiore*, 134 S. Ct. 1115 (2014), the court rejected this argument, noting that the defendant’s contacts with the forum state, not the plaintiff’s, are relevant for purposes of establishing personal jurisdiction. The court further found that even if Express could establish the purposeful direction prong, it had not made a prima facie showing that its injuries were the direct result of the activities that allegedly formed the basis for jurisdiction. Finally, the court rejected Express’s request to conduct jurisdictional discovery, finding that it had not identified any specific issue that would be “clarified” by discovery or explained what additional facts were necessary to the court’s determination regarding jurisdiction.


TFL Fishers, LLC and its owner, Rosalyn Harris, entered into a franchise agreement with Get in Shape Franchise, Inc. (GISFW) to operate a GISFW fitness studio for women in Fishers, Indiana. In June 2015, Harris formed Fit Chicks, LLC (Fit Chicks) and sold the assets of her GISFW stu-
dio to Fit Chicks for $1. Thereafter, the former GISFW studio was operated under the name “Fit Chicks.” Harris claimed that her sister, who lived in Georgia where she worked full-time as an accountant, owned Fit Chicks. Harris’s sister had no background in the fitness industry and did not spend any time in the Fit Chicks studio, although she allegedly spent ten hours per week working remotely on Fit Chicks matters. Harris served as the volunteer manager of the Fit Chicks studio and ran its day-to-day operations.

GISFW filed suit in the U.S. District Court for the District of Massachusetts against TFL Fishers, Harris, and Fit Chicks, asserting various claims, including breach of contract and trademark infringement. GISFW also filed a motion to enjoin the defendants from operating a competing business at the site of the former franchised GISFW studio. Harris, the only defendant who appeared, argued that the court should dismiss the case for lack of subject matter jurisdiction, lack of personal jurisdiction, and improper venue. In the alternative, Harris argued that the motion for injunctive relief should be denied because GISFW had not established it was likely to succeed on the merits or would suffer irreparable in the absence of the requested injunction.

The court first addressed Harris’s argument that GISFW did not have subject matter jurisdiction. Based on GISFW’s trademark infringement claim under the Lanham Act, the court found that it had federal question jurisdiction. The court also found that it had diversity jurisdiction after determining the amount in controversy exceeded $75,000.

The court next addressed Harris’s personal jurisdiction arguments. Harris claimed that the court lacked personal jurisdiction over her and TFL Fishers because she does not live in Massachusetts, the franchised business was located in Indiana, she spent only five days in Massachusetts for training, it would be financially burdensome for her to appear in Massachusetts, and the Indiana Deceptive Franchise Practices Act (IDFPA) governed some aspects of the case. Relying on the Supreme Court’s decision in the factually analogous Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1985), the court rejected Harris’s first three arguments. With respect to the argument that the IDFPA was applicable to the case (presumably TFL Fisher and Harris’s prospective claims), the court found that did not render jurisdiction in Massachusetts unconstitutional. Finally, the court found that Harris’s claimed financial burden argument was properly addressed in the context of her venue arguments. Accordingly, the court held that it had personal jurisdiction over Harris and TFL Fishers. The court found, however, that GISFW was unable to meet its burden of establishing that the court had personal jurisdiction over Fit Chicks because there was no evidence that Fit Chicks or its owner, Harris’s sister, had any dealings with GISFW or the state of Massachusetts.

The court then considered Harris’s argument that venue was improper in Massachusetts. The court held that venue was proper in Massachusetts with
respect to GISFW’s breach of contract claim, which the court found to be the “center of the dispute,” and the motion for injunctive relief, but not for the trademark infringement claims because any customer confusion occurred in Indiana where the Fit Chicks studio is located.

The court then turned to GISFW’s motion for a preliminary injunction. Based on its rulings that the court had personal jurisdiction over Harris and TFL Fishers and that venue was only proper with respect to the contract claims, the court only considered entering an injunction to enforce the covenant not to compete in the franchise agreement.

As a threshold matter, the court first analyzed whether the covenant was necessary to protect a “legitimate business interest,” reasonably limited in scope and duration, and “consonant with the public interest.” The court found the covenant was intended to protect GISFW’s trade secrets, confidential information, and customer goodwill and, therefore, protected legitimate business interests. The court also found the covenant was “reasonable in both temporal and geographic scope” under Massachusetts law because it was limited to two years and only prohibited Harris from engaging in or being employed by “any fitness center, health club, personal training studio, or any other business concepts that directly compete” with GISFW within an eight-mile radius of the former franchised business or any other GISFW studio location. Finally, the court found that enforcing enforceable agreements was consonant with the public interest.

The court had little difficulty in finding that GISFW was likely to succeed on its breach of contract claims because it was undisputed that Harris had failed to comply with the franchise agreement’s post-termination provisions in a variety of respects and violated the covenant not to compete by, at a minimum, assisting in starting Fit Chicks and working at the Fit Chicks studio as the volunteer manager. Although Harris argued that GISFW was unlikely to succeed on its contract claims because it had materially breached the franchise agreement, thereby excusing Harris’s non-performance of the post-termination provisions and covenant not to compete, the court found that Harris had not submitted sufficient evidence to support this argument.

The court then addressed the remaining injunction factors. With respect to the irreparable harm factor, the court found that GISFW had established it would suffer irreparable harm absent the requested injunctive relief because a competing studio at the location of the former GISFW studio would harm its goodwill and make it difficult for GISFW to establish another studio in Fishers. The court found that the balance of equities weighed in GISFW’s favor: it was effectively precluded from establishing a new GISFW in Fishers because of Harris’s involvement with Fit Chicks and failure to turn over customer and other business information and because Harris received no compensation as the volunteer manager of the Fit Chicks, although she occasionally received small amounts for providing personal training services. Finally, the court found that the public interest was served by enforcing a valid covenant not to compete. Therefore, the court enjoined...
Harris from volunteering for, consulting for, working at, or assisting Fit Chicks for a two-year period.

The court then considered whether the case should be transferred to Indiana pursuant 28 U.S.C. § 1404(a), even though Harris had not technically moved to transfer under § 1404(a). GISFW argued that the case should not be transferred because the franchise agreement contained a valid forum selection clause, there is a presumption in favor of the forum chosen by a plaintiff, and Harris had not submitted evidence that overcomes this presumption. Following the U.S. Supreme Court’s decision in Atlantic Marine Construction Co. v. U.S. District Court of the Western District of Texas, 134 S. Ct. 568 (2013), the court held that the private interest factors weighed “entirely in favor” of the Massachusetts forum because the franchise agreement included a forum selection clause. However, the court found that the public interest factors weighed strongly in favor of transferring the case to Indiana because a substantial portion of the relevant events occurred at the studio in Fishers, venue as to the trademark claims was proper in Indiana because any customer confusion would have occurred there, Indiana had a strong interest in deciding the case because the Act applied, and the court lacked jurisdiction over Fit Chicks. Accordingly, the court transferred the entire matter to the Southern District of Indiana.

LABOR AND EMPLOYMENT


Franchisees of a janitorial service regional franchisor that did not have employee subordinates were “workers” subject to the requirements of Washington’s workers’ compensation statute and Industrial Insurance Act (IIA), making the regional franchisor liable to pay workers’ compensation premiums on behalf of the franchisees. The Washington Supreme court held that franchisees that did not hire employee subordinates met the IIA’s definition of “worker” because the essence of the franchise agreement is the franchisees’ personal labor, making them workers as defined in the IIA. However, where franchisees hire workers, the franchisees’ personal labor is no longer the essence of the agreement.


Former workers in Friendly’s Ice Cream restaurants sufficiently alleged that the franchisor and its franchisees were joint employers for purposes of maintaining claims under the Fair Labor Standards Act (FLSA). Two of the named plaintiffs in the class action were employed as servers at a restaurant owned by the franchisor and another named plaintiff was employed at a fran-
chisee’s restaurant. The plaintiffs alleged that both the franchisor and franchisees violated the FLSA by requiring servers to perform work off the clock during unpaid meal breaks and after clocking out at the end of shifts; by not paying servers who worked more than forty hours per week at overtime rates; and not paying servers the non-tipped minimum wage for the twenty percent of their time spent on tasks, such as cleaning and restocking that were not part of their tip serving duties. The plaintiffs alleged that the franchisor oversaw day-to-day operations of all Friendly’s restaurants, created and enforced all policies related to employees’ wages and work tasks, and operated as a joint employer and integrated enterprise with its franchisees due to its high level of oversight and involvement with each restaurant.

In considering motions to dismiss, the U.S. District Court for the Middle District of Pennsylvania applied a multi-factor test to determine whether the franchisor and franchisees were joint employers, including: (1) the authority to hire and fire relevant employees; (2) the authority to promulgate work rules and assignments and set conditions of employment such as compensation, benefits, and hours; (3) involvement in day-to-day employee supervision, including discipline; and (4) control of employee records, including payroll, insurance, and taxes. The plaintiffs alleged that the franchisor was engaged in the day-to-day operations of all Friendly’s restaurants, including those owned by franchisees; that it set policies for all restaurants, including policies related to hiring, training, work hours, overtime, time keeping, and compensation; that Friendly’s provided ongoing operational support to franchisees through a franchise business consultant; that it had the authority to hire and fire employees and inspect and supervise their work through quality assurance visits; and that the franchisor used the same payroll system at all restaurants. The court agreed with the plaintiff’s arguments and the motions to dismiss were denied.


Plaintiff Lisa Wright filed suit in the U.S. District Court for the Western District of Virginia asserting Title VII Claims against her former employer, Mountain View Lawn Care, LLC and its franchisor, U.S. Lawns, Inc. Wright claimed that U.S. Lawns was her joint employer or, in the alternative, that U.S. Lawns and Mountain View were a single, integrated employer. U.S. Lawns filed a Federal Rule of Civil Procedure 12(b)(6) motion to dismiss Wright’s claims. The court permitted Wright to conduct limited discovery and the parties filed supplemental briefs. Because the parties submitted evidence outside of the pleadings, the court converted the motion to dismiss to a motion for summary judgment. The court granted the motion and dismissed Wright’s claims.

In reaching its decision, the court considered the Fourth Circuit’s recently articulated factors for determining whether there is a joint employer relationship. Although none of the factors is dispositive and the element of
control remains the “principal guidepost,” the Fourth Circuit identified the three factors that it believes are most important. The court considered these factors first.

With respect to the first factor, the authority to hire and fire the putative employee, the court found there was no evidence suggesting that U.S. Lawns had such authority and the evidence established that Mountain View’s partners made the decision to hire and terminate Wright. As to the second factor, responsibility for day-to-day supervision and employee discipline, the court found there was no evidence that U.S. Lawns “played any role whatsoever” in supervising or disciplining Wright and relevant personnel records were signed by one of Mountain View’s partners and state that Mountain View was the employer. The third factor, whether the alleged employer furnished equipment used at the place of work, also did not support a finding of joint employment because U.S. Lawns did not provide the equipment that Wright used (e.g., lawn mowers and other tools necessary for landscape maintenance) or the place of her employment. Although Wright wore a U.S. Lawns uniform and the trucks/trailers she used included U.S. Lawns signage, the court found that this was because she worked for Mountain View, which does business as U.S. Lawns of Roanoke, and its franchise agreement with U.S. Lawns requires “such branding.” The court also noted that Wright worked with Mountain View employees and customers. Accordingly, the court found that the most important factors did not militate in favor of finding that Wright was jointly employed by Mountain View and U.S. Lawns.

The court then analyzed the remaining factors, holding that they too did not support finding a joint employer relationship: (1) U.S. Lawns did not maintain possession of and was not responsible for Wright’s personnel records (fourth factor); (2) The fifth factor—“the length of time during which the individual has worked for the putative employer”—was not applicable because the “fundamental question” was whether she was ever employed by U.S. Lawns; (3) U.S. Lawns did not provide any training to either Mountain View or Wright (sixth factor); (4) Wright’s duties were not “akin” to a regular U.S. Lawns employee’s duties (seventh factor); and (5) Wright was not assigned to any extent, let alone “solely,” to U.S. Lawns (eighth factor). The court found that the only factor that potentially supported Wright’s claim—whether the individual employee or alleged employer intended to enter an employment relationship (ninth factor)—was of “minimal value” because the parties’ subjective intentions are typically of “minimal consequence.”

The court next addressed Wright’s overarching argument that U.S. Lawns exercised significant control over Mountain View. The court found this argument to be irrelevant because the central issue is the extent to which the purported employer controls the employee, not the joint employer. Because the court found that the evidence “does not suggest that U.S. Lawns exerted any control over Wright’s employment,” it held that
U.S. Lawns was not a joint employer and therefore could not be liable under Title VII pursuant to the joint employer doctrine.

The court then turned to Wright’s alternative argument that U.S. Lawns was liable under the single, integrated theory of employer liability. As an initial matter, the court noted that this theory is typically applied in the parent/subsidiary and franchisor/franchisee context, but that the existence of such a relationship does not, in and of itself, establish liability. Rather, the court must consider a “non-exhaustive,” four-prong test. Like the test for determining whether there is a joint employer relationship, the key factor is control.

As to the first and second factors, common management and interrelation between operations, the court found there was no evidence of common management of day-to-day operations or that U.S. Lawns had any involvement in employment decisions. The court similarly found there was no evidence supporting the third and fourth factors, centralized control of labor relations and common ownership/financial control. As a result, the court rejected Wright’s single, integrated theory of employer liability.

Finally, the court addressed Wright’s argument that Mountain View was U.S. Lawns’ apparent agent, as a result of which Wright believed U.S. Lawns controlled Mountain View’s operation. As support for this argument, Wright relied on a Fourth Circuit case involving Holiday Inns in which the question of whether Holiday Inns was liable for injuries sustained by guests at one of its franchised locations was permitted to go to a jury. The court found this case to be inapposite and questioned whether an apparent agency relationship could form the basis for a Title VII claim against the purported principal. However, assuming that such a theory was viable, the court found that Wright could not establish the existence of an apparent agency because there was no evidence suggesting that she relied on the U.S. Lawns marks in deciding to work for Mountain View. Further, there was evidence that should have caused Wright to know that she was working for an independently owned franchise (Mountain View) and not its franchisor.

NONCOMPETE AGREEMENTS


The U.S. District Court for the Eastern District of Michigan enjoined a former Domino’s pizza franchisee from operating a new pizza business at the site of the former Domino’s restaurant. The post-termination provision in the franchise agreement prohibited the defendants from operating any pizza business within ten miles of their Domino’s store for a period of one year. Despite this provision, the defendants began operating a new pizza business at the same location, using the same phone number as the former Domino’s restaurant.
The court granted Domino’s request for injunctive relief after determining Domino’s would suffer irreparable harm absent an injunction, that it was likely to succeed on the merits of its breach of contract claims, that the injunction would not result in any great harm to the defendants in light of their failure to respond to the complaint, and that it was in the public interest to enjoin the defendants’ continued operation of a pizza restaurant.

Domino’s subsequently filed a motion for contempt because the former franchisee continued to operate a pizza restaurant at the former Domino’s location using the same phone number as the prior Domino’s pizza business, both of which violated the injunction. The court determined that a sanction of $100 per day against each defendant was necessary to compel compliance with the injunction and that, after twenty-one days, a $300 per day sanction would be sufficient to compel compliance.

STATUTE OF LIMITATIONS


A poultry wholesaler sued a poultry manufacturer under Puerto Rico’s Dealers’ Contracts Law (Law 75). The wholesaler alleged that the manufacturer violated Law 75, which provides that the principal or granter may not directly or indirectly act detrimentally to the established relationship. The wholesaler alleged that it had an exclusive contract with the manufacturer in Puerto Rico and that the manufacturer violated Law 75 by selling directly and through other wholesalers. The wholesaler originally contacted the manufacturer in 2009 about reported violations of the exclusive distribution agreement. The manufacturer responded that there was no exclusive distribution agreement, but agreed to continue doing business with the wholesaler on a nonexclusive basis. The manufacturer continued to sell its product through other wholesalers in Puerto Rico and subsequently began making direct sales to various retailers in Puerto Rico. As a result, the wholesaler filed a claim for violations of Law 75.

The U.S. District Court for the District of Puerto Rico denied the wholesaler’s motion for injunctive relief and dismissed the case, finding that the three-year statute of limitations under Law 75 started when the wholesaler received notice in 2009 that the manufacturer did not consider the relationship to be exclusive. The court found that because the manufacturer’s letter sent in 2009 to the wholesaler advised that the manufacturer did not intend to treat its relationship with the wholesaler as exclusive, it put the wholesaler on notice that the manufacturer could begin working with other distributors at any time and the three-year statute of limitations period began to run. Accordingly, because the wholesaler did not file its lawsuit until four years after receiving the letter, the claims were barred.
On appeal the First Circuit agreed that the manufacturer’s 2009 letter was a “detrimental act” under Law 75, triggering the statute of limitation. In upholding the district court’s ruling, the First Circuit also rejected the wholesaler’s argument that the manufacturer’s statute of limitations arguments should be barred on equitable estoppel grounds and that the parties had a de facto exclusive relationship after the 2009 letter. The appellate court noted that the wholesaler had not raised these issues before the lower court.

STATUTORY CLAIMS

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

Three Indiana automobile dealers lacked standing under the Indiana Motor Vehicles Dealer Law to seek declaratory relief for a manufacturer’s alleged encroachment in their territory, according to a recent decision by the Indiana Supreme Court. Three dealers filed a declaratory judgment action with the State Auto Dealer Services Division, seeking a determination whether good cause existed for the manufacturer’s proposed relocation of a dealer to a site near the three dealers. The Division held that the dealers lacked standing because they were outside of the relevant statutory market area, which was a six-mile radius around the proposed location. On appeal, the Indiana Supreme Court held that because the statute reflects a legislative determination that relocating more than six miles from another dealership in a densely populated area does not trigger the protections offered to dealers by the law, the dealers lacked standing to challenge the manufacturer’s proposed relocation of the competing dealership.

The New York Court of Appeals found a performance standard that failed to take into account local brand popularity violated Section 463(gg) of the New York Franchised Motor Vehicle Dealer Act, but that a unilateral change to the dealer’s territory was not a violation of Section 463(ff).

Beck Chevrolet Co., a long-time Chevrolet dealer for General Motors, operated under a dealer agreement requiring it to achieve a specified level of sales performance within its designated territory. The methodology for measuring sales performance relied on statewide data and some local variances, but failed to account for local brand popularity. After falling short of the performance standards, GM advised Beck that any extension of the
agreement was contingent on meeting the designated benchmarks. GM then 
sent a separate letter informing Beck that it was unilaterally modifying Beck’s 

Beck first argued that the performance standard was contrary to Sec-
tion 463(gg), which makes it unlawful for any franchisor to use “an unreason-
able, arbitrary or unfair sales or other performance standard in determining a 
franchised motor vehicle dealer’s compliance with a franchise agreement.” 
The court agreed, finding that it is unlawful to measure sales performance 
by a standard that fails to consider the desirability of the brand itself when 
measuring the dealer’s sales performance. The court reached this conclusion 
even though GM’s methodology in calculating sales performance was consis-
tent with industry practice. Despite recognizing that industry norms are im-
portant because they are “borne of experience,” the court noted that it is im-
portant to be particularly cautious in an industry such as franchising because 
of the inherent inequality in bargaining positions. Accordingly, the court 
held GM could not rely on an unreasonable or unfair standard merely be-
cause it was industry practice, particularly within an industry regulated by 
the legislature.

Beck next argued that GM’s unilateral modification of its territory was an 
unfair modification within the meaning of Section 463(ff), which prohibits 
changes in a motor dealership franchise without proper notice setting 
forth the specific grounds for the modification. Beck argued the new area in-
creased its sales territory, thereby increasing its targets and facility require-
ments and violating Section 463(ff). The court disagreed, finding that the 
Dealer Act did not prohibit such a change. Although noting that the provi-
sion was not limited to changes in the franchise agreement because other 
documents may be constituent parts of the parties’ written arrangement, 
the court found the provision was concerned only with modifications that 
“may substantially and adversely affect the new motor vehicle dealer’s rights, 
obligations, investment or return on investment.” Because a change in terri-
itory could be beneficial, the court found the change increasing Beck’s sales 
territory was not a prohibited one. The court held that the applicability of 
Section 463(ff) needs to be assessed on a case-by-case basis, keeping in 
mind the impact of the revision on the dealer’s position.

The Fifth Circuit affirmed a decision of the U.S. District Court for the 
Northern District of Texas granting Red Mango FC, LLC’s motion to dis-
miss a claim by one of its franchisees, Braatz, L.L.C., that Red Mango violated 
Wisconsin franchise law by failing to comply with Wis. Stat. § 553.51(1). Sec-
tion 51(1) requires that an “offering circular” be given to potential franchisees 
at least fourteen days before the franchise agreement is signed or the franchi-
sor accepts payment.
Braatz had been provided with a franchise disclosure document (FDD) containing a “franchisee questionnaire” that it was asked to fill out and return to Red Mango. A month later, when Braatz requested that Red Mango provide any documents necessary to sign to purchase a franchise, it was sent documents identical to the earlier FDD. Red Mango instructed Braatz to wait at least seven days before returning the signed franchise documents, including the questionnaire, which it did a week later. Shortly afterward, Red Mango sent Braatz a fresh copy of the questionnaire and requested it to change two answers, which Braatz did.

Following closure of its store two years later due to financial difficulties, Braatz brought a claim against Red Mango alleging it violated the fourteen-day rule by orally instructing Braatz to change its answers to the questionnaire without allowing fourteen days before accepting a response. It argued that when a revision was made to the franchise questionnaire, the prospective franchisee must receive an additional fourteen days to review the documents under the rule. Red Mango moved to dismiss for lack of standing under Federal Rule of Civil Procedure 12(b)(1) and for failure to state a claim under Rule 12(b)(6). The district court denied Red Mango’s motion to dismiss for standing, but granted dismissal for failure to state a claim.

In upholding the district court’s judgment that Braatz had standing, the Fifth Circuit agreed that Braatz had established the necessary injury in fact, causation, and redressability. The court found that a violation of the fourteen-day rule created a “concrete” and “particularized” legal right, the injury was directly traceable to Red Mango’s alleged conduct in violating the rule, and redressability existed because the fourteen-day rule makes rescission possible.

However, the court also upheld the district court’s dismissal for failure to state a claim, holding that although the fourteen-day rule did not specifically define the term “offering circular,” other provisions in Chapter 553 made it clear that the phrase referred to disclosure documents required to be filed with the state. Contrary to Braatz’s submissions, the court concluded the language of the rule did not entitle a franchisee to fourteen days to consider, for example, “any new information” about the franchise agreement. It accordingly held that the revised questionnaire was not subject to the fourteen-day rule and upheld the district court’s decision to grant Red Mango’s motion to dismiss.


Darling’s Auto Mall is a General Motors (GM) dealer in Maine. Pursuant to the terms of its dealer sales and service agreement, Darling’s performs warranty work on qualified GM cars and is reimbursed by GM for labor and parts. Under the Maine Business Practices Between Motor Vehicles Manufacturers, Distributors and Dealers Act, GM is required to reimburse Darling’s for replacement parts used in the warranty work at its established
markup rate. A dispute arose whether “core charges” also must be reimbursed at the established markup rate. A core charge is essentially a deposit the dealer pays to the manufacturer for the replacement parts, which is refunded when the dealer returns the defective part. Although GM’s Services Policies and Procedures Manual specifically provides that core charges are not subject to markup for reimbursement, Darling’s claimed the Dealers Act requires GM to pay a markup.

Darling’s filed two small claims actions in Penobscot County District Court, asserting that GM was obligated to pay the established markup on the core charges. The court ruled in Darling’s favor, finding that Darling’s was required to pay “one amount of dollars” in order to obtain the necessary part although such amount consisted of both the cost of the part itself and the core charge. GM appealed to the Penobscot County Superior Court and requested a jury trial de novo. The court consolidated Darling’s claims and granted the requested jury trial de novo on the ground there was a disputed material fact as to “what the price of the parts were as charged.” The court held a jury trial and gave a contested jury instruction regarding the core charges. The jury found that the price Darling’s paid for parts excluded the core charges and judgment was entered in GM’s favor. Darling’s filed a post-trial motion for judgment as a matter of law, which was denied. It then appealed to the Maine Supreme Court.

The court rejected Darling’s first argument—that the superior court erred in granting the jury trial de novo because there was no dispute “that the price paid by Darling’s is the total price shown on the invoice”—on the ground that a decision to grant a jury trial de novo is not appealable. Rather, the appealable issue is whether the verdict is supported by the evidence.

Darling’s second argument was that the denial of its motion for judgment as a matter of law was in error. The court reviewed whether there was any reasonable view of the evidence and justifiable inferences from such evidence that supported the jury’s verdict. The court concluded that because the Dealers Act did not explicitly address core charges, the issue of whether such charges were subject to the mandatory markup could not be resolved without determining whether the core charges factor into the price paid for the replacement parts and how the industry treats such charges. The court noted that there was evidence the customer did not actually pay the core charges (because the customers were simultaneously debited and credited the amount of the core charge) and that GM automatically refunded the core charge to the dealer once the defective part was returned. Thus, the court concluded there was sufficient evidence to support the jury’s verdict that the price paid for the replacement parts excluded the core charges.

Darling’s final argument was that the jury instructions were deficient because they did not reference the Dealers Act and, therefore, “prevented the jury from determining whether statute requires a markup on the core charge.” The court rejected this argument, holding that instructing the
jury on the warranty reimbursement statute would have invited the jury to interpret the statute, which is the court’s responsibility.

Accordingly, the Maine Supreme Court denied Darling’s appeal and upheld the judgment.


Ervin Equipment, Inc. entered into a dealership agreement with Wabash National Corp. to sell semitrailers. Ervin’s area of responsibility (AOR) under the agreement included parts of Texas and all of Mexico. In July 2015, Wabash sent a letter to Ervin advising that it intended to terminate the dealership agreement on December 31, 2015. The basis for the termination was unclear, but appears to have been because Ervin was selling semitrailers outside of its AOR and not paying invoices on a timely basis. Although Ervin claims to have responded to the notice of termination both verbally and in writing, it failed to take any formal action until late November when it filed an action in the U.S. District Court for the Northern District of Indiana, asserting (1) violations of the Indiana unfair practices statute based on Wabash’s termination of the dealership agreement without good cause and the required detailed notice; (2) violations of the Indiana Franchise Act based on Wabash’s termination or failing to renew the dealership agreement without good cause; and (3) breach of contract because the provisions in the distribution agreement permitting termination without cause violated the Indiana Franchise Act and therefore were unenforceable. Ervin also filed a motion to enjoin the termination, and Wabash filed a motion to dismiss pursuant to Federal Rule of Civil Procedure 12(b)(6).

The court first addressed Wabash’s motion to dismiss. With respect to the unfair practices claim, the court reviewed a number of statutory definitions in finding that the dealership agreement granted Ervin a franchise and that Ervin was a franchisee within the meaning of Indiana’s unfair practices statute. The court then turned to the issue of whether the statute requires both good cause and detailed notice to the franchisee of the termination. Based on the language and intent of the statute, the court found that both were required. Because the issues of whether Wabash had good cause to terminate and had provided the required notice regarding the termination were questions of fact for a jury to decide, the court denied Wabash’s motion to dismiss Ervin’s unfair practices claims. As to the claim for wrongful termination under the Indiana Franchise Act, the court found that Ervin was not a franchisee as defined by the Act because there no “marketing plan or system [of operation] prescribed in substantial part” by Wabash; therefore, the motion to dismiss was granted as to this claim.

The court next addressed Ervin’s motion for a preliminary injunction. The court found that Ervin had established that it had more than the required “negligible” chance of prevailing, but expressed doubts as to whether Ervin could ultimately prevail given that it was admittedly selling Wabash
semitrailers outside of its AOR and had not submitted any evidence regarding the payment issues. With respect to whether Ervin would have an adequate remedy at law, the court found that money damages would be an adequate remedy because any lost profits or consequential damages could be computed. The court also found that Ervin had failed to establish that it would suffer irreparable harm absent an injunction, noting that it had submitted no evidence regarding any efforts to mitigate its claimed damages or why it would be unable to do so in the future. Finally, the court found that the balance of harms favored Wabash because granting the requested injunction would amount to granting Ervin a “nationwide dealership.” This would undermine Wabash’s other dealers and force it to continue doing business with Ervin even though it believed that Ervin was acting in a manner that was contrary to its interests and in breach of the dealership agreement. Accordingly, the court denied Ervin’s motion for a preliminary injunction.


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


This case is discussed under the topic heading “Definition of Franchise.”


Miller Construction Equipment Sales, Inc. was a dealer of Doosan equipment under a series of annual written agreements that it entered into with defendant Clark Equipment Co. (Doosan). Miller claimed that Doosan terminated the parties’ agreement. Although Doosan disputed the claim, it ultimately “accepted” Miller’s “resignation.” A further dispute arose whether Doosan was required to buy back three pieces of heavy equipment under Alaska’s statute governing distributorships. Miller filed an action in Alaska state court asserting various claims under the distributorships law and contract claims. Doosan removed the case to the U.S. District Court of Alaska and asserted counterclaims for breach of contract, violations of the Lanham Act, violation of Alaska’s Unfair Trade Practices and Consumers Protection Act (UTPA), and breach of contract. Miller subsequently filed a motion for summary judgment on its claim that the distributorships law required Doosan to repurchase the equipment and Doosan’s first three counterclaims.

The central issue with respect to Miller’s claim that Doosan was required to repurchase the equipment under the distributorships law was whether the buyback obligation extended to “gently” used equipment. The statute provides that the equipment must be “unused,” which is defined as being “unopened merchandise in the original factory packaging or container.” Miller
argued that in this context, “unused” means having less than 300 hours of use because it was undisputed that heavy equipment was delivered with little or no packaging and that equipment with less than 300 hours of use was considered new under the parties’ agreement. This was consistent with industry custom. Because the Alaska Supreme Court had not applied the distributorships law in similar circumstances, the court predicted how the Alaska State Supreme Court would decide the issue. Relying on a Delaware state court case interpreting a Delaware statute that is similar to the distributorships law, the court found that if the equipment was never in packaging, “unused” means “never commercially used.” Here, because the equipment had been used to some degree, it was not “unused” and Doosan was not required to repurchase it under the distributorships law. Accordingly, the court denied Miller’s motion for summary judgment on its claim with respect to the equipment repurchase.

The court then turned to the defendants’ counterclaims, starting with the breach of contract claim. Miller argued that the claim failed because the parties’ agreement was an unenforceable contract of adhesion. The court disagreed, finding that Miller had the opportunity to negotiate and modify the terms of the agreement. Miller also argued that Doosan’s contract claim failed because Miller had not breached the agreement by selling competitive equipment. The court found that even if Miller had breached the agreement as alleged, the claim failed because Doosan did not provide Miller with the contractually required written notice of the breach and an opportunity to cure. The court next considered Miller’s motion with respect to Doosan’s claim for injunctive relief and trademark infringement under the Lanham Act. Although it was undisputed that Miller continued to use the Doosan marks for at least six weeks after its resignation was accepted, the court held that no reasonable trier of fact could find that Doosan had suffered irreparable harm as a result of the infringement and, therefore, granted Miller’s motion for summary judgment as to Doosan’s claim for injunctive relief. However, the court denied Miller’s motion with respect to Doosan’s claim for trademark infringement, finding that there was a question of fact whether Doosan sustained damages as a result of Miller’s continued use of Doosan’s marks. Finally, the court denied the motion as to Doosan’s UTPA claim because the allegedly unfair act upon which the claim was based—Miller’s use of the trademarks after it no longer had the right to do so—remained an issue for the trier of fact to consider because it also formed the basis for the trademark infringement claim that survived.


Recovery Racing, LLC is a franchised Maserati dealer in Broward County, Florida. Rick Case Weston, LLC proposed establishing a new Maserati dealership seventeen miles away from Recovery’s dealership. In response, Recovery filed a petition with the Florida Department of Safety and Motor Vehi-
cles objecting to the proposed dealership. The Department is responsible for administering various statutes governing the licensing of automobile dealerships in Florida, including a statute that permits an existing dealer to protest a proposed new or relocated dealership if it “can establish that during any 12-month period of the 36-month period preceding the filing of the licensee’s application for the proposed dealership, such dealer or its predecessor made 25% of its retail sales of new motor vehicles to persons whose registered household addresses were located within a radius of 12.5 miles of the location of the proposed additional or relocated motor vehicle dealer” (the 25% test). Recovery claimed that it had standing under this statute to object to the proposed dealership and that the community was already “receiving adequate representation for the Maserati line” of cars. The proposed dealership and Maserati North America, Inc. filed a motion with the Department seeking a hearing on the issue of whether Recovery had standing to object. An administrative law judge (ALJ) granted the motion and further held that it was Recovery’s burden to establish that it had standing to object to the proposed dealership.

At the hearing, Recovery’s expert economist, Edward Stockton, opined that Recovery met the criteria for standing under the 25% test. The proposed dealership and Maserati argued that Stockton’s conclusions were based on a misinterpretation of the statute and “manipulated data” and that no more than 14.2% of Recovery’s retail sales during any twelve-month period were made to registered household addresses within 12.5 miles of the proposed dealership’s location. The ALJ agreed. The ALJ rejected Mr. Stockton’s definition of “registered household address” as being “the primary home address” of the “ultimate beneficiary” of the sale and instead found that it meant the address where the car was registered. The ALJ also rejected the expert’s interpretation of the term “retail sales” on the ground that it was essentially subjective. Finally, the ALJ rejected his definition of a “12-month period” as beginning on any day of any month and ending twelve months later, finding that the twelve-month period must be based on whole calendar months. The Department adopted the ALJ’s recommendations and Recovery appealed to the Florida District Court of Appeal.

Recovery argued that the Department incorrectly required Recovery to prove that it had standing and misconstrued the applicable statute. As a threshold matter, the court noted that the Department’s interpretation of the statute was entitled to “great weight” and would not be overturned “unless clearly erroneous.” The court disagreed with Recovery’s argument that the proposed dealership and Maserati bore the burden of proving that Recovery lacked standing, finding instead that the “plain language of the statute places the burden squarely on the existing dealer to show standing.” The court then turned to Recovery’s claim that the Department misinterpreted the statute, starting with Recovery’s argument regarding the meaning of the term “registered household addresses.” The court found that Recovery’s interpretation of this term essentially “ignore[s] the implications of the word
registered’ as used in the statute.” Because the court found that its holding regarding the meaning of this term was dispositive, it did not address Recovery’s other interpretation arguments and affirmed the Department’s ruling.


In this case, the U.S. District Court for the District of Arizona considered cross motions for summary judgment in a dispute between Chrysler and one of its alleged dealers in Arizona. The parties or related entities entered into several contracts evidencing their relationship. Pursuant to those agreements: (1) Alonzo Smith acquired a minority ownership interest and non-voting stock in the Chrysler dealership; (2) Chrysler owned the majority interest and all of the voting stock in the dealership; (3) Smith agreed to purchase Chrysler’s shares in the dealership over time; (4) Smith was hired by the dealership as its general manager; and (5) Chrysler had the “absolute right” to remove Smith as a director and employee of the dealership.

The dealership was initially profitable and Smith used portions of his annual bonus to buy Chrysler shares. Beginning in 2007, the dealership’s sales decreased dramatically. The dealership returned to profitability in 2011 and 2012. However, in October 2012, Chrysler terminated Smith as a director and general manager of the dealership without prior written notice, ostensibly as a result of the dealership’s low sales, Smith’s slow purchase of Chrysler’s stock in the dealership, and alleged operational deficiencies at the dealership. At the same time, Chrysler offered to purchase Smith’s shares in the dealership at book value. At the time of the termination, Smith owned a majority of the dealership’s stock. Smith filed a lawsuit asserting claims for breach of the implied duty of good faith and fair dealing, violations of the federal Automobile Dealers’ Day in Court Act (Federal Dealers Act) and several Arizona statutes protecting automobile dealers. Both parties sought declaratory relief.

The court first analyzed whether Smith was a “dealer” operating a “franchise” within the meaning of the Federal Dealers Act and the Arizona statutes. Chrysler argued that the dealership, and not Smith, was the dealer and, therefore, the federal and state statutes did not apply. In addressing this issue, the court relied on Kavanaugh v. Ford Motor Co., 353 F.2d 710 (7th Cir. 1965), which it found to involve “remarkably similar” facts to those at issue in this case. The court rejected Chrysler’s “formalistic” arguments, noting that the federal act and Arizona statutes were intended to protect dealers and that Chrysler’s theory would essentially insulate it from liability because it controlled the dealership and, therefore, the dealership would sue Chrysler only if Chrysler wanted it to. The court then turned to the question of whether Smith was a “dealer,” focusing on whether he was “essential” to the dealership’s operation. In determining that he was essential to the dealership’s operation and, therefore, the dealer, the court was persuaded by several factors: (1) Smith applied for the dealership as an individual; (2) Chrysler...
entered into the agreement with the dealership in reliance on Smith’s anticipated involvement with the dealership; and (3) at the time that he was terminated, Smith has been the dealership’s general manager for ten years and owned a majority of its stock. Finally, the court noted that if Smith was not the dealer, Chrysler’s “arrangement” with the dealership would have been illegal under Arizona law because an automobile manufacturer is prohibited from having an ownership interest in a dealership unless that ownership is temporary and the manufacturer is in a relationship with a person who makes a substantial investment in the dealership and is expected to acquire full ownership of the dealership within a reasonable period of time.

Having determined that Smith was a dealer, the court then addressed whether summary judgment was warranted as to each of Smith’s claims. Smith’s claim under the Federal Dealers’ Act was that Chrysler had not acted in “good faith” as defined by the statute (i.e., freedom from actual or threatened coercion or intimidation). As the court noted, in cases involving a termination, there must be a “causal connection” between the termination and the coercion/intimidation. The court found there was evidence supporting each party’s theory regarding the requisite causal connection and, therefore, denied their respective motions as to the Federal Dealers Act claim.

The court then turned to Smith’s two claims under the Arizona state statutes: (1) that Chrysler did not give the required written notice of its intent to terminate the franchise and, therefore, Smith was precluded from exercising his procedural rights to, among others, demand a good cause hearing; and (2) that Chrysler’s ownership interest in the dealership was illegal because it had the absolute right to terminate Smith and, therefore, he was not able to “expect” to acquire full ownership in the dealership. With respect to Smith’s first claim, the court granted summary judgment in favor of Smith because it was undisputed that Chrysler had not provided notice of its intention to terminate the franchise. As to Smith’s second claim, the court agreed that the dealership arrangement was unlawful, but deferred ruling on whether Chrysler’s violation of the statute caused or contributed to Smith’s injury.

The court next considered Smith’s common law claim for breach of the implied duty of good faith and fair dealing regarding the termination. Predictably, the parties advanced different theories as to why Smith was terminated. The court found that there was a triable issue of fact regarding this claim because evidence in the record supported each party’s theories.

TERMINATION AND NONRENEWAL


Karamjeet Sodhi was a long-time operator of six 7–Eleven convenience stores in New Jersey. 7–Eleven, Inc. terminated Sodhi’s franchise agree-
ments based on numerous financial irregularities discovered during the course of an audit and subsequent investigation. 7–Eleven filed an action in the U.S. District Court for the District of New Jersey seeking a declaration that Sodhi’s franchise agreements had been properly terminated. Sodhi and others filed counterclaims asserting violations of the New Jersey Franchise Practices Act (NJFPA), breach of the implied duty of good faith and fair dealing, violations of the Fair Labor Standards Act (FLSA), and violations of the New Jersey Law Against Discrimination (NJLAD). 7–Eleven filed a motion for summary judgment on its declaratory relief claim and the defendants’ counterclaims.

The court first addressed the defendants’ claim that 7–Eleven violated the NJFPA by imposing unreasonable standards on Sodhi’s stores and attempting to terminate the franchise agreements without good cause. The defendants failed to submit any evidence of 7–Eleven’s “unreasonable standards” or even respond its arguments, and the court granted 7–Eleven’s motion as to this counterclaim based on a failure of proof. The defendants’ second NJFPA claim was that 7–Eleven failed to provide sufficient notice and an opportunity to cure the alleged breaches of the franchise agreements and that the termination was based on “racial bias and other animus.” The court found that 7–Eleven provided the requisite sixty days’ notice and, based on Sodhi’s admission that he did not cure the defaults, any ulterior motive was irrelevant. Thus, the court found there was good cause for the termination and granted summary judgment on this claim.

The court then turned to the breach of implied covenant of good faith and fair dealing claim. Because the implied duty does not “preclude a party from exercising its express contractual rights” and based on its finding that there was good cause for terminating the franchise agreements, the court held that 7–Eleven was entitled to summary judgment on this claim.

The FLSA claim was premised on Sodhi being an employee of 7–Eleven. In analyzing whether Sodhi was an employee, the court considered six factors and concluded that five of them supported a finding that he was not an employee and one was neutral. Among other things, the court found that the evidence established that 7–Eleven did not control the “manner in which [Sodhi] performed his 7–Eleven business.”

Finally, the court reviewed the defendants’ claim that 7–Eleven violated the NJLAD by either discriminating against Sodhi as an employee or, if he was not an employee, by refusing to do business with or terminating him as an independent contractor. The court disposed of the defendants’ first theory based on its prior finding that Sodhi was not a 7–Eleven employee. The court rejected the defendants’ second theory because, although the NJLAD makes it unlawful for a party to refuse to do business with someone on the basis of race, it does not prohibit “discrimination during the ongoing execution of the contract” and the defendants’ allegations related to the parties’ ongoing business relationship and not any refusal on the part
of 7–Eleven to do business with the defendants. Accordingly, the court found that the NJLAD claim also failed as a matter of law.


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


Nabil Gazaha and his company, NAYAA, LLC (collectively, Gazaha) entered into a franchise agreement with KFC Corp. to operate a KFC restaurant in Baltimore. Gazaha is African American. KFC terminated Gazaha’s franchise after the location received four food and safety violations within a six-month period. Notwithstanding the termination, Gazaha continued to operate the location as a KFC restaurant. After the termination, Gazaha sold non-approved products, ceased paying royalties and advertising co-op fees, and posted signs at the restaurant accusing KFC of racial discrimination.

KFC filed an action in the U.S. District Court for the Eastern District of Virginia and sought to enjoin Gazaha’s continued use of the KFC marks. The court granted KFC’s motion. Gazaha subsequently filed counterclaims, alleging the franchise was wrongfully terminated, intentional racial discrimination, and wrongful termination in violation 42 U.S.C. § 1981. Gazaha sought damages and reinstatement of the franchise. KFC filed a motion for summary judgment, which the court granted.

With respect to Gazaha’s wrongful termination/breach of contract claim, KFC argued that Gazaha could not establish damages, a necessary element of a breach of contract claim under Kentucky law, because Gazaha’s restaurant lost money between 2011 and 2015. Gazaha attempted to rebut the financial evidence by claiming that a number of personal expenses were run through the business and, therefore, the “book losses” did not accurately reflect the restaurant’s profitability. The court rejected this argument, noting that the purported personal expenses were actually related to the operation of the restaurant, including, for example, a mortgage secured by Gazaha’s personal residence that was used to purchase and operate the restaurant. Gazaha also submitted evidence of alleged offers to purchase the restaurant and the opinion of his expert that the restaurant was worth approximately $750,000. The court found, however, that this evidence had no probative value because there was no evidence establishing what the restaurant was worth before the termination. Accordingly, the court held that Gazaha had failed as a matter of law to present any evidence that it had sustained damages as a result of the termination of the franchise.

KFC also argued that Gazaha’s alternative request for reinstatement of the franchise failed as matter of law. In opposition to this argument, Gazaha relied on _Semmes Motors, Inc. v. Ford Motor Co._, 429 F.2d 1197 (2d Cir. 1970),
and other cases in which courts have enjoined the termination or closure of a franchise before the termination had become effective. The court found that these cases were inapposite because the termination of Gazaha’s franchise had already occurred and Gazaha had, among other things, “long since ceased all operations as a KFC franchisee” and operated the restaurant in a manner that was “inconsistent with his claim for equitable relief in the form of reinstatement.”

Gazaha’s discrimination and § 1981 claims fared no better. KFC argued that Gazaha could not present any direct evidence of discrimination or satisfy the applicable burden-shifting framework for purposes of establishing discrimination. The court found that the only evidence submitted by Gazaha of discrimination—statements by a third-party health inspector and an unnamed KFC employee that the neighborhood in which the restaurant was located was not “safe” and statistical evidence establishing that KFC franchises owned by African Americans were terminated at a higher rate than those owned by Caucasians—was neither “direct” nor of sufficient probative value to defeat summary judgment. The court found that the alleged statements were isolated and of “zero to exceedingly marginal” probative value and, importantly, were not made by anyone with the authority terminate the franchise. The court rejected the statistical evidence on the basis that such evidence cannot, by itself, establish a racial discrimination claim and that Gazaha had not submitted any evidence that he was targeted for termination because of his race. The court further held that, even if he could make out a prima facie case of racial discrimination, KFC had offered evidence of a “legitimate, non-discriminatory reason” for the termination (i.e., failure of numerous health inspections). As such, the burden shifted back to Gazaha to submit evidence raising an inference that the reasons for the termination were pretextual and the court noted that he had failed to present any such evidence.


The defendants sought leave to add and supplement counterclaims for, among other things, breach of contract, breach of the covenant of good faith and fair dealing, fraud, deceptive trade practices, breach of fiduciary duty, and unspecified “injunctive relief.” The proposed counterclaims alleged the franchise agreements were unenforceable based on purported
misrepresentations and because the revised franchise agreements had been forced upon her. More specifically, the defendants alleged that the revised franchise agreements were unconscionable adhesion contracts “foisted upon” them and that LAIF fraudulently induced Montes into signing the franchise agreements, Montes was not provided the requisite 14 days’ notice period to review the franchise agreements, and the revised franchise agreements were unenforceable because they were not supported by consideration.

The court granted the defendants’ request on the ground that, if proven in court, the alleged facts would render the franchise agreements unenforceable. It rejected LAIF’s argument that the defendants’ allegations were false because factual considerations were an issue for trial. The court also rejected LAIF’s arguments that the defendants had “failed to explain” their assertion that the agreements were forced upon them and that the claims would not survive summary dismissal because they were barred by integration clauses in the franchise agreements. Finally, the court rejected LAIF’s arguments that, as a matter of law, franchise agreements do not give rise to a fiduciary relationship, citing case law finding such a relationship exists.


The U.S. District Court for the Southern District of New York ruled in favor of Neopharm Ltd., an Israeli distributor of medical products, after manufacturer Wyeth–Ayerst International LLC ended the parties’ long-term contractual relationship. Both parties moved for judgment on the pleadings pursuant to Federal Rule of Civil Procedure 12(c), requesting that the court determine whether their distribution agreement allowed Wyeth to unilaterally terminate the agreement without cause. In concluding that unilateral termination was not permitted under the circumstances, the court also granted Neopharm’s motion to dismiss Wyeth’s counterclaim that it lawfully terminated the agreement for cause.

With Wyeth’s consent, Neopharm entered into an agreement to supply the Israeli Ministry of Health with a vaccine. Following this, Neopharm and Wyeth amended the termination provision (section 7.1) in their original distribution agreement, which had allowed the parties to terminate without cause upon three years’ notice, to require that three years’ notice to be given after all business with the Ministry had been concluded. The contract also included a provision (section 7.5) allowing for the payment of three years’ damages in lieu of notice. Arguing the termination provisions in the agreement operated independently and section 7.5 could be invoked before Neopharm’s supply of the vaccine to the Ministry ceased, Wyeth terminated the agreement one year prior to Neopharm’s business with the Ministry ended.

The court disagreed, interpreting language in section 7.1, such as “full force and effect,” “for an indefinite period,” and “unless section 7.2 is invoked for cause or the parties give mutual written consent,” as excluding
other possibilities for termination beyond those explicitly mentioned in the provision. It further held that Wyeth’s interpretation of section 7.5 was unreasonable given the plain language of the contract as a whole and the context. The court held that Wyeth’s interpretation was also inconsistent with section 7.5 because the section would be rendered “meaningless” without being read in conjunction with section 7.1.

The court rejected a counterclaim from Wyeth that Neopharm had willfully made material false or untrue statements or representations contrary to a contractual provision. The court found Neopharm’s statements, made in an email pitching new business, did not amount to “material false or untrue statements,” holding that nothing suggested that the statements in question were either materially false or made in the performance of Neopharm’s obligations under the agreement.

TRADEMARK INFRINGEMENT


The U.S. District Court for the Middle District of Pennsylvania denied a franchisor’s request for treble damages, finding that a former franchisee’s continued use of the franchisor’s marks following rebranding and termination did not constitute “counterfeiting” under 15 U.S.C. § 1117.

HI Hotel Group, LLC, a former G 6 Hospitality Franchising LLC franchisee operating as a Motel 6, had previously breached its franchise agreement by failing to pay monthly fees and maintain brand standards. The motel was rebranded as a Travel Inn, but continued to use the Motel 6 name and marks. G 6 Hospitality filed an action against HI Hotel, a sham successor, and its members for breaching the franchise agreement by failing to pay required fees and maintain brand standards, and for trademark infringement under the Lanham Act based on HI Hotel’s continued use of the Motel 6 marks. A jury awarded $125,000 in damages to G 6 Hospitality.

G 6 Hospitality subsequently filed a petition for treble damages, attorney fees and costs, and prejudgment interest, claiming it was entitled to treble damages under § 1117 based on HI Hotel’s use of counterfeit marks. Although the court granted G 6 Hospitality’s request for attorney fees and costs, it declined to award treble damages, relying on *United States Structures, Inc. v. J.P. Structures, Inc.*, 130 F.3d 1185 (6th Cir. 1997), as well as § 1117’s legislative history. In that case, the Sixth Circuit held that where a holdover franchisee continued to use the franchisor’s trademark after the franchise has been terminated, it was not using a counterfeit mark within the meaning of § 1117 because the mark in the case of a holdover franchisee is genuine and authentic, although the use is unauthorized. As such, HI Hotel’s continued use of the Motel 6 marks did not constitute use of counterfeit marks under the Act.