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ABA Publishing
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From the Editor-In-Chief

Daniel J. Oates

As the new Editor-in-Chief of the Franchise Law Journal, I want to thank you for your support of the Journal, and welcome you to read the submissions of our talented pool of authors in this latest edition. Before I begin this editorial in earnest, however, I would first like to extend my gratitude to my predecessors-in-interest Gary Batendorst and Bethany Appleby for their able stewardship of the Journal, along with their kindness, warmth, and mentorship of junior editorial board members. Without their guidance, support, and encouragement, I would not be in this position today, and I look forward to taking up the mantle of leadership for the next three years.

Well-deserved accolades aside, however, some of you are probably wondering why you are even bothering to read the editorial column of the Fall 2018 edition of the Franchise Law Journal. Due to some predictable hand-wringing on my part, I spent a considerable amount of time wondering the same thing. Why do people read the editorial column? What are you looking for? Information? Wisdom?

On a recent Saturday afternoon, this anxiety inexorably led me down a rabbit hole of self-doubt that had me combing thirty-five years of the Journal’s editorial columns prepared by my predecessors. During that process, I was somewhat surprised to learn that the Journal’s editorial column has, from time to time, been the home of full-length substantive law review articles, practical guides, ABA advertisements and solicitations, and descriptive indexes to the [then] current issue with background and commentary on

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1. Like Batman, but way less cool. You know, if instead of fighting crime with high-tech gadgets and martial arts, Batman performed meticulous peer-review of scholarly articles, inserting the random Oxford comma, and confirming verb tense consistency. So definitely not Val Kilmer Batman-cool.

2. Or not. Maybe this is your bag.

Daniel J. Oates (dan.oates@millernash.com) is a partner in the Seattle office of Miller Nash Graham & Dunn LLP. Dan focuses his practice on franchising and distribution litigation. Feel free to reach out to Dan directly for comments on this editorial or matters related to the Franchise Law Journal.
published articles, all depending on the whim and style of the Editor-in-Chief. In keeping with this past tradition, I intend on adopting a different style for editorials than my predecessors that is consistent with my own personality, experience, and point of view. Expect more footnotes. And humor.

Most critically, however, I hope to use this space to get you excited about all things franchising because, if you are not already, you should be. These are exciting, dynamic times, and if you want to zealously advocate for your franchisor or franchisee clients, you need to be in the know.

And really, that is what this editorial is about. Excitement and growth. The 2016 survey of the ABA’s Forum on Franchising revealed that the Forum is not immune to the overall trend in the legal profession toward an aging membership. The report revealed that the individuals who are least likely to attend the annual meeting are members aged twenty to thirty years old. How do we keep the excitement alive for our long-term members, while cultivating the next generation of franchise attorneys?

Opportunity is one way to keep our newest members engaged. Opportunities for advancement in the organization, opportunities for recognition by their peers, and opportunities for exposure to colleagues and potential clients. The FLJ plays a leading role in many of these opportunities, and I will continue to encourage the Forum’s talented new members to seek out openings on the Journal’s editorial board and to submit their written work for publication. The Forum’s annual Edward Wood Dunham Rising Scholar Award presents a golden opportunity for junior members to make a name for themselves. Having read each of the submissions eligible for the 2018 award (winner to be announced at the Forum in October), I can assure you that the future of our membership is bright, especially if we work hard to cultivate and encourage our newest members to participate. And existing members benefit from the infusion of new leadership. Excitement is contagious.

Excitement also depends upon good content. I commit that during my tenure, the FLJ will strive to improve upon its consistent history of quality articles. We will also seek to expand our practice-based materials, a common request from readers that want advice from people with hands-on experience. And we will endeavor to find new authors with different perspectives, be they franchisor, franchisee, or the myriad of other third parties who are so vitally essential to the franchising relationship. After all, “Many of the truths we cling to depend greatly on our own point of view.” It is only through

3. If you can’t tell, I really enjoy using footnotes in my writing. In addition to providing delicious nuggets of interesting data, they are the perfect outlet for much needed comic-relief. Usually of the self-deprecating variety.
4. Seventy-four percent of all respondents to the survey were over the age of forty, as compared with seventy percent in 2011. ABA Forum on Franchising 2016 Member Survey Results 6 (2016). Twenty-six percent are over the age of sixty, up from sixteen percent in 2011. Id.
5. Id. at 44.
vigorous discourse and civil debate that we will advance our understanding and appreciation of the law of franchising.

Finally, there needs to be an element of fun. Excitement depends on passion, and, to be passionate about something, it helps to have fun. This journal remains fiercely dedicated to the serious pursuit of the scholarship of franchising,8 but that objective does not mean that the content and style of the publication cannot be engaging and entertaining, while still being educational and thoughtful.

Thank you for your continued support of the *Franchise Law Journal*.

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8. Batman references notwithstanding. And yes, if you've been wondering this entire time, I think Val Kilmer is the coolest iteration of Batman.
Employee “No-Poaching” Clauses in Franchise Agreements: An Assessment in Light of Recent Developments

Josh M. Piper & Erik Ruda

In the past few years, a new battle has emerged in the struggle between business and labor, and franchise systems have again been singled out, forcing franchisors to defend themselves on several fronts: in private class-action lawsuits, in government enforcement actions, in Congress, and in the national media. These new fronts involve a contractual clause that goes by several names (no-hire, anti-poach, and non-solicitation to name a few), which can be generically called “no-poaching” clauses. Anyone who has followed the joint employer issue (as it has affected franchising) will recognize the similar path that the no-poaching controversy has followed. A mix of academic policy papers, sensational headlines, regulatory actions, and private lawsuits have combined to throw into unknown territory what was once a commonplace part of most franchise systems. Although perhaps not as threatening to the franchise industry overall as the changed joint employer definition, the issue of “no-poaching” clauses has nonetheless become another source of legal risk for the industry—and a growing risk at that.

The first part of this article summarizes the various forms of no-poaching clauses, some of the recent attention on no-poaching agreements, and the current state of federal competition law as it relates to no-poaching clauses. The second part of this article analyzes four primary antitrust lawsuits recently brought against franchisors based on no-poaching clauses in franchise agreements. The third part reviews the various regulatory and legislative developments that have occurred in the past year related to no-poaching clauses.
clauses. The article concludes with discussion of considerations for franchisors (and their counsel) in evaluating no-poaching issues in their systems going forward.

I. Background on No-Poaching Clauses and Competition Laws Affecting Them

Historically many franchise agreements have included no-poaching clauses. What are these provisions, and why are they suddenly controversial?

A. No-Poaching Clauses in Franchise Agreements

No-poaching agreements come in various forms, but, generally speaking, in a no-poaching agreement one party agrees not to solicit or hire the employees of another party. In the franchise context, the term typically refers to a clause in a franchise agreement that limits a franchisee’s ability to solicit or hire workers from another location in the franchise system. Here, for example, is a no-poaching clause taken from a franchise agreement recently filed with a registration state:

Franchisee agrees not to employ or seek to employ any person employed by Franchisor or by any other franchisee of Franchisor, or otherwise directly or indirectly induce or seek to induce such person to leave his or her employment during the term of this Agreement, without first obtaining the consent of Franchisor or any other franchisee of Franchisor.

No-poaching clauses in franchise agreements come in a variety of forms, with several variables that may impact whether the clause is found to violate antitrust laws. The primary variables among no-poaching clauses are the following:

- **Unilateral/Mutual**: The obligation not to poach could be unilateral (only the franchisee has an obligation) or mutual (both franchisor and franchisee agree not to poach each other’s employees).
- **Type of Location**: The obligation could be limited to employees of other franchised units, or it could extend to units owned by the franchisor or the franchisor’s affiliates.
- **Solicitation/Hiring**: The obligation might be limited to not soliciting others’ employees or limited to not hiring others’ employees. (Most agreements apply to both activities.)
- **Type of Employee**: The restriction may apply to any employee of another location, or it may be limited to a subset of employees (usually those that have received extensive training, such as managers).
- **Time**: The restriction may only apply to persons currently employed at other locations or may extend to such employees for some number of months after they are no longer employed in the system. The restriction may also apply to the franchisee for a period after the franchise agreement ends.
• **Geography**: The restriction may apply to all employees of other locations anywhere, or it may be limited in geographic scope to include only those locations within a certain radius of the franchisee where poaching is most likely to occur.

• **Enforcement**: The clause may be enforceable only by the franchisor, or it might grant third-party beneficiary status on other franchisees that are affected by a breach of the no-poaching clause.

Some of these variables are factors in the pending class-action lawsuits against franchisors, and these variables play a role in the plaintiffs’ arguments for strict scrutiny under the antitrust laws.

B. Recent Attention on No-Poaching Clauses in Franchise Agreements

Recently there has been a wave of critical attention on no-poaching clauses in franchise agreements. The swell began with two class-action lawsuits filed against well-known franchisors in 2017.¹ Later that year, two well-known economists—Alan Krueger and Orley Ashenfelter of Princeton University—published a working paper that used no-poaching agreements in the franchise industry to explore the wage effects of such agreements and the conditions that made franchisors more likely to include no-poaching clauses in their agreements.² The Krueger & Ashenfelter paper found that no-poaching clauses were common among the largest franchise systems, but especially within certain industries like quick-service restaurants (QSRs).³ The *New York Times* promptly translated the working paper’s findings in the article “Why Aren’t Paychecks Growing? A Burger Joint Clause Offers a Clue”⁴ and an op-ed co-authored by Krueger titled “Corporate America is Suppressing Wages for Many Workers.”⁵ State attorneys general have since initiated large investigations into no-poaching clauses in franchise systems, and two prominent U.S. Senators have taken on the issue as a pet project, all directly or indirectly naming the Krueger & Ashenfelter working paper as a major influence.⁶ All of these critics generally argue that the practice suppresses wages, leaves open jobs unfilled, and harms economic growth.⁷

¹. See cases cited infra Section III.A–B.


³. Id. at 21.


⁷. See Abrams, supra note 4; Kreuger & Posner, supra note 5.
As a result of all the recent negative attention, franchisors are being forced to defend the practice. One of the primary reasons franchisors include no-poaching clauses in their franchise agreements is to protect each franchisee's investment in the specialized training that its employees receive, especially as it relates to that specific franchise system. At least in theory, this protection strengthens each franchisee's incentive to invest in the training of employees. No-poaching clauses are also designed to cultivate greater system harmony so as to better compete against other franchise systems in the same industry. In essence, franchisors argue that these clauses have significant procompetitive effects and that each system lacks significant power in the larger labor market to unreasonably affect competition.

C. Antitrust/Competition Law

Antitrust law provides the primary legal framework for attacking no-poaching agreements. Putting aside the specific context of the franchisor-franchisee relationship, antitrust laws prohibit any agreement that restrains trade. Among the several different laws that may apply to such agreements is Section 1 of the Sherman Act, which prohibits a “contract, combination . . . or conspiracy in restraint of trade or commerce.” Courts’ longstanding interpretation is that the Act only prohibits “unreasonable” restraints of trade. Reasonableness, however, is measured by determining whether the agreement has a net anticompetitive effect (and not by the participants’ beliefs as to whether it is reasonable to restrain trade).

Courts have developed various rules to guide interpretation of whether an agreement unreasonably restrains competition. One such rule is the “per se” rule, under which certain agreements (such as price-fixing agreements between competitors) are illegal without inquiry into the specific agreement’s actual effects on competition. Another rule is the more flexible “rule of reason,” which requires an examination of the actual effects of an agreement, and proof of competitive harm. An intermediate standard, called the “quick look” doctrine, also exists, and courts use it to quickly assess competitive effects when per se illegality is inappropriate. The “quick look” approach, sometimes referred to as a truncated rule of reason analysis, allows a court to determine that the anticompetitive effects of a challenged agreement outweigh any procompetitive benefits without conducting a full “rule of reason” analysis. The “quick look” approach is justified when “an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and


9. See, e.g., Standard Oil Co. of New Jersey v. United States, 221 U.S. 1, 59–60 (1911).

markets.”11 The applicable evaluative approach is important, because the per se rule prevents the parties from defending their agreement based on its actual effects on competition.

At a general level, naked agreements between competitors to fix prices or restrict output are per se illegal.12 Courts generally interpret the antitrust laws through the lens of protecting the benefits of competition, including consumer benefits such as enhancing output and reducing price.13

U.S. antitrust laws also apply to competition among firms to hire employees in the same way that they apply to competition among firms to sell goods and services.14 Accordingly, an agreement that restricts the ability of one company to hire another company’s employees requires analysis under antitrust and competition law. The United States Department of Justice Antitrust Division (DOJ) considers certain no-poaching agreements between competitors to be “market allocation” agreements treated as per se illegal under the Sherman Act.15 Enforcement by the federal antitrust agencies has really gained steam in the last decade.16

Antitrust laws prohibit “agreements” that restrain trade, but not unilateral conduct that might have the same results.17 Under the Copperweld doctrine, the Supreme Court has long held that a parent corporation and its wholly owned subsidiary are incapable of conspiring with one another in violation of Section 1 of the Sherman Act.18 Lower courts have extended this principle to partially owned subsidiaries and some other related entities.19

11. Cal. Dental Ass’n v. FTC, 526 U.S. 756, 770 (1999); see also Polygram Holding, Inc. v. FTC, 416 F.3d 29, 34, 36–37 (D.C. Cir. 2005) (accepting an “inherently suspect” analytical framework employed by the FTC in considering restraints imposed as part of a joint venture).


15. For example, in April 2018, DOJ filed a civil antitrust lawsuit and reached a settlement with Knorr-Bremse AG and Westinghouse Air Brake Technologies Corp., based on the government’s allegation that these companies and a third company reached naked no-poaching agreements over several years, which the government claimed eliminated competition for hiring workers, to the detriment of employees by depriving them of the chance to bargain for better job opportunities and terms of employment. See, e.g., United States v. Knorr-Bremse AG, Case 1:18-cv-00747-CKK (D.D.C. July 11, 2018), ECF No. 19, https://www.justice.gov/atr/case/us-v-knorr-bremse-and-westinghouse-air-brake-technologies (last visited Sept. 14, 2018).

16. See infra notes 69–70; see also Michael Lindsay & Katherine Santon, No Poaching Allowed: Antitrust Issues in Labor Markets, 26 ANTITRUST 3 (Summer 2012).

17. Antitrust laws also prohibit monopolization, but that is a different matter.


19. See, e.g., Coast Cities Truck Sales, Inc. v. Navistar Int’l Transp. Co., 912 F. Supp. 747, 765 (D.N.J. 1995) (extending Copperweld to parent and 70% owned dealerships); Day v. Taylor, 400 F.3d 1272, 1278 (11th Cir. 2005) (extending Copperweld to rental truck company and independent dealers); Pink Supply Corp. v. Hiebert, Inc., 788 F.2d 1313, 1317 (8th Cir. 1986) (extending Copperweld to manufacturer and four sales representatives). The application of the Copperweld doctrine to no-poaching agreements between a franchisor and franchisee is discussed infra in more detail in the Recent Cases section of this article, Section III(B).
But it is unclear whether the *Copperweld* doctrine extends to no-poaching clauses in the franchise context and, if so, under what circumstances.\(^{20}\) The protection no-poaching agreements provide against intrabrand raiding may encourage franchisees to invest in training their managerial employees with “skills, knowledge, and trade secrets that make the [franchisee’s] business more productive.”\(^{21}\)

II. Recent Private Litigation

The last two years have brought a raft of private party lawsuits against franchisors and franchisees, alleging that the no-poaching clauses in franchise agreements constitute illegal restraints of trade. Most of these cases have been brought as putative class actions on behalf of affected employees. Some have challenged the agreements not just as rule of reason violations, but as per se violations of the antitrust laws.

A. Deslandes v. McDonald’s USA, LLC

In June 2017, the plaintiff, a department manager at a franchisee-owned McDonald’s location, filed a class-action complaint in the U.S. District Court for the Northern District of Illinois on behalf of McDonald’s employees alleging that McDonald’s no-solicitation and no-hire agreements among and between itself and its franchisees were an illegal restraint of trade under Section 1 of the Sherman Act and state antitrust law. The plaintiff’s theory was that McDonald’s has implemented general policies to encourage competition between its franchisees but has limited the ability of its franchises to compete with one another for employees.

According to the plaintiff, until 2017, McDonald’s required its franchisees to enter into specific “no-poach” contractual agreements, such as the following:

> Franchisee shall not employ or seek to employ any person who is at the time employed by McDonald’s, any of its subsidiaries, or by any person who is at the time operating a McDonald’s restaurant or otherwise induce, directly or indirectly, such person to leave such employment. This paragraph [] shall not be violated if such person has left the employ of any of the foregoing parties for a period in excess of six (6) months.\(^{22}\)

The plaintiff alleged that the policy applied to hiring both by franchisees and by company-owned locations; the plaintiff claimed that he specifically...

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\(^{20}\) See Williams v. I.B. Fischer Nevada, 794 F. Supp. 1026, 1029–33 (D. Nev. 1992) (noting that “no-switching” agreements do not involve anyone outside the Jack-in-the-Box system and are lawful under the rule of reason because of pro-competitive purpose and because the agreements did “not bar competitors of Jack-in-the-Box from hiring away these managerial employees”), aff’d, 999 F.2d 445, 448 (9th Cir. 1993) (“[T]he no-switching agreement is not anticompetitive and thus does not establish a section 1 claim.”).

\(^{21}\) See Polk Bros., Inc. v. Forest City Enters., Inc., 776 F.2d 185, 189 (7th Cir. 1985).

\(^{22}\) Amended Complaint at ¶ 87, Deslandes v. McDonald’s USA, LLC, No. 17-CV-04857 (N.D. Ill. Sept. 18, 2017), ECF No. 32.
was prevented from being offered a higher paying job at another McDonald's location due to the clause.23

In October 2017, McDonald’s moved to dismiss the complaint for failure to state a claim pursuant to Federal Rule of Civil Procedure 12(b)(6).24 McDonald’s motion argued that the plaintiff had failed to plead a plausible Section 1 claim and that the per se illegality rule was inappropriate to a no-poaching agreement.25 In June 2018, the court issued its order partially granting and partially denying McDonald’s motion.26 The court ruled that, while the per se rule was not appropriate, the plaintiff could proceed under a “quick look” claim theory and also gave the plaintiff leave to amend to state a claim under the “rule of reason” approach.27

Every franchisor should take note of the court’s ruling. “A horizontal agreement not to hire competitors’ employees is, in essence, a market division. . . . [T]he Court has no trouble concluding that a naked horizontal no-hire agreement would be a per se violation of the antitrust laws.”28 This, of course, is consistent with the DOJ/FTC Antitrust Guidance about no-poaching agreements in general.

Courts typically judge vertical agreements (e.g., between a manufacturer and a distributor) more leniently than horizontal agreements. The court rejected McDonald’s argument that the restraint on hiring was merely vertical (i.e., at different levels of the supply chain), because the competition between McDonald’s company-owned stores (McOpCos) and franchisees meant that it affected horizontal (i.e., direct) competitors as well. “This case . . . is not about competition for the sale of hamburgers to consumers. It is about competition for employees, and, in the market for employees, the McDonald’s franchisees and McOpCos within a locale are direct, horizontal, competitors.”29

As noted previously, the court determined that the per se rule was inappropriate because the no-poaching clauses were “ancillary” to the franchise agreements. In other words, the franchise agreements, by creating the opportunity for private companies to open restaurants under the McDonald’s brand (and consistent with the McDonald’s format), increased output and competition by allowing a new location to operate. But the court ruled that the plaintiff had done enough to plead a claim under a “quick look” analysis, meaning that the plaintiff would be allowed to seek discovery and present evidence that McDonald’s lacks any legitimate justification.

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23. See generally id.
25. Id. at 6–15.
27. Id. at *13–14.
28. Id. at *17–18.
29. Id. at *22.
for facially anticompetitive behavior, potentially allowing the court, without resort to analysis of market power, to “condemn the practice without ado.”  

There are three key takeaways for franchisors going forward from the *Deslandes* decision. First, the court clearly ruled that the no-poaching clause in McDonald’s franchise agreements concerned *horizontal competition*, at least in part, because the agreements were applied to protect McDonald’s company-owned restaurants from competition in hiring employees from its franchisees. Any franchisor with company stores should take notice because it is much more difficult to state a Sherman Act claim based on a vertical restraint than on a horizontal one.

Second, although the court’s ruling that the no-poaching agreement could not be *per se* illegal is encouraging to franchisors, the court’s ruling that the “quick look” approach may be appropriate should raise concerns. A similar claim evaluated under the full “rule of reason” approach would be more difficult for a plaintiff to prove, as the court acknowledged, because it requires proof of market power by the defendant (i.e., the ability to suppress wages of affected employees). Application of a “quick look,” however, leaves open the door for a court to conclude that a no-poaching clause was anticompetitive (and therefore unlawful) without extensive market analysis.

Third, despite its ruling that the clauses were not *per se* illegal in this case, there is no guarantee that future courts will agree.

**B. Bautista v. Carl Karcher Enterprises, LLC**

In February 2017, a Carl’s Jr. shift leader filed a putative class-action suit against Carl Karcher Enterprises, LLC (CKE), claiming that the “no hire” clause in the CKE franchise agreements violated antitrust laws. The clause allegedly provided in part that no franchisee shall “[k]nowingly employ or seek to employ any person then employed by CKE or any franchisee of CKE as a shift leader or higher, or otherwise directly or indirectly induce such person to leave his or her employment.”

The complaint alleged that the no hire clause was an illegal restraint on competition for hiring CKE restaurant managers under California antitrust law. In particular, the plaintiff relied on the following alleged facts to support her claims: (1) CKE materials point to an internal preference for hiring management employees with specific CKE experience; (2) CKE materials

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30. Id. at *14 (citing, inter alia, Agnew v. Nat’l Collegiate Athletic Ass’n, 683 F.3d 328, 36 (7th Cir. 2012)). Although the court also gave the plaintiff the opportunity to replead a claim under the rule of reason, it noted that it was “unsurprising” that she had not initially done so, given the difficulty in proving such a claim, including proof of a defendant’s market power in a relevant market.


32. *Deslandes*, 2018 U.S. Dist. LEXIS 105260, at *18 (“[B]ecause a no-hire agreement is, in essence, an agreement to divide a market, the Court has no trouble concluding that a naked horizontal no-hire agreement would be a *per se* violation of the antitrust laws.”).


34. Id. ¶¶ 2–4.
focused on intrabrand competition; (3) the independence of its franchisees; and (4) CKE’s ownership and operation of approximately thirty percent of its restaurants (meaning that it is therefore an alleged horizontal competitor with its franchisees).35

CKE moved to dismiss (demurrer, under California law) the complaint. In an unusual March 2018 decision, the court ordered further briefing on the motion because the parties “do not cite or discuss the Copperweld case or the intra enterprise conspiracy doctrine,” or the “vertical relations doctrine in antitrust law.”36 The court noted the general benefits of interbrand competition, requiring effective cooperation within a single trademarked enterprise.37 The court reasoned that the U.S. Supreme Court’s decision in American Needle, Inc. v. National Football League, 560 U.S. 183 (2010), likely did not apply because Carl’s Jr. operated under only one trademark. The court further invited amicus briefing from fifteen antitrust scholars. As of July 2018, the parties have agreed in principle on a settlement and are negotiating a settlement agreement, which if approved will prevent any final decision on the defendant’s motion.38

Nevertheless, the court’s decision raising the Copperweld doctrine is interesting because it is unclear whether the doctrine applies to agreements between a franchisor and franchisees under entirely separate ownership. Although some decisions apply the doctrine to franchisors and franchisees under particular facts, there is no authority that generally holds that a franchisor cannot illegally conspire with its franchisee(s) in violation of the antitrust laws.39

Additionally, the court’s focus on vertical restraints seems to ignore the distinction at issue in the McDonald’s case, which focused in part on the alleged horizontal competition in the employment market between the franchisees and the franchisor’s corporate-owned restaurants. The CKE plaintiff had alleged the same horizontal competition. The court’s invocation of American Needle as inapplicable is potentially puzzling, given the Supreme Court’s holding that the National Football League was not a single enterprise for antitrust purposes (at least regarding certain licensing activities). Although the court’s initial impression was that Carl’s Jr.’s use of a single trademark made the holding inapplicable, commentators have noted that American Needle may specifically make it more difficult for franchisors to

35. Id. ¶¶ 41, 75–79, 96–103.
37. Id. at 3–4.
argue that they constitute a single economic firm or enterprise.\textsuperscript{40} If the parties reach—and the court approves—a settlement, then the court will not need to revisit the \textit{Copperweld} issue.

\section*{C. Butler v. Jimmy John’s Franchise, LLC}

In January 2018, a former Jimmy John’s delivery driver and in-store employee brought an antitrust suit on behalf of himself and other employees, challenging the no-poaching clauses in the Jimmy John’s franchise agreements and the Jimmy John’s employee noncompetition agreement.

Jimmy John’s franchise agreement from 2016 to the time of the lawsuit filing provided that each franchisee would not “solicit or initiate recruitment of any person then employed, or who was employed within the preceding twelve (12) months, by [Jimmy John’s], any of [Jimmy John’s] affiliates, or another Jimmy John’s Restaurant franchisee.”\textsuperscript{41} The contractual remedies for violations of this clause are increased if the employee is in a management position at a restaurant.\textsuperscript{42} In its standard franchise agreement, franchisees are “third-party beneficiaries” of the non-solicitation and non-recruitment clauses.\textsuperscript{43}

Additionally, the plaintiff’s suit focuses on allegations that go beyond typical non-solicitation and non-recruitment clauses, pointing to provisions in the franchise agreement under which franchisees agreed to restrict their own employees

from becoming a partner of or investor/owner with, or working for, another Jimmy John’s franchisee for at least twelve (12) months after they leave [the franchisee’s] employment and to advise them that other Jimmy John’s franchisees are contractually prohibited by [Jimmy John’s] from recruiting them as partners or investors/owners, or from hiring them, for at least twelve (12) months after they leave your employment (regardless of the reason for their departure).\textsuperscript{44}

This obligation and policy was then carried out through requiring individual employees to agree to noncompetition agreements.\textsuperscript{45}

Jimmy John’s moved to dismiss the plaintiff’s complaint for failure to state a claim in March 2018.\textsuperscript{46} It challenged the plaintiff’s individual standing but also his general theory that employee no-hire agreements could be per se unlawful.\textsuperscript{47}

\begin{footnotesize}
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\item \textsuperscript{40} See Barry M. Block & Matthew D. Ridings, \textit{Antitrust Conspiracies in Franchise Systems After American Needle}, 30 \textit{Franchise L.J.} 216, 217–19 (2011).
\item \textsuperscript{41} Class Action Complaint at ¶ 78, Butler v. Jimmy John’s Franchise, LLC, No. 18-CV-0133 (S.D. Ill. Jan. 24, 2018), EFC No. 1 (alterations in original).
\item \textsuperscript{42} Id. ¶ 83.
\item \textsuperscript{43} Id. ¶¶ 85, 91.
\item \textsuperscript{44} Id. ¶ 90.
\item \textsuperscript{45} Id. ¶¶ 92–97.
\item \textsuperscript{46} Memorandum in Support of Motion to Dismiss, Butler v. Jimmy John’s Franchise, LLC, No. 18-CV-0133 (S.D. Ill. Mar. 21, 2018), EFC No. 28-1.
\item \textsuperscript{47} Id.
\end{itemize}
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On July 31, 2018, the court granted in part and denied in part Jimmy John's motion to dismiss.\(^{48}\) The court noted the basic fact that Jimmy John's franchisees are independent contractors who explicitly may face competition from other franchisees and that the non-solicitation and non-recruitment clauses at issue are explicitly included for the benefit of all franchisees.\(^{49}\) In applying the Sherman Act to plaintiff's claims, the court explained that “antitrust laws are meant to protect the labor market—among other markets—because ‘employer conspiracies controlling employment terms . . . tamper with the employment market and thereby impair the opportunities of those who sell their services there.’”\(^{50}\)

The court took up the issue of whether the no-poaching clauses at issue were vertical, horizontal, or some combination of the two. The question as presented was slightly different than in the McDonald's case, because almost all of the Jimmy John's restaurants are owned by franchisees, and therefore the case did not present an issue of horizontal competition between franchisees and the franchisor. Nevertheless, the Court ruled that plaintiff had carried his pleading burden to state horizontal agreements as a “hub-and-spoke” conspiracy. In a “hub and spoke” conspiracy, there is one firm (the hub) that coordinates the agreements among all the “spokes.” Here, Jimmy John's was the “hub,” and the franchisees (who had not entered into agreements directly with one another) were the spokes.\(^{51}\) Perhaps most important was the third-party beneficiary provision that allowed each franchisee to enforce the no-hire clauses against other franchisees.\(^{52}\)

Ultimately, the court determined that it could not rule at this stage on whether the per se rule, “quick look,” or rule of reason would apply:

> This case could prove to be a hornbook example of [the “quick look”] rule: Although the franchisees are dealing in the same brand, they are still competitors, and anyone with a rudimentary understanding of economics would understand that the no-hire agreements have an anticompetitive effect on the labor market targeted by those firms . . . . And if the quick-look approach applies, Butler would not be required to go through the industry and market power analysis, and Jimmy John's would be able to argue the procompetitive intrabrand justifications for the agreements.

Ultimately, however, the Court cannot decide at this early stage in the proceedings which rule will apply. If the evidence in this case shows that the franchisees are truly as independent as Butler pleads, this case will likely result in a quick look analysis. If the evidence of franchisee independence is Herculean, then the per se rule might even apply. And if the evidence of franchisee independence is weak, or if Jimmy John's carries its burden under the quick look approach, then the rule of reason may rear its head and burn this case to the ground. But that is a matter for a later stage in these proceedings. At this point, for the foregoing

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\(^{49}\) Id. at *2–4.

\(^{50}\) Id. at *15 (quoting Eichorn v. AT&T Corp., 248 F.3d 131, 141 (3d Cir. 2001)).

\(^{51}\) Id. at *16–17.

\(^{52}\) Id. at *19–20.
reasons, Butler has stated a plausible claim for relief under Section 1 of the Sherman Act.53

There are two key implications from the court’s decision. First, the court ruled that the plaintiff had sufficiently pleaded a horizontal agreement despite the lack of actual agreement directly between Jimmy John’s franchisees and without reference to competition between franchisees and corporate-owned restaurants. The bar for challenging a vertical restraint on competition is much higher, so this reasoning is an important ruling for franchisors facing similar claims. The court was persuaded, in large part, by the fact that the no-poaching clauses at issue were explicitly designed for the benefit of all other franchisees as third-party beneficiaries.

Second, the court ruled that the plaintiff had pleaded a valid per se illegality theory, although it declined to rule definitively that the per se rule would ultimately apply. The court’s final determination will depend on the degree of “independence” of the franchisees (in particular, the degree of competition among them). But leaving open the door to per se (or even “quick look” treatment) is much more than a mere doctrinal abstraction. As the court’s ruling itself notes, the specific approach that the court will ultimately use may be outcome-determinative.54 The potential application of the per se rule significantly raises the costs and litigation exposure of a defendant.

D. Ion v. Pizza Hut, LLC

Finally, a similar putative class action antitrust suit was filed against Pizza Hut in the U.S. District Court for the Eastern District of Texas in November 2017 by a shift manager of a Pizza Hut franchisee’s restaurant in Pennsylvania. The antitrust claims challenged a clause in Pizza Hut’s franchise agreements under which Pizza Hut and each franchisee agreed to not “employ, directly or indirectly, any individual in a managerial position who is at the time or was at any time during the prior six months employed in a managerial position by any other franchisee of [Pizza Hut].”55 The clause included an exception that the restriction did not apply when the former employer provided written consent.56

Similar to the plaintiff in the McDonald’s case, the plaintiff claimed that the no-poaching clause was a per se violation of Section 1 of the Sherman Act or, in the alternative, under a “quick look” approach and that the agreement suppressed wages and otherwise eliminated competition between Pizza Hut and its franchisees for the services of management employees.57 The plaintiff’s theory was based in part on language providing that all other

53. Id. at *21–23.
54. Id. at *23 (noting that “the rule of reason may rear its head and burn this case to the ground”).
56. Id.
57. Id. ¶¶ 12, 75–91, 124.
franchisees are “intended beneficiaries” of the no-poach section of the agreement.58

Pizza Hut moved to dismiss the complaint. Pizza Hut did not deny that the clause existed in its franchise agreements, although it did argue that the clause did not apply to the plaintiff (who therefore lacked standing).59 Pizza Hut argued that the per se rule did not apply, as every “court to reach the issue has held that the per se rule does not apply to no-hire clauses because such clauses can conceivably have procompetitive benefits.”60 Pizza Hut also argued that the plaintiff had not pleaded sufficient facts to state a claim under the rule of reason also required dismissal.

Pizza Hut’s basic theory, rooted in well-established precedent, was that the clause allows it to promote its franchisees’ competition with other pizza chain restaurants (interbrand competition) by encouraging its franchisees to invest in training their managerial employees with the security of avoiding raiding by another Pizza Hut franchisee.61 In contrast, the plaintiff argued that antitrust laws clearly apply to the labor market and that, as a plain agreement not to compete, the no-poaching clause warranted per se treatment.

On July 6, 2018, the plaintiff dismissed the complaint without prejudice.62 The court had not yet issued a decision on Pizza Hut’s pending motion to dismiss for failure to state a claim; the dismissal without prejudice preserves the plaintiff’s right to refile her claim in the future. Interestingly, Pizza Hut’s argument that no-hire agreements cannot be illegal per se, and must be evaluated under the rule of reason under existing precedent (which was ultimately not decided by the court due to the plaintiff’s voluntary dismissal), is directly contradicted by the McDonald’s decision discussed previously, as well as the explicitly stated federal agencies’ approach.63 Although the court in the McDonald’s matter declined to apply the per se rule, it also clearly determined that the per se rule could apply to a no-poaching agreement between competitors as a type of naked labor market division.

III. Recent Regulatory and Legislative Activities

The courts are not the only place where no-poaching agreements have been the subject of disputes and claims of illegal impact on labor markets. Federal enforcers have targeted no-poaching agreements generally, although not yet in franchise systems. State regulators, in contrast, have been very active in seeking to curtail, if not eliminate altogether, the use of

58. Id. ¶ 7.
61. Id. at 6.
no-poaching agreements within franchise systems. Indeed, state-level focus on the issue only seems to be increasing. Legislative activity, meanwhile, has been somewhat limited.

A. Federal Enforcement

The DOJ and the Federal Trade Commission (FTC) have targeted what they view as unlawful agreements with respect to labor markets as far back as the 1990s. But their enforcement focus significantly gained steam recently, with perhaps the most high-profile cases thus far being three that involved technology companies that had entered into no-poaching agreements with their competitors (eBay and Intuit; Lucasfilm and Pixar; and Adobe, Apple, Google, Intel, Intuit, and Pixar). All three of those cases brought by the DOJ ended in consent judgments against the companies, and not surprisingly were accompanied by civil class-action lawsuits that resulted in the companies agreeing to pay over $435 million in damages combined.

In October 2016, the FTC and DOJ’s Antitrust Division issued guidance (Antitrust Guidance) aimed at businesses and their HR professionals on the application of antitrust laws to the employment arena. The Antitrust Guidance was strong and explicit: “Naked . . . no-poaching agreements among employers, whether entered into directly or through a third-party intermediary, are per se illegal under the antitrust laws,” where “naked” means “the agreement is separate from or not reasonably necessary to a larger legitimate collaboration between the employers.”

If the education and encouragement in the Antitrust Guidance is a carrot, the stick is DOJ’s declaration in the Antitrust Guidance of its intent “to criminally investigate naked no-poaching or wage-fixing agreements that are unrelated or unnecessary to a larger legitimate collaboration between the employers.” The Antitrust Guidance even likens such “naked” no-poach agreements to “hardcore cartel conduct.”

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66. See eBay Inc., Trade Cas. (CCH) ¶ 78,887; Lucasfilm, Inc., 2011-1 Trade Cas. (CCH) ¶ 77,476; Adobe Sys., 2001-1 Trade Cas. (CCH) ¶ 77,483.


68. Antitrust Guidance, supra note 14; see also Michael Lindsay, Jaime Stilson & Rebecca Bernhard, Employers Beware: The DOJ and FTC Confirm That Naked Wage-Fixing and “No-Poaching” Agreements Are Per Se Antitrust Violations, 16 Antitrust Source 2 (Dec. 2016) (explaining that guidance “puts employers and HR personnel on notice that the antitrust laws will be strictly enforced to prevent agreements that restrain competition in the employment market”).

69. Antitrust Guidance, supra note 14, at 3.

70. Id.

71. Id. at 4.

72. Id.
prosecution is an escalation from the tack taken with the technology companies earlier in the decade, all of which were brought as civil enforcement actions. And, in fact, DOJ apparently views the issuance of the Antitrust Guidance as a demarcation point for its approach to prosecution. The Principal Deputy Assistant Attorney General conveyed this sentiment in a January 2018 speech, saying that “the Division expects to pursue criminal charges” for agreements that began after October 2016 as well as for agreements that began before but continued after that date.73

For no-poaching agreements that were formed and terminated before the Antitrust Guidance was issued, the DOJ appears to still be pursuing civil enforcement actions. In April 2018, the DOJ filed a civil settlement agreement with two of the world’s largest rail equipment suppliers, Knorr-Bremse AG and Westinghouse Air Brake Technologies Corporation (Wabtec)—competitors that were alleged to have entered into several of such “naked” no-poaching agreements over many years, but which were terminated before the Antitrust Guidance was issued.74 While these two companies may have escaped criminal prosecution by the DOJ, the settlements with the DOJ (which disclosed the existence of the no-poaching agreements) have prompted numerous class-action lawsuits by current and former employees, most of which have been consolidated into multidistrict litigation.75

Although franchise systems do not appear to be a current focus,76 the FTC and DOJ are focused on and concerned about the potential negative impacts of no-poaching agreements on employees in general.77 As the DOJ Antitrust Division stated in April 2018: “Market participants are on notice: the Division intends to zealously enforce the antitrust laws in labor markets and aggressively pursue information on additional violations to identify and end anticompetitive no-poach agreements that harm employees and

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76. As of the time of this writing, and despite all the focus on no-poaching clauses in franchise agreements over the past year in the media, neither the FTC nor DOJ has publicly announced any investigations of no-poaching clauses in franchise agreements, much less any complaints against or settlements with any franchisors. Perhaps federal regulators are more sympathetic to viewing a franchise system as a “larger legitimate collaboration between employers” to which the no-poaching agreement is reasonably related. Or perhaps federal regulators have simply decided to let private parties (see supra Section III) and state attorneys general (see infra Section IV.B.) take the lead. Of course, it is also possible such investigations and settlement discussions are currently underway with the FTC or DOJ and have not been publicly announced yet.
77. See Press Release, Dep’t of Justice, supra note 73.
the economy. Franchisors, franchisees, and their lawyers should consider themselves warned.

B. State Enforcement

Arguably the most consequential outcomes thus far have come from the hands of state attorneys general. And none has been more active than Attorney General Robert Ferguson of the state of Washington (AG Ferguson). AG Ferguson’s office launched an investigation in January 2018 into the use of no-poaching clauses in fast-food chains. As part of its investigation, Ferguson’s office issued Civil Investigative Demands to many QSR franchisors with locations in Washington, asking for detailed information on the franchisor’s use of and rationale for no-poaching clauses in their franchise agreements, along with copies of all relevant franchise agreements.

In July 2018, AG Ferguson announced that he had entered into Assurances of Discontinuance (AODs) with seven major QSR franchisors operating in the state of Washington. One month later in August 2018, another eight major QSR franchisors also agreed to AODs with AG Ferguson, as did another eight major QSR franchisors in September 2018. All twenty-three QSR franchisors were ones identified in the Krueger & Ashenfelter paper. AG Ferguson also announced the remaining major QSR franchisors that his office was still investigating and that he was extending the investigation not only to franchisors in other industries but also to smaller QSR franchisors (those with fewer than 500 U.S. locations).

These AODs are all similar and impose the same general obligations on each franchisor, including the following:


82. See Krueger & Ashenfelter, supra note 2, at 29–30.

83. Baskin Robbins, Domino’s, Quiznos, Firehouse Subs, and Jersey Mike’s. Wash. Attorney Gen., supra note 81.

84. Id.
The franchisor will no longer include no-poach clauses in any of its future franchise agreements nationwide;

The franchisor will no longer enforce no-poaching clauses in any of its existing franchise agreements nationwide nor intervene or defend the legality of the no-poach clause in any litigation a franchisee might bring to enforce the clause;

The franchisor will notify all franchise operators in Washington (or nationwide for some AODs) of the AOD and provide a copy;

Within 60 to 120 days, the franchisor will endeavor to amend all existing franchise agreements with Washington franchisees to remove any no-poaching clauses and report any franchisee that refuses to consent to the change; and

The franchisor will amend all other existing franchise agreements nationwide to remove no-poaching clauses, as the agreements come up for renewal in the ordinary course of business.85

Each of these twenty-three very large franchisors agreed to a nationwide ban on the use and enforcement of no-poaching clauses, even though their settlement was with a single state attorney general. Indeed, seeking such relief was a specific focus of AG Ferguson, who has said his goal is to eliminate no-poaching clauses in the fast-food industry nationwide. He has publicly delivered an ultimatum to other franchisors: “Other fast food companies that use no-poach provisions are now on the clock to accept a similar deal or face litigation from my office.”86

Perhaps inspired by the actions of AG Ferguson, in July 2018, a coalition of eleven state attorneys general sent a letter to eight national fast-food franchisors requesting information and copies of documents related to “no-poach” clauses in their franchise agreements.87 AG Ferguson’s announcement of the twenty-three AODs with nationwide commitments may have some effect on the resources that other states choose to dedicate to their investigation. But they almost certainly will continue to pursue the issue, especially for any franchisors that do not have locations in the state of Washington or have not yet agreed to an AOD with AG Ferguson’s office, and possibly for franchisees in their respective states that attempt to enforce a no-poaching clause.

Franchisors of any moderate size that have not been contacted by any attorney general’s office should expect to receive a Civil Investigative

86. Wash. Attorney Gen., supra note 80.
Demand or other communication. Before rushing to accept the terms of an AOD offered by AG Ferguson or any other attorney general, franchisors should carefully assess any collateral exposure that could arise from entering into the AOD and its specific language. A settlement with a state attorney general or other enforcer will very likely lead to the filing of class-action complaints—indeed, class plaintiffs promptly filed complaints against at least four of the franchisors that have entered into AODs with the state of Washington, on claims that the no-poaching agreements violated antitrust laws and resulted in suppressed workers’ wages. Franchisees have also been named as defendants in some of those complaints. Franchisors that are considering entering into any kind of AOD should work with counsel to negotiate out any language that could be unnecessarily detrimental in any future private no-poaching litigation or is otherwise too expansive.

The bottom line for franchisors and franchisees that have no-poaching clauses in their franchise agreements, especially those in the QSR industry and those with a large number of locations nationwide, is to expect to be contacted by state regulators if such franchisors or franchisees have not already, to be prepared with a response strategy, to pay attention to developments in the pending cases discussed earlier, and to work carefully with franchise and antitrust counsel on any responses and negotiated settlements with government regulators.

C. Legislative Developments

Legislators are also getting in on the action to eliminate no-poaching agreements in the franchise industry. At the federal level, U.S. Senators Cory Booker and Elizabeth Warren have been the primary actors. In November 2017, Senators Booker and Warren sent a letter to the DOJ citing the concerns raised in the Krueger & Ashenfelter paper regarding the potential effect of no-poaching agreements in franchising and asked whether the DOJ had “changed its position” regarding or planned to revisit the Antitrust Guidance discussed earlier, whether the DOJ was pursuing legal action


89. See, e.g., id.

90. As a starting point, franchisors can compare the differences in the AODs that others have already negotiated, especially with regard to any admissions of how the no-poaching clauses were used and enforced. Also, franchisors that are affiliated with other brands through a common parent company may want to ensure the scope of parties bound to an AOD does not include its remote affiliates.

91. For a discussion on responding to government inquiries, see Eric L. Yaffe & Christopher A. Nowack, The Unwelcome Phone Call—Responding to Regulatory Audits and Investigations, 17 Franchise L.J. 393 (Winter 2018).
against franchisors, and whether further congressional action was needed to “curtail the use of collusive no-poach agreements.”

Senators Booker and Warren later co-sponsored a bill on March 1, 2018, entitled the End Employer Collusion Act that would make almost any kind of no-poaching agreement unlawful to enter into or to enforce. The bill targets agreements between two or more employers that restrict one employer from hiring another employer’s current or former employees. Importantly, the bill would provide a private right of action for violation of the prohibition on no-poaching agreements, including punitive damages and recouping of attorney’s fees as allowed by the court.

Presumably knowing that their bill was unlikely to advance in a Republican-controlled Congress, Senators Booker and Warren followed up with a July 12, 2018, letter to the CEOs of eighty-nine of the largest franchisors in the United States, urging them to remove no-poaching clauses from their franchise agreements and asking them to respond to questions about their use of no-poaching clauses in their franchise agreements and any rationale for their use. Perhaps because there is no legal obligation to respond to the Senators’ requests for information (as opposed to a civil investigative demand from an attorney general), the Senators have not announced receipt of any substantive responses to their letter. Thus, despite all the efforts of Senators Booker and Warren, for the time being it does not appear likely that federal legislation specifically targeting no-poaching agreements will be enacted. Some state legislatures may take up the mantle given the federal inaction—some have recently enacted legislation to limit noncompetition agreements for certain employees—but as of this writing, the authors know of no significant state legislation currently proposed that specifically targets no-poaching clauses.
IV. What to Do About No-Poach Clauses

Given all of this ongoing activity, what should a franchisor do about no-poaching clauses in existing franchise agreements and particularly in new franchise agreements currently being offered? Clearly, the potential risks of continuing to include no-poaching clauses in new franchise agreements (and to enforce existing no-poaching clauses) have gone up. The risks include having to respond to state and federal investigations, as well as follow-on class-action lawsuits brought on behalf of system-wide employees. There is also the risk of bad press and reputational harm, unwanted attention from legislators and regulators, and distraction from the business. One truly adverse decision could transform the current trickle of private litigation into an open fire hydrant.

However, the increase in potential litigation costs may be temporary if future court decisions solidify around a view that the rule of reason should apply to evaluate such agreements within a franchise system. Ambitious state attorneys general and national legislators may move on to the next cause célèbre. In the meantime, franchisors should evaluate the likelihood of these legal, regulatory, and reputational risks arising in their systems, and their magnitude if they do arise, all of which may depend on, inter alia, the specific language and variables used in the applicable no-poaching clause, the number of locations in the system, and the average wages and skill level of a typical franchisee employee.

Franchisors should weigh those indisputably increased risks (and the attendant costs of defending government investigations and private class actions) against the benefits of including no-poaching clauses in their franchise agreements. In other words, even if a franchisor believes that its no-poaching clause is ultimately defensible from an antitrust standpoint (a different question, of course, from the likelihood of being sued), does the benefit of the no-poaching clause outweigh the costs?

Asking this question is not a pre-judgment of the value of a no-poaching clause to any particular franchisor. To be sure, some systems’ franchisees may believe the no-poaching clauses are extremely important to their businesses, and franchisors may value the harmony achieved within the franchise system through the use of no-poaching clauses. That harmony may help the franchisor’s system compete more effectively against other brands. Obviously, several of the largest franchisors in the United States (i.e., the twenty-three so far that have settled with the Washington attorney general) have decided that the benefits to them and their systems do not outweigh the continued burden of litigating the issue with regulators and classes of employees.

If a franchisor decides to retain some form of no-poaching clause in its franchise agreements, it should consider modifying its existing clause to tailor it as narrowly as possible (e.g., limit the geographic scope and apply only to management-level employees) and, if possible, eliminate any of the troublesome elements that the McDonald’s court or Jimmy John’s court have focused
on in considering per se treatment (e.g., third-party beneficiary status and special application to direct horizontal competition from the franchisor).

If a franchisor decides to eliminate its no-poaching clause or to stop enforcing existing clauses (or both), it should consider whether to make any recommendations to franchisees about other alternatives that franchisees can implement on their own to achieve similar ends. For example, franchisees may be able to protect their investment in senior staff through the use of non-compete agreements or other incentive-based concepts like training repayment programs. Naturally, franchisors should not mandate such practices and, at most, only suggest or recommend, and leave the matter entirely in each franchisee’s discretion after consultation with its own legal counsel.

Franchisees with a no-poaching clause in their franchise agreements may find themselves in a predicament. On the one hand, franchisees are named defendants in some of the private class-action lawsuits brought by franchise system employees. And the AODs into which many franchisors entered with the state of Washington require the franchisor to report to AG Ferguson’s office any franchisee that the franchisor learns is attempting to enforce a no-poaching clause. A franchisee may understandably feel exposed if it continues to comply with the no-poaching clause. On the other hand, no-poaching clauses are material obligations in their franchise agreements, the legality of which is still unsettled. A franchisee may risk breaching the franchise agreement if it decides not to adhere to the no-poaching clause. And some franchisees that find great value in the no-poaching clauses, and would fight to see them enforced, may end up hamstrung by a franchisor that has agreed not to enforce the clauses. Given these variables, franchisees should independently assess their exposure and consider alternatives as noted earlier with franchisors.

Although the threat to the franchise industry of no-poaching clause litigation and enforcement actions is not likely to rise to the level of the revised joint employer standard, the potential liabilities for any particular system could be quite large. And the focus on no-poaching agreements by the plaintiff’s bar and government is not likely to diminish in the near term. Ultimately, each franchisor must assess any no-poaching issue for itself with advice from experienced counsel. The balance of business utility to legal risk that may have warranted inclusion of a no-poaching clause only three years ago may require reassessment in light of the changing calculus of legal risk today.
Managing Catastrophic Risks in Franchise Systems

Morgan Ben-David

I. Introduction

Risk is an unavoidable aspect of any business. However, certain types of catastrophic events have the potential to create severe financial or reputational damage to a brand and a company’s activities. Where companies neglect risk, or fail to prepare for and manage risk, the reputational and financial consequences can be dire. Today, companies are realizing more than ever that they need to have proactive plans for dealing with natural and man-made disasters, whether it be hurricanes, active shooter threats, cyber attacks, foodborne illnesses, or public relations crises.

A “wait and see” approach is no longer an option. According to a recent study conducted by Freshfields Bruckhaus Deringer and public-relations firm MWWPR, twenty-eight percent of crises rebound around the globe in one hour, while it takes the average brand twenty-one hours to respond to a crisis. Indeed, with the increasing significance of social media, timing is everything to ensure getting ahead of a crisis, as news can become viral in an instant.


Ms. Ben-David

Morgan Ben-David (morgan@axslawgroup.com) is a partner of AXS Law Group, PLLC, in Wynwood, Miami, Florida.
A franchise system, specifically, faces unique risks and vulnerabilities due to the division of control and responsibility inherent in franchising. First, while franchised units may be independently owned and operated businesses, the franchisor and other franchisees in the system will be exposed to the risks emanating from the franchised operations. Second, because the franchisees and franchisor are tied to one another by a common brand name, the media and the consuming public will often not distinguish the actions of a franchisee or a franchisee’s employee from the brand as a whole. Accordingly, an event that occurs at one franchised unit, and the actions taken by the franchisee or franchisor in response, can have a ripple effect throughout the entire system, and what was otherwise thought of as an isolated incident can turn into system-wide crisis.

Take, for instance, the 2009 Domino’s food safety scandal resulting from one YouTube video posted by employees of a franchised unit in North Carolina. The video depicted one of the workers putting food in his nose, putting nasal mucus on the food, and violating other health codes as the food was being prepared for a customer. Within a matter of days, the video had been viewed by millions of people, and the incident appeared in over half of the search results on the first page of Google when “Domino’s” was searched. The news quickly went viral, with mainstream media reporting the incident with headlines splashed across television sets across the country. Fortunately for Domino’s, it had a crisis management plan and an appropriate team in place to properly handle the aftermath and counter the negative publicity.

This article will first provide a general framework for managing catastrophic risks, including pre-planning strategies, communications plans, and public relations considerations. Then, the article will look at specific catastrophic risks that can threaten a franchise system, by providing historical examples of crises that have jeopardized the business operations and reputations of well-known brands, as well as providing pre-planning and response strategies for a given crisis. With each catastrophic risk, risk management and communication plans need to be tailored accordingly, and the most effective plan must take into account the brand itself, the parties involved,

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6. Id.
7. Id. To address the increasing negative brand perception, Domino’s quickly posted its own video on social media, with the company’s president personally addressing the public to assure them that the two employees have been fired and that the company was dedicated to increasing food safety monitoring. 22 Biggest Crisis Communications Challenges in Restaurant History, AARON ALLEN & ASSOCIATES BLOG (Apr. 20, 2014), http://aaronallen.com/blog/21-biggest-crisis-communications-challenges-in-restaurant-history. Domino’s also rolled out its “Pizza Tracker,” allowing consumers to track their pizzas in real time. Id. The Domino’s incident and the company’s quick and personalized response proved to be a good example of how to quickly recover from a crisis communication event.
the applicable legal considerations, and the nature and scope of the specific crisis.

II. General Catastrophic Risk Planning and Response Strategies

To determine the potential magnitude of loss and how to minimize such loss, it is vital to understand the interaction between catastrophic risk and the vulnerabilities involved in any given company and industry.9 A plan for managing catastrophic risk and communicating with clients, customers, franchisees, attorneys, suppliers, and the media must be created in advance, and the plans must be effectively communicated, implemented, and updated on a continuing basis.10

A. Identify, Assess, and Prioritize

The first step in developing a catastrophic risk management plan is for a franchisor to identify and prioritize the risks faced by corporate and franchised units, as well as by the system as a whole. The risks may be unique to a specific industry or geographic location. For example, businesses located in coastal areas and hurricane-prone locations will need to adequately prepare for environmental risks, while food service franchises face unique risks of foodborne illness or food shortages. The public figure and face of a brand may commit a heinous crime or speak out on politically driven, controversial issues. A CEO of a franchisor may suddenly have a heart attack. The personal information of hundreds of thousands of consumers may be compromised by hackers. Franchisors should define what constitutes catastrophic risk or crisis events, and those definitions should be laid out for franchisees in training manuals or the franchise agreement.11

Ultimately, the franchisor should be proactive in assembling a crisis team to assess the risks faced by corporate-owned and franchised units and should

9. Banks, supra note 1, at 8.
11. For example, Teriyaki Madness requires its franchisees to immediately inform the franchisor by telephone and email upon the occurrence of a “Crisis Management Event,” defined as “any event that occurs at or about the Teriyaki Shop that has or may cause harm or injury to customers or employees, such as food contamination, food spoilage/poisoning, food tampering/sabotage, contagious diseases, natural disasters, terrorist acts, shootings, or any other circumstances which may damage the System, Marks, or image or reputation of us.” See Teriyaki Madness Franchise Disclosure Document C-12 (Mar. 23, 2017), http://franchise.teriyakimadness.com/wp-content/uploads/2017/05/Teriyaki-Madness-2017-FDD-v2F-00065302-5xE74D.compressed.pdf (noting that Franchise Agreement gives franchisor the right to require franchisees to temporarily close the franchised business and, in such cases, disclaims any liability for any losses or costs, including consequential damages occasioned by such closure). Conversely, Marriott categorizes its crises events into “Tier 1 and Tier 2” events, differentiated by either local events on the one hand, and national/international events or local events that may become national or international in scope, on the other hand. See Leslie D. Curran et al., Crisis and Reputation Management: Shaping Standards of Behavior and Implementing Response Plans, 36 ABA ANNUAL FORUM ON FRANCHISING 16 (2013), https://www.americanbar.org/content/dam/aba/administrative/franchising/w18-2013.authcheckdam.pdf.
involve other stakeholders in the process, including franchisees, suppliers, and outside experts who may be better positioned to identify risks and develop steps to address a crisis. By involving franchisees, the franchisor can instill a culture of trust, communication, and transparency that can go a long way in the event of a crisis.

B. Risk Management and Response

Once potential crises have been identified within a franchise system, it is critical that a crisis management plan is developed to help the entire system navigate and respond to a crisis. These plans should be simple and understandable, and should account for the difference phases of a catastrophe as it unfolds. The plan should also designate a core leadership team or select individuals who should be contacted in the event of a crisis.

Pre-planning and response strategies tailored for specific catastrophic risks are discussed later in Section III. However, the general procedures that should be addressed in any risk management plan include: (1) gathering information needed to answer critical questions, such as Who is involved? How did the problem occur? When, where, and why did the crisis occur?; (2) notifying whoever is in charge internally within the franchise system, as well as a notification system for other stakeholders, including suppliers, vendors, and family members of victims (as applicable); and (3) responding to the crisis, including who will be communicating in response to inquiries and in what format. In managing catastrophic risks related to events occurring at individual franchised units, franchisors should also be diligent in qualifying franchisees prior to awarding them a franchise, especially where personal services are involved. Establishing insurance requirements and conducting audits are other ways to reduce or transfer risk.

For franchisees, it is also important to understand that they cannot rely solely on the franchisor to solve local issues, which are often the source of catastrophic risk. Franchisees need to know their customers, employees, and their applicable geographic area. Franchisees should also become familiar with their local law enforcement and local government officials. When a catastrophe occurs, “one size fits all is rarely going to work for everyone.”

C. Communication Planning Is Key

With franchising in particular, the public is likely to hold both the franchisor and the franchisee responsible regardless of the legal distinction between the two. Therefore, ensuring that the lines of communication between franchisor and franchisee are well-defined is a fundamental aspect of crisis response preparedness. A culture of transparent communication across a franchise system is fundamental to the success not only of the brand as a

13. Id.
whole, but also to the success of a crisis early-warning system.\textsuperscript{14} An effective crisis management plan should accordingly address communications and serve as a clear internal policy that franchisees can follow when a catastrophe occurs. The plan should include names and contact information for everyone who may need to be reached in the event of a crisis, at all hours, including identified leadership, roles, and appropriate contacts to further enable a franchise to manage a crisis effectively. “The middle of a crisis is not the time to start trying to figure who the players are, what the game is, and what your spokespeople are going to say.”\textsuperscript{15} A crisis communications plan answers questions such as: (1) What is the issue? (2) What needs to be said? (3) What needs to be done? (4) Whom are we talking to? (5) How do they prefer to see the message? and (6) How quickly can the message be disseminated?\textsuperscript{16}

In today’s digital era, brands are able to monitor and listen to consumers and other stakeholders via social media like never before. Public discourse is digitally evolving, and the level of political and social activism is at an all-time high. Consumers, customers, and investors alike are increasingly expecting “a corporate embrace of values supposedly more sublime than merely making sales and profits.”\textsuperscript{17} Indeed, with the power of social media, timing is everything to ensure getting ahead of a crisis and controlling the narrative.\textsuperscript{18} A brand no longer has the luxury to allow a statement about it to go unchallenged. According to public relations expert Seth Arenstein, “the culture today, particularly millennials, often assume the first thing they hear is the truth, and if it’s not corrected quickly, it certainly is the truth.”\textsuperscript{19} Karen Kessler, CEO and founder of Evergreen Partners, Inc., a public relations firm specializing in crisis communications, reputation management, litigation support, and issues management consulting, warns:

> It is a click universe we live in, where everybody is a journalist. Everyone has a cellphone. Every cellphone has a camera. Every employee, every customer, every vendor, everybody is a journalist. Unlike responsible, legitimate news outlets, where reporters have to check sources and confirm facts, social media and citizen journalism have no rules. Rumor becomes fact. Fact becomes rumor. If you are not tracking social media, then you can be days late to a crisis because by the time you find out about it, it spreads dramatically.\textsuperscript{20}

\textsuperscript{14} Deborah Hileman, \textit{How PR Pros Can Shape a Brand’s Culture to Avert Looming Crises}, \textit{PR News Crisis Management Special Report} 8 (2016).
\textsuperscript{16} Mark Renfree, \textit{6 Ways to Turn Employees into Ambassadors When a Crisis Hits}, \textit{PR News Crisis Management Special Report}, at 22 (2016).
\textsuperscript{18} Wilson, supra note 3.
\textsuperscript{20} Telephone Interview with Karen Kessler, President, Evergreen Partners, Inc. (July 11, 2018).
A successful crisis communication plan should have the following components:

- Message mapping, including template and form messages, press releases, and form social media posts that can be quickly tailored to address and respond to a given crisis;
- Media training, which will include media contact numbers, media kits, lists and contacts for outside experts. Franchisors need to be vigilant in communicating to and training franchisees on how to handle media inquiries;
- Providing form responses to common questions;
- Monitoring of social, electronic, and print media via Google Analytics and other tools available so that a brand can anticipate a crisis and stay attuned; and
- Establishing metrics to evaluate effectiveness.21

Another key ingredient in successful crisis communications is developing goodwill in local communities and news outlets before a crisis occurs.22 Kessler goes on to say that “[a] charitable arm of any business is really important to build goodwill for the times when you’re going to need it. . . . Those companies who aren’t active in the community are going to lose. People expect a culture of engagement.”23

III. Catastrophic Risks Facing Franchise Systems Today

A. Cyber Attacks and Security Breaches

Cyber attacks and data breaches continue to remain the top threats to organizations around the globe.24 In the United States alone, data breaches cost organizations an average of seven million dollars per year due to reputational damage, legal costs, direct financial losses, and recovery.25

Franchises, specifically, remain an appealing target for hackers, due to customer data being collected from multiple entry points, including at each company-owned and franchised unit, as well as at each point of sale or computer terminal at each unit.26 Information collected also includes private data on franchisees and employees. Therefore, when a franchise falls victim to a

23. Kessler Telephone Interview, supra note 20.
24. Gianluca Riglietti & Lucila Aguada, Bus. Continuity Inst., Horizon Scan Report 2018 10 (Jan. 2018) (presenting findings on business threats and business continuity arrangements, based on a survey that included 657 respondents from 76 countries). For the third year in a row, cyber attacks, data breaches, and IT outages are the top 3 concerns, respectively, for business continuity and resiliency. Id.
cyber attack or data security breach, the consequences can quickly have a domino effect throughout the system. To make matters worse, once hackers attack a merchant’s point of sale system, it can often take months for a company to discover that its network (along with its customers’ private information) has been compromised. The damage from these malicious cyber attacks can have devastating effects on a franchise system’s reputation and sales.27

Aside from having sound cyber security measurements in place, loss can be mitigated during and after a cyber attack if an entire franchise system’s organization is well informed and trained in cyber response and disaster recovery practices. A comprehensive risk security program to manage and respond to cyber-related risks should include: 28

• reviewing and updating website privacy policies and terms of use, and ensuring accuracy and compliance with law;
• reviewing vendor contracts to ensure that contractual provisions cover data privacy and security;
• providing initial and continuing training to employees and franchisees;
• utilizing third-party experts and vendors to outsource training and data collection processes, such as credit card transactions, to reduce liability and to allow the day-to-day security to be handled externally; 29
• implementing minimum requirements for computer equipment and software for all franchisees;
• obtaining cybersecurity insurance;
• establishing security protocols for obtaining and safeguarding customer data consistent with applicable law and best practices, including data encryption, access limitations, and dual authentication procedures;
• creating security audit procedures for field personnel who visit franchised units; and

27. In 2016, it took Noodles and Company 5 months to discover a data breach that affected more than 400 restaurants in 27 states. See Bluefin News & Blog, The Impact of Data Breaches on Franchises: Brand Name and Reputational Risk (Mar. 9, 2017), https://www.bluefin.com/bluefin-news/data-breaches-franchise-name; Bret Thorn, Noodles & Company Offers Update on Restaurant Closures, Nation’s Restaurant News (Mar. 2, 2017), https://www.nrn.com/operations/noodles-company-offers-update-restaurant-closures. After closing underperforming restaurants, the company reported a net loss of $71.1 million for 2016, which included $29 million to terminate leases and to pay employee severance, as well as $10.6 million charge for claims and anticipated claims related to the data breach. Id.

28. See Jason Adler, Megan Demicco & Jon Neiditz, Critical Privacy and Data Security Risk Management Issues for the Franchisor, 35 Franchise L.J. 79 (Summer 2015), for a detailed analysis of the practical steps franchisors should take to protect data.

29. Moving franchise Two Men and a Truck, with over 340 locations, invited a third-party payment security company and vendor to attend its 2017 annual franchise conference to provide educational sessions to franchisees regarding PCI-validated Point-to-Point Encryption solutions to prevent data from being present in a merchant’s system or network in the event of a data breach. See Bluefin News & Blog, supra note 27. Two Men and a Truck likewise utilizes its third-party vendor to provide a call center and other solutions for franchisees. Id.
• timely informing those affected, offering solutions, and taking measures to control further damage.

Following a data breach, civil litigation including class-action and shareholder derivative suits, as well as suits on behalf of government entities, often follow. This can create the additional risk of reputational and financial damage to an entire franchise system.30 In recent years, companies have further been tasked with navigating the constantly evolving landscape of cybersecurity and privacy, with data breaches becoming larger than ever before and technology becoming more advanced. With a new administration in the U.S. White House, there has also been a shift in priorities regarding cybersecurity and privacy issues, as well as competing and overlapping efforts of different federal and state regulators, including the Federal Trade Commission,31 Federal Communications Commission, Consumer Financial Protection Bureau, and State Attorneys General.32 Given the risks and unknowns involved in data breach litigation, franchisors who have been the target of litigation and regulatory action often choose to settle.

Overlapping international privacy frameworks have also posed additional challenges for U.S. franchisors and franchisees. Namely, franchisors and franchisees that are based in Europe, do business in Europe, or collect personal data relating to European residents, now have the additional onus of


31. On three occasions in 2008 and 2009, hackers breached information technology systems at Wyndham Worldwide Corporation (Wyndham), stealing debit and credit card account information of hundreds of thousands of consumers, leading to over $10.6 million dollars in fraudulent charges. FTC v. Wyndham Worldwide Corp., 799 F.3d 236, 239 (3d. Cir. 2015). According to a 2012 lawsuit filed by the Federal Trade Commission (FTC) seeking to hold the franchisor liable for the system breaches, Wyndham “unreasonably and unnecessarily exposed customers’ personal data to unauthorized access and theft,” by storing credit card information in readable text; allowing easily guessed passwords; failing to employ new security measures; and not following proper incident response protocols. Id. at 240–41. The FTC further alleged that the company engaged in unfair and deceptive business practices and failed to live up to its implied promises contained in its company’s privacy policy. Id. at 239. On December 9, 2015, the FTC filed a stipulated order settling the litigation and requiring Wyndham to implement a comprehensive information security program, including certain administrative, physical, and technical safeguards appropriate for the company’s size, scope and nature of business activities, and the sensitivity of customer data. FTC v. Wyndham Worldwide Corp., No. 14-3514, slip op. at 11 (3d Cir. Aug. 24, 2015). The settlement is a clear indication that the FTC will continue to be focused on ensuring compliance with industry standards for data protection, and franchisors should take proactive steps to monitor compliance within their entire franchise systems.

ensuring that their data processing practices comply with the recent European Union General Data Protection Regulation (GDPR), which came into effect on May 25, 2018. Time will tell how the GDPR affects data protection regulation in the United States and worldwide.

B. Hurricanes and Natural Disasters

Climate and environmental-related threats are the most likely and most damaging global risks over the next decade. The 2017 hurricane season was the most expensive in U.S. history, with seventeen named storms causing damages totaling more than $200 billion. An unprecedented six million people evacuated in the face of category-five storm Hurricane Irma in September, 2017, which was the largest evacuation in U.S. history.

When Hurricane Maria hit Puerto Rico on September 20, 2017, it left behind a state of unprecedented disaster, with approximately 3.7 million residents without power. At the time, Marco’s Pizza franchisees Edgardo Santiago and Luisaliz Rivera had just attended their final training session prior to opening their franchised location in Bayamón, Puerto Rico, joining six other Marco’s Pizza franchisees on the island. After the storm, the biggest challenge for the franchisees was finding fuel for generators and setting up systems to receive merchandise. There was no water or electricity, and key deliveries were suspended. In addition, government agencies where Santiago and Rivera would need to obtain required permits as a condition to opening were closed or lacked Internet, and it was nearly impossible to obtain the required materials to complete construction. However, Santiago and Rivera were fortunate enough to be part of a local franchise community with a well-thought-out communications system prepared in advance of the storm to help ensure business continuity. Under the program, experienced franchise owners collectively prepared an alternative mechanism to cell phones by using channels like Facebook and Whatsapp and creating special accounts exclusively for the restaurants’ managers and franchisees to coordinate distribution of food. By leveraging the support of their fellow franchisees, team members, and the franchisor’s executive team, Santiago and Rivera were able to open for business.

38. Id.
39. Id.
40. Id.
41. Id.
seven months after the storm. The lesson learned for franchisees, and franchisors alike, is that the importance of putting in place a detailed communications system cannot be understated:

Let your employees, clients and customers know what is happening. Provide notifications regarding ordering, shipping, and inventory. Share details of expected opening or re-opening dates. Also consider leveraging social media to provide community updates, well wishes and support/resources you know of or can provide to aid in the recovery. Be as detailed as possible in your communications. This will show your ability to properly deal with problems and develop solutions, even as you gain trust from your company and fellow businesspeople.42

Franchise systems that embrace a culture of community and support have proved to be more resilient after a storm. Indeed, where franchisors prioritize people and safety over profits in times of adversity, they generate increased goodwill among franchisees and the public. In another example, after dozens of franchised Sylvan Learning Centers in Texas and Florida were affected by Hurricane Harvey and Hurricane Irma, the franchisor responded by creating a new program, Sylvan Cares, to provide monetary assistance and volunteer time to franchisees displaced or affected by the storm.43 The franchisor also set up a PayPal account which allowed any Sylvan employee or franchisee to donate directly to affected families within the Sylvan community.44 Sylvan was forced to cancel its annual franchisee conference, scheduled to be held in Orlando the same day Hurricane Irma made landfall.45 To provide its annual content and a forum for its franchisees, Sylvan adapted quickly by (1) launching a virtual conference through a series of videos; (2) organizing a town hall meeting in an open forum for franchisees; and (3) holding regional meetings for franchisees across the United States and Canada over the course of three months following the storms.46 “[W]e know it’s important to keep the communication flowing on each side of a franchisee-franchisor relationship,” said CEO John McAuliffe.47

To better prepare itself and its franchisees for disasters, Sonic has a disaster-relief fund to which its franchisees contribute.48 Therefore, when Hurricane Harvey damaged or closed many of its vulnerable drive-in model restaurants, the recovery effort was faster and better than most.49 In addition, the franchisor has systems in place to win new consumers and to drive system

42. Id.
44. Id.
46. Id.
47. Id.
49. Id.
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sales through the use of distinctive ad campaigns, increasing media reach, and adapting technological enhancement.\textsuperscript{50} Despite 2017’s natural disasters, Sonic was able to increase its per-share net income for the entire fiscal year by being prepared and working with its franchisees, many of whom are long-time, experienced franchise owners and operators.\textsuperscript{51}

These examples demonstrate that the physical manifestation of the unpredictable risks associated with climate change can be catastrophic and interfere with short, medium, and long-term operations, including not only the damage directly sustained by fire, wind, storm, or flood, but also other indirect sources of loss, such as (1) service interruptions and power outages; (2) inability to access business establishments because of floods, debris, or other closures of roads and parking lots; (3) customers staying indoors before, during, and after a storm; (4) looting; and (5) necessary discounts offered to move excess inventory.\textsuperscript{52}

In preparing for a storm or other natural disaster, it is critical to develop and have in place pre-relationships with necessary third-party contractors, vendors, and suppliers to minimize business interruption.\textsuperscript{53} In addition, the ability to gather information at an early stage is critical to recovering from a natural disaster. Hotels and gas stations, specifically, must also have plans for emergency preparedness and for continued operations. These franchise systems must have procedures in place for preventing price-gouging when demand exceeds supply and must have procedures for coordinating and communicating with federal, state, and local agencies and media outlets.\textsuperscript{54}

The extent to which companies may recover losses after a severe weather event can also depend on the insurance coverage that was obtained before the loss occurred. Key clauses in commercial property insurance policies that can help food and beverage companies determine the extent of recoverable losses and manage risk include: (1) valuing finished stock inventory on a selling price basis at the time of loss as opposed to a replacement cost basis; (2) a control of damaged goods provision, covering who should judge whether goods are damaged; (3) service interruption for off-premises power to provide coverage for losses resulting from the interruption of third-party utilities; (4) an ingress/egress or civil or military authority extension; and (5) a manner for indemnifying loss during the period in which access to real or personal property is impaired either due to an insured peril or governmental authorities.\textsuperscript{55}

\begin{itemize}
\item \textsuperscript{50} Id.
\item \textsuperscript{51} Id.
\item \textsuperscript{53} Jeff Holdaway et al., Hurricanes, Pandemics and Terrorism—Planning for Disasters and Coping with Them When They Hit, 29TH ABA ANNUAL FORUM ON FRANCHISING 4 (2006) (W-13), https://www.americanbar.org/content/dam/aba/images/disaster/franchisees.pdf.
\item \textsuperscript{54} Curran et al., supra note 11, at 4.
\item \textsuperscript{55} See generally Marsh, supra note 52, at 2–4.
\end{itemize}
C. Terrorism, Gun Violence, and Security

Twin Peaks.56 Waffle House.57 Jack in the Box.58 Franchised restaurants and retail locations are public places where threats of gun violence and other acts of violence, including lone-wolf terrorist attacks, can occur in an instant. The frequency of active shooter events has increased in recent years, with the number of deaths caused by gun violence increasing each year.59

Gun attacks, while rare, are usually high-profile events. For franchised operations with multiple locations, fear often spreads quickly. A shooting at one location can therefore have an adverse impact on the business operations across all locations within the system. “As active shooters often attack locations with which they have no connection, no business can consider itself immune to the threat. Organizations must be prepared for a potential attack at any time,” according to insurance company Marsh & McLellan Companies.60

A franchise system’s emergency response plan should include how to interact with local law enforcement and emergency responders. However, a franchisor should also integrate a high-level crisis management and emergency response plan that supports its individual franchisees. Given that there are usually no warning signs of a gunshot, franchisees, management, and employees must be well prepared and trained to act quickly.61 An emergency management and response plan should focus on planning ahead at all locations, including:

• Conducting safety drills and simulation exercises;
• Considering how customers and bystanders can quickly receive emergency information during a crisis;

56. In May 2015, a Waco Twin Peaks was the setting of a mass gun fight, leaving several people dead, many injured, over one hundred arrested, and 1,000 weapons seized. Paul R. Fransway, A View from Twin Peaks, DICKINSON WRIGHT’S: FRANCHISE & DISTRIBUTION NEWS (July 2015), https://www.dickinson-wright.com/-/media/Files/News/2015/07/Newsletter_6_15.pdf.
60. Id.
61. Id.
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• Ensuring that employees and managers understand when and how to evacuate or hide and otherwise are prepared to make a life-or-death decision in determining the best way to protect themselves and others;
• Having a clear strategy for how franchisees and employees will communicate with each other, as well as the franchisor, law enforcement, security personnel, and customers;
• Having clear emergency dialing instructions to quickly report threats, as well as a process to report suspicious or violent behavior;
• Heeding the advice of local enforcement before, during, and after a violent attack, and reviewing existing guidance available from law enforcement; and
• Identifying an experienced individual to represent the brand in communications with the media.

Following a shooting, the franchisor and franchisee should also consider whether and how to provide assistance to employees, customers, and victims and their families. The period immediately following an incident of gun violence or a terrorist attack is not the time to place blame. Rather, franchisors need to be proactive in protecting the brand and providing assurances that customers and employees can feel safe in their establishments. A one-sentence tweet stating that “our thoughts and prayers are with the families and victims of the tragedy” is not going to be a sufficient response when fatalities are involved.

The location of an individual unit may also determine the applicable level of threat. In systems where threats of terrorism are identified as catastrophic risks, some franchisors have opted to take a proactive stance in developing planning and security tools for all units, regardless if company-operated or franchised, recognizing that the benefit outweighs the risk of vicarious liability.62

D. Food Safety and Supply Chain Management

Restaurants and other food service franchise systems are faced with the unique issue of food safety, which, if not handled timely and correctly, can have a catastrophic effect on a brand’s reputation. While illness may be the result of unsafe handling or contamination at an individual franchised unit, very often food safety will be the result of an issue along the franchise system’s supply chain. In addition, the unethical or illegal behavior of a franchise system’s suppliers can often be associated with the brand itself, as

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62. For example, Marriot developed certain safety protocols following the September 11th, 2001, terrorist attacks, which dictate certain minimum standards with respect to crisis response management and security for certain high-risk hotels located in areas with a high incidence of terrorist activity or political or civil unrest. See Curran et al., supra note 11, at 15.
consumers and the media continue to put pressure on companies to engage in socially responsible business practices.\textsuperscript{63}

In managing risk, franchise systems involved in food service should therefore prioritize food safety as an integral part of a company’s culture, involving input from leadership, franchisees, and other stakeholders to not only ensure product uniformity, quality, and safety but to also sustain reduction in risks.\textsuperscript{64} In building a food safety culture, franchisors should likewise assess and monitor what is going on within the franchise system and use assessment scores as a catalyst for change. Assessments should not be used to only focus on the negative or to default a franchisee. Rather, when feedback and assessments highlight positive attributes, a franchisee may be more receptive to critique and changing behaviors.\textsuperscript{65}

Sometimes, the source of a catastrophic risk can be a link in a franchise system’s supply chain, and all franchisors should ensure that tight supply chain controls are in place. In building an effective supply chain, it is advisable to incorporate hazard analysis critical control point (HACCP) principles or other food safety management systems in each corporate owned and franchised restaurant, as well as at each point across the supply chain to analyze and control certain hazards to food products. In addition, food service franchise systems must also stay informed of, and comply with, applicable laws and regulations with respect to food safety.\textsuperscript{66} Establishing a supplier code of conduct is another way a franchise system can manage risk and preserve its reputation, with codes of conduct addressing such areas as (1) animal welfare; (2) human rights and labor practices; (3) environmentally sustainable business practices; (4) accountability and reporting; (5) anti-corruption; (6) conflicts of interests; and (7) communicating with the press.\textsuperscript{67}

Ultimately, transparency along a franchise system’s supply chain and the ability to quickly identify where an item was affected are vital to preventing and controlling foodborne illnesses before a catastrophic risk occurs. Recently, those in the food and beverage industry are looking to blockchain technology in order to improve safety, streamline, and track the supply chain

\textsuperscript{63} Gina Romo et al., \textit{Building an Effective Supply Chain and Distribution System}, \textit{35th ABA Annual Forum on Franchising} 6, 56 (2012) (W-15).
\textsuperscript{64} See generally id.
\textsuperscript{66} Romo et al., \textit{supra} note 63, at 6. HACCP includes performing a hazard analysis; determining critical control points and critical limits (such as temperature); establishing corrective and verification procedures; monitoring; and record keeping. Id.
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processes. While blockchain technology is still developing, it offers promise to provide manufacturers, distributors, and processors valuable information regarding each link in the supply chain as well as the ability to trace any product and its ingredients back to the origin in seconds.

How a franchisor and its franchisees handle and respond to a food-safety issue or a supply-chain problem is also a critical factor in managing the risk and potential resulting losses, given that the consuming public can be less forgiving where public health is involved. In 2003, the first major public E. coli outbreak in modern U.S. history hit the Jack in the Box restaurant chain. The source of the E. coli was the restaurant’s meat, resulting in four deaths, more than six hundred people sick, and between twenty and thirty million dollars in total losses. In responding to the outbreak, the franchisor promised to cover all medical costs of those who were affected and made changes to its suppliers and food safety protocols. However, it took years for the restaurant chain to recover.

Even one disgruntled customer or employee at one location can have an adverse impact on a brand’s goodwill, especially where the brand involved is a nationally well-known food service franchise. In 2005, a customer of a San Jose Wendy’s falsely reported that she found a finger in her cup of Chili. Despite Wendy’s efforts to investigate the source of the severed fingertip, it failed to effectively communicate with the public during the public relations crisis. For example, Wendy’s did not offer outside verification of its system-wide hygiene management and cleanliness standards, nor did it remove chili from its menus while the crisis was unfolding. Due to the finger scandal, the brand lost a total of $21 million in sales, with some franchised locations suffering losses close to fifty percent. On the other hand, how Taco Bell responded to a 2011 lawsuit alleging that its taco filling was not really beef serves as an example of how a quick and well-thought out response can reduce financial losses and combat the threat to a brand’s reputation.

69. Id. at 2 (“Digital encryption, GS1-compliant global trade item numbers, or SKU numbers are assigned to each transaction point on a food or beverage item’s journey from farm to fork or manufacturing facility to table.”).
70. However, when KFC was forced to shut down 800 out of its 900 locations in the United Kingdom after it ran out of chicken due to a logistical snafu, it quickly issued a high-profile, humorous apology that was well-received. See Robbie Abed, KFC Just Handled a Public Relations Crisis Perfectly with a Single Picture, Inc. (Aug. 8, 2018), https://www.inc.com/robbie-abed/kfc-just-handled-a-public-relations-crisis-perfectly-with-a-single-picture.html. The bright red print ad appeared in British newspapers depicting an empty chicken bucket with the brand’s initials to say “FCK” on it, along with an apology. Id.
73. Id.
company launched a three million dollar advertising campaign with print ads in all major national newspapers as well as online ads, and offered food discounts and giveaways via Facebook. The cheeky print ads depicted a letter from Taco Bell’s President with huge letters stating, “Thank you for suing us. Here’s the truth about our seasoned beef.”

E. The #MeToo Movement and Other Employment Practices

In October 2017, following sexual misconduct allegations against high-profile celebrities and other public figures, the “#MeTooMovement” spread virally on social media in an attempt to bring the widespread prevalence of sexual harassment and assault to the forefront. As the national conversation against sexual harassment becomes more prevalent, victims feel more empowered than ever to come forward regarding claims of sexual misconduct. In the wake of sexual harassment scandals across the country, sexual harassment should be a top concern for franchisors and franchisees alike, and not fully understanding the financial and reputational consequences of the risks involved could have a devastating effect.

In February 2018, Vox Media reported that from 2005 to 2015, hotel and restaurant employees filed at least 5,000 sexual harassment complaints with the Equal Employment Opportunity Commission, with the accommodation and food services industry accounting for 14.2 percent of claims—the most out of any other industry. In these industries, “men hold the majority of management and higher-paying jobs, while seventy-one percent of servers


76. See Jodi Kantor & Megan Twohey, Harvey Weinstein Paid Off Sexual Harassment Accusers for Decades, N.Y. TIMES, Oct. 6, 2017, at A1 (detailing decades of sexual harassment allegations against the now-infamous Hollywood producer, Harvey Weinstein). By meticulously chronicling Weinstein’s abuses, New York Times investigative reporters Twohey and Kantor “inspired other people to speak out and go public about the cultures of harassment in the workplace.” Brent Lang, How New York Times Reporters Broke Hollywood’s Biggest Sexual Harassment Story, VARIETY (Dec. 14, 2017), https://variety.com/2017/biz/features/new-york-times-harvey-weinstein-report-megan-twohey-jodi-kantor-1202637948. Subsequent public events of the #MeToo movement’s timeline included, for example: (1) the October 15, 2017, tweet by actress Alyssa Milano, “If you’ve been sexually harassed or assaulted write ‘me too’ as a reply to this tweet”; (2) the October 18, 2017, tweet by Olympic gymnast McKayla Maroney stating that she was sexually assaulted by former team doctor, Lawrence G. Nassar, who was recently sentenced to sixty years in federal prison on child pornography charges; (3) the October 29, 2017, public accusation by Anthony Rapp alleging that actor Kevin Spacey made sexual advances toward him when he was fourteen; (4) the November 9, 2017, investigative report by the Washington Post detailing Republican Senate nominee Roy Moore’s alleged history of sexual assault against underage girls; (5) the November 29, 2017, public announcement by the Today Show that co-host Matt Lauer had been fired after allegations of sexual misconduct; and (6) Time magazine naming the “Silence Breakers” its 2017 Person of the Year on December 6, 2017. See Christen A. Johnson & KT Hawbaker, #MeToo: A Timeline of Events, CHICAGO TRIBUNE (Aug. 20, 2018), http://www.chicagotribune.com/lifestyles/ct-me-too-timeline-20171208-htmlstory.html (detailing events through August, 2018).

are women who are three times more likely to be paid below the poverty line when compared to the general workforce. Where a large, well-known franchise is involved, sexual harassment claims against an individual franchisee can often be viewed as a larger, more systemic problem within a franchise system.

Franchisors and franchisees do not have the option of ignoring the “#MeToo Movement.” Allegations must be responded to promptly and with proper legal counseling. However, the biggest question arising for a franchisor is what role and responsibility the franchisor should have. Due to concerns of joint-employer and vicarious liability, franchisors have increasingly taken a hands-off approach and do not control franchisees’ hiring practices, wages, and other human resources and employment issues. While the onus of complying with employment laws is placed on the individual franchisees, franchisors should still instill a business culture across the entire franchise system and set good examples for their franchisees by having a zero-tolerance policy covering all types of sexual harassment. Franchisors can also take an educational approach by providing guidelines, refresher courses, and continuing education through an outside third-party HR provider, which can further insulate liability.

Depending on the nature of the services being provided by individual franchised locations, however, it may be advisable for a franchisor to take a more hands-on approach where risks of impropriety are greater. The recent Massage Envy scandal is a prime example. In September 2017, a woman brought suit against Massage Envy, alleging that she was sexually assaulted while receiving a massage at a Massage Envy.

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79. See, e.g., Patterson v. Domino’s Pizza, LLC, 60 Cal. 4th 474, 497–98 (2014) (In business format franchising, a franchisee has the right to hire employees and oversee performance, and a franchisor “becomes potentially liable for actions of the franchisee’s employees, only if it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and relevant day-to-day aspects of the workplace behavior of the franchisee’s employees.”). In *Patterson*, the court held that Domino’s was not vicariously liable for the acts of a franchisee’s assistant manager, who sexually harassed and assaulted a teenage worker at the franchised business. Specifically, “with respect to training employees on how to treat each other at work, and how to avoid sexual harassment,” it appeared that the franchisee, not Domino’s, was in control. *Id.* at 501. However, in its conclusion, the court cautioned:

Nothing we say herein is intended to minimize the seriousness of sexual harassment in the workplace, particularly by a supervisor. Nor do we mean to imply that franchisors, including those of immense size, can never be held accountable for sexual harassment at a franchised location. A franchisor will be liable if it has retained or assumed the right of general control over the relevant day-to-day operations at its franchised locations that we have described, and cannot escape liability in such a case merely because it failed or declined to establish a policy with regard to that particular conduct. Our holding is limited to determining the circumstances under which an employment or agency relationship exists as a prerequisite to pursuing statutory and tort theories like those alleged against the franchisor here.

*Id.* at 503 (internal citations omitted).

found that more than 180 people had brought sexual assault lawsuits, police reports, and state board complaints against Massage Envy franchised businesses, their employees, and the franchisor, resulting in a flurry of related lawsuits against other franchisees and the franchisor and an investigation into the complaints by the Illinois attorney general.\textsuperscript{81} Even though all of the improprieties allegedly occurred at franchised locations, the problem was system-wide.

It ultimately took an increasingly dire marketing crisis for Massage Envy to take the necessary steps to address the issues within its system and put in place a risk management and communications plan. It was not until December 2017, when Massage Envy announced the launch of its Commitment to Safety, a plan to “strengthen its safety policies and programs and to guide how franchise locations handle reports of sexual assault.”\textsuperscript{82} It subsequently also formed the Massage Envy Safety Advisory Council, a board of advisors “made up of leading authorities on sexual assault prevention, investigation, and victim support, representatives from the massage therapy profession, Massage Envy franchise owners, and members of the Massage Envy leadership team.”\textsuperscript{83} By March, 2018, the franchisor announced its adoption of the Universal Background Screening (UBS) system in all franchise locations, effective May 1, 2018.\textsuperscript{84} By adopting the UBS system, all franchisees will perform pre-hire and ongoing annual background checks on current employees.\textsuperscript{85} Massage Envy also formed a partnership with RAINN, the largest anti-sexual violence organization in the nation, to provide safety training to more than 1,300 franchisees and their managers, as well as provide a hotline number, assistance, and other resources for prospective victims.\textsuperscript{86} Time will tell if Massage Envy’s actions were too little, too late, and how the brand will recover from the damage caused.

Ultimately, however, franchisees should not rely on their franchisor to address the multifaceted challenges of sexual harassment and similar issues. Such proactive steps include:

- adopting and enforcing a written anti-harassment policy, which contains documented step-by-step instructions for reporting instances of sexual misconduct;
- as applicable, conducting an internal audit of its employment practices;
- ensuring that all managers and employees are immediately informed regarding any updates to the law or employment procedures;
- providing separate HR training for managers and other staff;

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\textsuperscript{81.} See id.
\textsuperscript{83.} Id.
\textsuperscript{84.} Id.
\textsuperscript{85.} Id.
\textsuperscript{86.} Id.
• engaging an employment lawyer or consultant to prepare and update employment handbooks to ensure compliance with sexual harassment, anti-discrimination, and employment laws; and
• taking every complaint of sexual harassment seriously, documenting it and investigating it.

Lastly, franchisors and franchisees alike should pay special attention to the importance of employment practices liability (EPL) insurance. Franchisors should require its franchisees carry EPL insurance and name the franchisor as an additional insured in the event that it is sued.

IV. Conclusion

Recent events have shown that companies have entered a new era of catastrophic risks, with catastrophes having a greater chain reaction throughout an entire franchise system. Franchisors and franchisees alike can learn from past mistakes or success stories in order to better manage and respond to catastrophic risks. However, the only way to truly be equipped to manage and respond to catastrophic events within a franchise system is to proactively take the steps necessary to avoid lasting damage. As they say, failing to plan is planning to fail.
Allocation of Sales and Income Tax Liability Between Franchisors and Franchisees for Online Sales

Christina Heddesheimer

Every franchisor and franchisee that conducts business in the United States must consider the U.S. federal, state, and local tax implications of its operations, that is, what types of taxes are owed, how much tax is owed, and, in the case of state and local tax, in what state(s) taxes are owed. This analysis is particularly complex for franchise systems that sell goods and services online, where franchisors and franchisees are typically selling to customers in a large number of states, each of which has its own tax laws regarding when a business is subject to tax in that state, and how to calculate the amount of tax owed. Additionally, following a recent U.S. Supreme Court decision, South Dakota v. Wayfair Inc.,1 franchisors and franchisees with online sales will most likely be subject to sales tax in an increasing number of states and should continuously monitor the sales tax rules in each state where goods are sold to determine whether and how much sales tax may be owed in each jurisdiction.

Specifically, Wayfair greatly expands a state’s constitutional authority to impose tax on online sellers by broadening when a business is deemed to have sufficient presence in a state to be subject to sales tax without violation of the due process clause.2 Prior to Wayfair, it was unconstitutional to require a business with no physical presence in a state (e.g., an out-of-state business with just online sales shipped to a state) to collect and remit sales tax in that state.3 In Wayfair, however, the U.S. Supreme Court held that a business can be subject to sales tax in a state based on economic factors alone, without requiring any physical presence in the state.4 The analysis of determining when a business can constitutionally be subject to tax is referred

2. Id.

Christina Heddesheimer, LL.M. (christina.heddesheimer@haynesboone.com) is an associate in the Dallas office of Haynes and Boone, LLP.
to as “nexus,” and if a business has tax nexus in a state, it will have a tax filing obligation in that state for certain types of taxes.5

This article outlines the analysis involved in determining the existence of tax nexus and the amount of tax liability for online sales in a franchise system. The discussion will focus on how to determine whether tax nexus exists, with a particular emphasis on nexus rules targeting online sellers, and, if tax nexus does exist, how to determine the responsible party and the applicable sales tax rate on a sale. This article will also discuss common sales tax exemptions and the apportionment of income tax liability with respect to sales made in a franchise system, including examples of the allocation of income and sales tax liability in a fictitious franchise system that will illustrate tax considerations in several common online sale scenarios.

Note that this article only discusses nexus and apportionment issues related to sales tax and income tax, with a particular emphasis on sales tax. The analysis of federal tax liabilities and other state and local tax liabilities, such as franchise tax and property tax, is distinct and beyond the scope of this article, but should also be considered when assessing the total tax liability within a franchise system.

I. State Tax Nexus

The nexus rules in a state determine the amount of business activity that a taxpayer must have in the state before the taxpayer becomes subject to tax in that state. The primary types of state tax nexus applicable to a franchise system are sales tax nexus and income tax nexus.6 Although the two nexus regimes include many common factors, the two analyses are different and must be undertaken separately. As a rule, there is a lower activity threshold for sales tax nexus than income tax nexus, particularly following the ruling in Wayfair.7 Accordingly, a franchisor with sales tax nexus in a state may not have income tax nexus in that state, but a franchisor with income tax nexus in a state will typically also have sales tax nexus in that state.

Although often similar, each state has its own distinct set of nexus laws and rules, and each state's respective laws must therefore be considered separately. The following is a general overview of the different types of sales and income tax nexus laws, followed by an overview of the calculation of sales tax rates and the apportionment of income if income tax nexus is established.

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6. Id.

A. Sales Tax Nexus and Sales Tax Rates

A company will have sales tax nexus in a particular state if it has a significant enough connection to the state to create a sales tax filing obligation in that state. If a franchisor or franchisee has sales tax nexus in a state, it will be liable for sales and use tax for sales made in that state, unless an exemption applies. Without sales tax nexus, there is no liability for sales or use tax for sales made in that state. Use tax is traditionally a tax owed by an end consumer on a sale that would not otherwise be subject to sales tax. Some nexus statutes are styled as the obligation for a seller to remit a buyer’s use tax, presumably to avoid the pre-Wayfair physical presence requirement. Because the obligation to remit use tax is virtually identical to the obligation to remit sales tax, for simplicity, this discussion will refer only to the obligation to collect and remit sales tax, which in some states may technically be an obligation to collect and remit use tax.

Each state has its own set of nexus rules, but, in general, before Wayfair, sales tax nexus was created by having a physical presence in a state, such as an office, employee, storage of inventory in a warehouse, presence at a trade-show, or presence of an affiliate. Now, following Wayfair, physical presence in a state is not required, and economic presence, such as making sales that exceed a certain dollar threshold within a state, or having a certain number of transactions with customers within the state, may be enough to create sales tax nexus. Following is an overview of the primary types of sales tax nexus laws aimed at taxing sales from online sellers, followed by an overview of how to determine the applicable sales tax rate.

1. Economic Nexus

Under economic nexus laws, certain out-of-state sellers are obligated to collect and remit sales tax to the state on in-state sales based on an economic presence alone. Although the threshold for economic nexus varies by state, it is generally based on the number of sales a seller made in the state, or the seller’s gross receipts in the state from in-state sales during the previous year. The gross receipts threshold for economic nexus is generally between

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11. See, e.g., Wash. Admin. Code § 458-20-221(2)(b)(ii) (requiring out-of-state sellers, with certain types of nexus, such as affiliate nexus, to collect and remit use tax on in-state sales).
12. See Gall & Kulwicki, supra note 9.
14. See Appendix 1 for a summary of all economic nexus laws.
15. Id.
$100,000\textsuperscript{16} and $250,000,\textsuperscript{17} but can be as high as $500,000,\textsuperscript{18} and the threshold for the number of sales for economic nexus is generally 200\textsuperscript{19} separate transactions in the immediately preceding calendar year.

Although some states had economic nexus laws prior to \textit{Wayfair}, their constitutionality was uncertain. The \textit{Wayfair} decision, however, has confirmed the constitutionality of economic nexus laws, and thus a large number of states are passing economic nexus laws, and will likely continue to do so in the months and years to come, to increase sales tax revenue collected from out-of-state sellers. Specifically, in the few months since the \textit{Wayfair} decision, states that have enacted economic nexus laws, or announced enforcement of previously enacted economic nexus laws, include Alabama (enforcement beginning October 1, 2018), Colorado (enforcement beginning December 1, 2018), Connecticut (enforcement beginning December 1, 2018), Georgia (enforcement beginning January 1, 2019), Hawaii (enforcement beginning July 1, 2018), Illinois (enforcement beginning October 1, 2018), Indiana (enforcement beginning October 1, 2018), Iowa (enforcement beginning January 1, 2019), Kentucky (enforcement beginning October 1, 2018), Louisiana (enforcement beginning January 1, 2019), Maine (enforcement beginning July 1, 2018), Maryland (effective October 1, 2018), Michigan (enforcement beginning October 1, 2018), Minnesota (enforcement beginning October 1, 2018), Mississippi (enforcement beginning September 1, 2018), Nebraska (enforcement beginning January 1, 2019), Nevada (enforcement date pending), New Jersey (enforcement beginning October 1, 2018), North Carolina (enforcement beginning November 1, 2018), North Dakota (enforcement beginning October 1, 2018), South Dakota (enforcement date pending), Tennessee (enforcement date pending), Utah (enforcement beginning January 1, 2019), Vermont (enforcement beginning July 1, 2018), Wisconsin (enforcement beginning October 1, 2018), and Wyoming (enforcement date pending).\textsuperscript{20}

2. Affiliate Nexus

In states with affiliate nexus laws, certain out-of-state sellers who have a connection to an in-state entity that may be related in some way, or that perform certain work that can be attributed to the out-of-state seller, may be liable for state sales taxes.\textsuperscript{21} The type of connection that creates affilia-

\textsuperscript{17} See Ala. Admin. Code § 810-6-2-.90.03 (amended 2018).
\textsuperscript{20} See Appendix 1.
ate nexus differs by state, but, in some states, these laws create nexus for a franchisor that has a franchisee in a particular state.

For example, in Michigan, sales tax nexus exists if the seller or another person, including an affiliated person, sells a similar line of products as the seller and does so under the same or similar business name as the seller. In Georgia, sales tax nexus exists if an out-of-state seller (1) has a related member with substantial nexus in Georgia that sells a similar line of products as the out-of-state seller, and does so under the same or similar business name, or (2) uses trademarks, services marks, or trade names in Georgia that are the same or substantially similar to those used by the out-of-state seller.

3. Click-Through Nexus

Click-through nexus laws generally create sales tax nexus when an out-of-state seller contracts with an in-state marketing company that receives a commission on sales for posting web-links on their in-state website that connect visitors to the website of the out-of-state seller. Nexus is presumed under these laws if the sales generated through the marketing company's website exceed a certain revenue threshold, which is typically $10,000 for the preceding twelve months. For example, in Ohio, a seller has nexus with the state if it enters into an agreement with a resident of the state and the resident, for a commission or other consideration, directly or indirectly refers potential customers to the seller, whether by a link on a website, an in-person oral presentation, telemarketing, or otherwise, provided the cumulative gross receipts from such sales referred to the seller by such resident exceeded $10,000 during the preceding twelve months.

4. Other Types of Sales Tax Nexus and Notice and Reporting Requirements

Other types of sales tax nexus aimed at taxing sellers who do not have a physical presence in a state include mail-order sales nexus, which is created when out-of-state sellers solicit orders for in-state sales by mail, advertising, catalogs, or other forms of media. For example, in Florida, every dealer

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23. A “related member” is defined in Georgia as a taxpayer (A) that is a related person, (B) that is a member of a group of controlled group of corporations (as defined in Section 1563(b) of the Internal Revenue Code), (C) to or from whom there would be required an attribution of stock ownership under Section 1563(c) of the Internal Revenue Code, or (D) that bears the same relationship to the taxpayer as a person described in (A) through (C). Ga. Code Ann. § 48-7-28.3(7).
27. See, e.g., Fla. Stat. § 212.0596(2).
who makes a mail-order sale is subject to Florida’s sales tax if the dealer, by purposely or systematically exploiting the market provided by Florida through any media means—including direct mail advertising, unsolicited distribution of catalogs, computer-assisted shopping, television, radio, magazine or newspapers—creates nexus with Florida.29

Certain states also impose notice and reporting requirements that require out-of-state sellers to report retail sales and provide notice to customers of tax due when the seller does not collect sales or use tax on taxable sales. For example, Kentucky requires out-of-state sellers lacking a physical presence in the state that make sales of tangible personal property or digital property from outside the state for use in Kentucky, that are not required to collect tax in Kentucky, to notify Kentucky customers of the obligation to report and pay use tax directly to the Kentucky Department of Revenue.30

5. Sales Tax Rate

After a franchisor determines that sales tax nexus exists based on the applicable state law, the next step is to determine how the applicable sales tax rate for a sale is calculated. Accounting software ordinarily assists with the calculation of sales tax rates, but it is helpful to have a basic understanding of how the rates are calculated. As with nexus rules, each state has its own set of rules related to the calculation of sales tax. Each state with a sales tax31 has a base sales tax rate, generally ranging from four percent to seven percent, that applies to all sales made within the state.32 Although some states only have a base sales tax rate,33 most states impose additional local county and city taxes, and some states also impose taxes in special taxing districts.34 For example, the total 6.75% sales tax rate in Centennial, Colorado, is calculated as follows: (a) 2.9% for State of Colorado, (b) 0.25% for Arapahoe County, (c) 2.5% for the City of Centennial, (d) 1% for the Regional Transportation District, and (e) 0.1% for the Scientific and Cultural Facilities District,35 which includes the Colorado base sales tax rate of 2.9%, plus additional local taxes.

For online sales, two methods generally determine which sales tax rate applies to the sale.36 States tend to calculate the sales tax rate based either on

29. Id.
31. All states except Alaska, Delaware, Montana, New Hampshire, and Oregon charge a sales tax.
the location of the seller (Origin-Based Sales Tax Collection), or the location where the goods are delivered (Destination-Based Sales Tax Collection). 37 For states that have Origin-Based Sales Tax Collection, the sales tax rate will be based on the location where the order is received and will be the same for all sales made within the state from that location. 38 A sale is generally deemed to be made within a state for purposes of Origin-Based Sales Tax Collection if the order is received at a business location within the state and shipped to a buyer located within the same state. 39 The definition of when an order is received varies by state, but, for example, in Arizona, an order is deemed to be received when all of the information necessary to accept the order has been received by or on behalf of the seller, regardless of where the order is accepted or approved. 40

Note that the Origin-Based Sales Tax Collection rule generally applies only to sales made in a state where the seller has some sort of physical business location where orders can be accepted and approved. 41 That is, if the seller (or someone who accepts orders on behalf of the seller) does not have a physical location in a state, the Origin-Based Sales Tax Collection rule will generally not apply to sales shipped to that state, and Destination-Based Sales Tax Collection will apply to the out-of-state sales that are shipped into the state. 42

For states that have Destination-Based Sales Tax Collection, the sales tax rate will generally be based on the location where receipt by the purchaser occurs, which can be indicated by the address listed in the delivery instructions, 43 regardless of whether the order is received from a business location within the state. Almost all states that do not have Origin-Based Sales Tax Collection have Destination-Based Sales Tax Collection, meaning that the majority of states have Destination-Based Sales Tax Collection.

37. Id.
39. See, e.g., Statutes Cited, supra note 38.
40. Ariz. Rev. Stat. Ann. § 42-5040(A); see also Ohio Rev. Code Ann. § 5739.033(B)(3) (“The location where an order is received by or on behalf of a vendor means the physical location of the vendor or a third party such as an established outlet, office location, or automated order receipt system operated by or on behalf of the vendor, where an order is initially received by or on behalf of the vendor . . . .”).
41. See Statutes Cited, supra note 38.
42. See Statutes Cited, supra note 38.
43. See, e.g., tit. 1, 3 Vt. Code R. § 1.9701(8)-3(A)(2) (“When the product is not received by the purchaser at a business location of the seller, the sale is sourced to the location where receipt by the purchaser . . . occurs, including the location indicated by instructions for delivery to the purchaser.”).
To illustrate the application of Destination- versus Origin-Based Sales Tax Collection, if an order is received at an office in Dallas, Texas, with instructions to deliver the product to a buyer in Houston, Texas, the applicable sales tax rate will be based on the location of the seller in Dallas, Texas, because Texas is an Origin-Based Sales Tax Collection state, and the order was received at a business location in Texas. On the other hand, if an order is received at an office in Dallas, Texas, with instructions to deliver the product to a buyer in Salt Lake City, Utah, the applicable sales tax rate will be the location of the buyer in Salt Lake City, Utah, even though Utah is an Origin-Based Sales Tax Collection state, because the order was received outside the state and thus Destination-Based Sales Tax Collection will apply.

B. Income Tax Nexus and Income Apportionment

1. Income Tax Nexus

Unlike the post-Wayfair sales tax nexus rules, income tax nexus requires that a franchisor have some sort of physical presence in a state, such as a brick-and-mortar storefront or some other physical location, inventory in a warehouse, employees who are soliciting sales or performing other functions in the state, or contracting with an in-state firm to perform certain services on behalf of the franchisor. The issue of whether physical presence is required to create income tax nexus is still uncertain, as the Wayfair decision only addressed whether physical presence was required to create sales tax nexus.

In 1959, Congress passed Public Law No. 86-272 to protect out-of-state companies from being subjected to income tax in a state based only on having independent contractors in the state soliciting sales from in-state customers. The protection provided by Public Law 86-272 is still applicable today and is important to understanding what can and cannot create income tax nexus. Specifically, Public Law 86-272 provides that a company that only performs the following activities in a state cannot be subject to income tax in that state:

- directly or indirectly soliciting sales of tangible personal property;
- providing services that are ancillary to the sales of property;
- displaying samples of goods for display in the state and other property, such as cars and computers, used for sales in the state; and
- accepting and fulfilling orders outside the state.

However, the following activities are not protected under Public Law 86-272:

- selling services (only the sale of tangible personal property is protected);
- accepting orders in a state, delivering property into the state via company vehicles, accepting deposits for sales in the state;

44. 15 U.S.C § 381.
45. Id.
• repossessing property in the state; or
• having inventory in the state.\footnote{46}

Based on Public Law 86-272, a state cannot find income tax nexus for a taxpayer whose only connection to a state is the solicitation of orders for tangible personal property, provided that the orders are accepted, shipped, or delivered from outside of the state. Public Law 86-272 only protects companies from being subjected to income tax, and not sales tax, or any other type of tax.

In 2002, in an attempt to make income nexus laws more uniform among states, the Multistate Tax Commission published the “Factor Presence Nexus Standard for Business Activity Taxes”\footnote{47} (MTC Standard). The MTC Standard provides that substantial nexus is established if any of the following thresholds are exceeded during the tax period:

(a) a dollar amount of $50,000 of property;
(b) a dollar amount of $50,000 of payroll;
(c) a dollar amount of $500,000 of sales; or
(d) twenty-five percent of the company’s total property, total payroll, or total sales are located in the state.\footnote{48}

Although the property and payroll factors would require a physical presence in the state, the sales factor is based on economic presence.\footnote{49} Many states have adopted some variation of the MTC Standard.\footnote{50}

Franchisors should be aware that the mere presence of intangibles in a state, including licensing intangibles to an in-state franchisee, may create income tax nexus.\footnote{51} Although this issue is still not settled, in 1993 the South Carolina Supreme Court held that parent company Toys “R” Us, Inc. which had no physical presence in the state, had income tax nexus in South Carolina because its intellectual property holding company, Geoffrey LLC, licensed trademarks and trade names to subsidiaries in South Carolina who paid a royalty fee to Geoffrey LLC for the use of the intellectual property.\footnote{52} Similarly, in \textit{KFC Corporation v. Iowa Department of Revenue},\footnote{53} an Iowa district court held that KFC, a Delaware corporation with its principal place of business in Delaware, had income tax nexus in Iowa because it had intangible assets in Iowa and its intellectual property was used by an Iowa franchisee.

\textsuperscript{48} Id. at 1, § (B).  
\textsuperscript{49} Id. at 2–3, § (C)(3).  
\textsuperscript{53} KFC Corp. v. Iowa Dep’t of Rev., 792 N.W.2d 308 (Iowa 2010).}
of business in Kentucky, had income tax nexus in Iowa because it licensed the KFC trademark and system to franchisees in Iowa, for which it received royalty payments, even though KFC had no physical property or employees in Iowa.54

As with sales tax nexus, an income tax nexus analysis should be undertaken in each state in which a company has any type of connection. It is possible that states may base income tax nexus on economic factors alone, although income tax nexus based on economic factors alone has not been definitively declared constitutional.55

2. Income Apportionment

In general, if a company has income tax nexus in only one state, all of its income will be subject to income tax in that state, and the analysis of income apportionment is not relevant. However, if a company has income tax nexus in more than one state, it must determine which portion of its income is taxed in each state.56 The goal of income apportionment between states is that each portion of a company's income should only be taxed once. Most states have an income apportionment formula that is based on the Uniform Division of Income for Tax Purposes Act of 1957 (UDITPA).57 The UDITPA formula apportions income from a company based on an average of three ratios:

1. property in the state divided by all company property;
2. payroll in the state divided by all company payroll; and
3. sales in the state divided by all company sales.58

The apportionment formula is then multiplied by a company's total income to determine how much income is allocable to that state.59 Some states weigh one factor more heavily than another in their apportionment formulas, and some may even consider only a single factor in their formula.60 For example, Alabama uses a three-factor apportionment formula and double-weights the sales factor.61 Kentucky, for tax years beginning on or after January 1, 2018, uses a single sales factor formula to determine income apportionable to the state and does not consider property or payroll at all.62

54. Id.
55. There has, however, been some speculation that the Wayfair ruling may also be used as a basis to eliminate the physical presence requirement from income tax nexus. See Deloitte Tax, Wayfair—Potential Income Tax Nexus Ramifications, External Multistate Tax Alert (June 28, 2018).
56. Multistate Tax Comm’n, Allocation and Apportionment Regulations (Feb. 21, 1973, as revised July 29, 2010).
58. Id.
59. Id.
It should be noted that, even if a company has income that would otherwise be apportioned to a state, no income tax is owed in a state unless income tax nexus exists. Thus, confirmation of nexus should precede any analysis of income apportionment.

II. Sales Tax Exemptions

A sales tax exemption is a law or rule that exempts certain transactions from sales tax. Common sales tax exemptions are based on the type of goods sold, the use of the goods sold, and the type of purchaser. In addition, like nexus laws, the sales tax exemption laws, although often similar, vary by state, and each state’s exemptions must be considered individually.

A. Sales Tax Exemptions for Type of Goods Sold

Sales tax generally applies to tangible personal property and certain services, such as, depending on the state, amusement services, credit reporting services, debt collection services, insurance services, Internet access services, personal services (laundering, dry cleaning, massage), motor vehicle and parking services, real property services, and intangibles like digital goods. Examples of goods that may be exempt from sales tax or subject to sales tax at a reduced rate include necessity goods, such as grocery store foods and prescription drugs. However, alcoholic beverages, over-the-counter drugs, soft drinks, candy, and confection, as well as prepared foods like hamburgers, sandwiches, and juices, are generally not tax-exempt and subject to sales tax at the full rate.

Additional examples of the types of goods that may be exempt from sales tax, depending on each state’s laws include:

- certain clothing and footwear;
- computer software;
- digital products;
- containers and packaging;
- paper goods or products;
- bakery items;
- non-carbonated beverages (although, in some states, these must be sold for consumption off premises);
- certain types of medical equipment;
- mobility enhancing equipment;

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64. Id.
65. Id.
66. Id.
67. Id.
• vitamins and supplements; and
• newspapers.68

Examples of the types of services that may be exempt from sales tax, depending on each state’s laws include:
• copying services for copying documents and other papers;
• delivery services for the delivery of tangible personal goods;
• transportation services;
• warehousing services;
• building maintenance services;
• dry cleaning services;
• janitorial services;
• lawn care services;
• pest control/extermination services;
• pool cleaning services;
• snow removal services;
• trash/garbage removal services;
• alteration of clothing services;
• computer services;
• Internet access services;
• butchering/meat cutting services;
• home health services;
• medical services;
• armored car services;
• car washing services;
• limousine services;
• motor vehicle towing services;
• accounting services;
• advertising services;
• credit and collection services;
• engineering services, legal services;
• management consulting services;
• payroll services;
• security services; and
• veterinary services.69

68. Id.
69. Id.
Sales tax exemptions based on the type of goods and services are the most difficult to navigate, given the number of different categories of goods and services. Franchise systems should evaluate what types of goods and services they provide, and which of these goods and services may qualify for sales tax exemptions in the states where sales tax nexus exists.

B. **Type of Use for Goods Sold**

Goods that are finished products sold for resale, or goods that are sold as component parts to be included in a finished product, are typically exempt from sales tax, assuming that the reseller can provide a valid resale certificate. The reseller is then required to collect and remit sales tax when the reseller later sells the finished products, unless the finished product qualifies for some other type of sales tax exemption.

To qualify for this type of exemption, in most states the seller who sells to the reseller must receive a valid resale certificate from the reseller; otherwise, the original seller will generally remain liable for sales tax on the sale. The requirements for a valid resale certificate vary by state, but most states accept either a resale certificate issued by the state, or a Uniform Sales and Use Tax Certificate from the Multistate Tax Commission. For wholesalers that deal primarily in resale transactions, some states allow for “blanket” resale certificates that apply to numerous transactions for repeat customers who make multiple purchases throughout the year.

A resale certificate alone may not be sufficient to qualify for the resale exemption, as the original seller must generally have a good-faith basis to believe the exemption applies. A good-faith basis is typically present if the original seller verifies the information on the certificate is accurate, that the certificate fits the business for which it is given, and that the exemption could reasonably apply to the sale. Additionally, in some states, a resale certificate

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70. See, e.g., Ala. Code § 40-23-1(a)(9)(b) (noting that sales of materials that become ingredients or component parts of manufactured items are exempt from sales tax in Alabama); Colo. Rev. Stat. § 39-26-102(20)(a) (noting that sales of materials that become ingredients or component parts of manufactured items are exempt from sales tax in Colorado).
73. See, e.g., Conn. Agencies Regs. § 12-426-1 (Connecticut permitting a blanket resale certificate if a buyer plans on making a continuing line of purchases for resale from the same seller).
74. See, e.g., Conn. Gen. Stat. §12-410(2) (Connecticut requiring that a seller accepts the resale certificate in good faith for the resale certificate to be valid).
75. See, e.g., id. §12-410(2)(C) (noting that a certificate in Connecticut is deemed to be taken in good faith if “the tangible personal property or service purchased is similar to or of the same general character as property or service which the seller could reasonably assume would be sold by the purchaser in the regular course of business”).
expires after a certain period of time.\footnote{76 See, e.g., Fla. Admin. Code Ann. § 12A-1.039(2)(a) (noting that a resale certificate is valid in Florida for one year); Me. Rev. Stat. Ann. 36 § 1754-B(2-C) (noting that a resale certificate is valid in Maine for five years).} Therefore, it is good practice for an original seller to request an updated resale certificate from resellers on an annual basis. Additionally, some states require that resale certificates be kept for a certain period in case they need to be presented to the state later during an audit. For example, Georgia requires that a seller keep a resale certificate for three years,\footnote{77 See Ga. Code Ann. § 48-8-52(a).} and Maine requires retailers to retain resale certificates for at least six years.\footnote{78 Me. Instructional Bulletin No. 54 (Jan. 12, 2007).} Other states, such as Texas, do not require retail sellers to keep resale certificates on file.\footnote{79 See, e.g., Tex. Tax Code Ann. § 131.054(e) (Texas requiring only that a resale certificate be in the seller’s possession at the time the exempt transaction occurs, or within 60 days from the Comptroller’s notice to the seller requiring that the certificate be produced).} Even in states that do not require sellers to keep resale certificates on file, it is advisable to always request and retain one in the event of an audit.

C. Type of Purchaser

Federal law prohibits states from taxing sales that are made to the federal government or various federal agencies.\footnote{80 McCulloch v. Maryland, 17 U.S. 316 (1819).} Most states also have sales tax exemptions for sales to the state, state agencies, cities, counties, and other local governmental jurisdictions in the state.\footnote{81 See, e.g., Ala. Code § 40-23-4(a)(11) (noting that sales to state government are exempt in Alabama); Conn. Gen. Stat. § 12-412(1) (noting that sales to state government are exempt in Connecticut).} Sales to certain types of non-profit organizations, such as charitable, religious, and educational organizations, may also be exempt from sales tax.\footnote{82 See, e.g., Conn. Gen. Stat. § 12-412(8) (noting that sales of tangible personal property to nonprofit organizations are exempt from sales tax in Connecticut); Ind. Code § 6-2.5-5-25 (noting that sales of tangible personal property to nonprofit organizations are exempt from sales tax in Indiana).}

III. Examples of Allocation of Income and Sales Tax Liability

To illustrate the application of the concepts discussed previously and the impact of \textit{Wayfair} in the franchise context, the following are examples of how to allocate and calculate income and sales tax liability on online sales made within a fictitious franchise system in various scenarios, along with examples of how \textit{Wayfair} might impact sales tax nexus. The examples will use the fictitious franchisor “Shake It Off” that franchises the opportunity to own and operate a business that sells nutritional weight loss shakes. Shake It Off is based in Virginia and has a place of business in the city of Fairfax, Virginia, with employees who process orders received from Internet sales. Shake It Off also has income and sales tax nexus in Virginia, and it has only sales tax nexus in Maryland, the District of Columbia, New Hampshire, and...
Ohio. Additionally, Shake It Off has franchisees in Virginia, Maryland, the District of Columbia, New Hampshire, and Ohio and requires franchisees to purchase all shake products directly from Shake It Off.

A. Allocation of Sales Tax Liability and Expansion of Sales Tax Nexus

1. Direct Franchisor Sale to End User

Shake It Off provides customers with the option to purchase its shakes online from the franchisor. If the shakes are sold online from Shake It Off and shipped to customers, Shake It Off will be responsible for collecting and remitting sales tax on online sales made to customers located in states where Shake It Off has sales tax nexus, that is, for sales made to customers in Virginia, Maryland, the District of Columbia, New Hampshire, and Ohio.

The method of determining sales tax rate will differ based on whether the shakes are sold to customers located in Virginia, or outside Virginia, since Shake It Off has a place of business in Virginia where orders are accepted, and Virginia is an Origin-Based Sales Tax Collection state.\(^83\) Specifically, in Virginia, the remote sale (by telephone, Internet, or mail order) of tangible personal property from an in-state dealer with a place of business in Virginia is sourced to the location in which the order was first taken.\(^84\) Therefore, if Shake It Off makes an online sale from its place of business in the city of Fairfax to a customer located in Loudoun County, Virginia, the sale will be sourced to the city of Fairfax, and the sales tax rate in the city of Fairfax will apply to the sale.\(^85\)

However, if Shake It Off sells shakes to a customer located in Ohio, the sales tax rate will be based on the location where the shakes are delivered,\(^86\) even though Ohio is an Origin-Based Sales Tax Collection state,\(^87\) because the origin-based rules apply only if the seller receives the order in Ohio and the goods are shipped to a buyer in Ohio.\(^88\) Because Shake It Off will receive the order at its place of business in Virginia, outside Ohio, the sales tax rate will be determined by the location where the buyer receives the shakes.

Following Wayfair, it is expected that Shake It Off will have sales tax nexus in additional states. For instance, owing to the popularity of Shake It Off’s peach-flavored shakes in Georgia, Shake It Off had gross revenue from sales in Georgia of $300,000 in 2017 and expects even greater revenue from Georgia sales in 2018. Despite this forecast, Shake It Off does not currently have sales tax nexus in Georgia because it has no franchisees in Georgia and has no other presence in Georgia that could have previously created nexus.\(^89\)

However, beginning January 1, 2019, Shake It Off is expected to have sales

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83. See discussion of Origin Based Sales Tax Collection, supra Section (II)(B).
85. Id. § 10-210-2070(B)(1).
87. Id. § 5739.033(B).
88. Id.
89. For purposes of this analysis, we are assuming that Shake It Off did not conduct any other activities in Georgia that may have created nexus, such as making regular deliveries to the
tax nexus in Georgia, since Georgia recently enacted an economic nexus law that provides that any seller that has gross revenue exceeding $250,000 in the previous or current calendar year from sales of tangible personal property delivered electronically or physically in Georgia, or that makes 200 or more sales of tangible personal property delivered electronically or physically in Georgia in the previous or current calendar year, will have sales tax nexus.\textsuperscript{90} Thus, beginning January 1, 2019, Shake It Off will need to collect and remit sales tax on online sales that it ships to customers located in Georgia.

2. Franchisor Sale to Franchisee Who Sells to End User

In this scenario, Shake It Off permits its franchisees to also sell its shakes online directly to customers. Since Shake It Off requires its franchisees to purchase all shakes from the franchisor directly, Shake It Off sells the shakes to its franchisees to hold in inventory. The sale from Shake It Off to its franchisees is generally expected to be exempt from sales tax, under a sale for resale exemption, provided that Shake It Off obtains a proper resale certificate from its franchisees to ensure the sale will be exempt from sales and use tax.\textsuperscript{91} It is best practice for Shake It Off to keep these resale certificates in its files in the event of a state audit and should be aware if any states require them to maintain resale certificates on file for a certain period of time.

The sale will be subject to sales tax when a customer submits an online order for a shake to a franchisee, at which point the franchisee will be responsible for collecting and remitting the sales tax in states in which the franchisee has sales tax nexus.\textsuperscript{92} The analysis for the applicable sales tax rate is the same as a sale from a franchisor to a customer; that is, if the sale is made in an Origin-Based Sales Tax Collection state and the franchisee receives an order from a place of business within that state, the applicable sales tax rate will be the rate that applies where the place of business that accepted the order is located. However, if the sale is made in a Destination-Based Sales Tax Collection state, or to a state where the franchisee does not have a place of business where orders are accepted, the applicable sales tax rate will be the rate that applies to the address where the shakes are instructed to be delivered, and sales tax will generally be owed in the state where the shakes are delivered.

B. Allocation of State Income Tax Liability

The analysis of allocation of income tax liability between a franchisor and franchisee will be the same regardless of whether a sale is made online or at a brick and mortar store. The following is a basic and limited discussion of state using its own vehicles or having an agreement with a Georgia resident where the resident receives a commission for referring customers to Shake It Off’s website.

\textsuperscript{90} GA Code § 48-8-30.

\textsuperscript{91} See discussion of resale certificates, supra Section (III)(B).

\textsuperscript{92} See discussion of resale certificates, supra Section (III)(B).
how income tax liability for the sale of the shakes will be allocated between a franchisor and a franchisee.

1. Direct Franchisor Sale to End User

If Shake It Off sells its shakes directly to its customers, it will be responsible for paying state income tax on all sales in Virginia, regardless of the location of the buyer, since Shake It Off has income tax nexus only in Virginia. However, if Shake It Off had income tax nexus in more than one state, it would need to use the income apportionment rules, discussed earlier in Section II(B)(2), to determine how to apportion its income among the various states in which it has income tax nexus.

A complete discussion of the calculation of income subject to state income tax is beyond the scope of this article. But, in general, it is expected that Shake It Off will be entitled to subtract expenses for its cost of goods sold, such as the cost of the fruit that it uses in its shakes, from the amount of income subject to state income tax.93 This reduction is proper because the amount of income subject to state sales tax, before any state additions, subtractions, payments, credits, deductions, etc., is based on total federal taxable income,94 and the cost of goods sold are subtracted from the calculation of federal taxable income.95

2. Franchisor Sale to Franchisee Who Sells to End User

If a franchisee sells directly to customers, it is generally expected that it will owe state income tax on the sale of the shakes, and it will also need to use the income apportionment rules, discussed earlier in Section II(B)(2), to determine how to apportion its income among the various states in which it has income tax nexus. Additionally, the franchisee should be entitled to subtract the cost of the shakes purchased from the franchisor from the amount of income subject to state tax,96 as the cost of the shakes is expected to qualify as a cost of goods sold.

IV. Conclusion

Every state has different, although often similar, laws related to sales tax and income tax nexus, sales tax exemptions, and income apportionment. A franchise system that conducts business in more than one state must therefore determine the applicable laws and rules in every state in which it has a physical presence, an economic presence, an affiliate such as a franchisee, or any other type of activity that may create nexus. The same state-by-state analysis is necessary to determine if the type of sales or services that a franchise

---

94. Id.
95. 26 C.F.R. 1.61-3(a).
96. See 2017 Virginia Form 500, supra note 93.
system sells are exempt from sales tax, or issues such as the type of resale certificate required for sales for resale. This analysis is particularly important for franchise systems with online sales because both the franchisors and the franchisees often overlook tax liability in states where only online sales are made, especially if those sales are not substantial. Franchise systems should be proactive about ensuring that all tax obligations are being met, both to avoid interest and penalties for late tax payments, as well as to avoid issues related to tax compliance if a franchisor decides to sell its franchise system or if a franchisee decides to sell its individual franchised location.
APPENDIX 1
Summary of States with Economic Nexus Laws

(as of September 14, 2018)
<table>
<thead>
<tr>
<th>State</th>
<th>Authority</th>
<th>Effective Date</th>
<th>Sales and Transaction Thresholds</th>
</tr>
</thead>
<tbody>
<tr>
<td>Alabama</td>
<td>Ala. Admin Code r. 810-6-2-.90.03</td>
<td>Oct. 1, 2018</td>
<td><strong>Sales:</strong> More than <strong>$250,000</strong> in sales of tangible personal property in the previous calendar year.</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Transaction:</strong> N/A</td>
</tr>
<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Other:</strong> Seller must also conduct certain other activities such as occupying or using a facility directly or indirectly, employing a sales representative or agent, or engaging in substantial and recurring solicitation of orders.</td>
</tr>
<tr>
<td>Colorado</td>
<td>Press Release, Colorado Dep't of Rev. Colorado to require online retailers to collect sales tax (Sept. 11, 2018)</td>
<td>Nov. 30, 2018</td>
<td><strong>Sales:</strong> More than <strong>$100,000</strong> in state sales of products annually; OR</td>
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<td></td>
<td></td>
<td></td>
<td><strong>Transaction:</strong> More than <strong>200</strong> separate transactions annually.</td>
</tr>
<tr>
<td>Connecticut</td>
<td>Conn. Gen. Stat. § 12-407(a) (15)</td>
<td>Dec. 1, 2018</td>
<td><strong>Sales:</strong> More than <strong>$250,000</strong> in gross receipts during the twelve-month period ending Sept. 30, 2018; AND</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Transaction:</strong> More than <strong>200</strong> retail sales during the twelve-month period ending Sept. 30, 2018.</td>
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<td></td>
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<td></td>
<td><strong>Other:</strong> Seller must also engage in regular or systematic solicitation of sales of tangible personal property in the state by doing things such as displaying advertisements on billboards, advertising by print, radio or television or by Internet, for the purpose of effecting retail sales.</td>
</tr>
<tr>
<td>Georgia</td>
<td>Ga. Code Ann. § 48-8-30</td>
<td>Jan. 1, 2019</td>
<td><strong>Sales:</strong> More than <strong>$250,000</strong> in gross revenue from retail sales of tangible personal property in the previous or current calendar year; OR</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Transaction:</strong> <strong>200</strong> or more retail sales of tangible personal property in the previous or current calendar year.</td>
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<tr>
<td></td>
<td></td>
<td></td>
<td><strong>Note:</strong> Sellers have the option to instead abide by notice and reporting requirements.</td>
</tr>
<tr>
<td>State</td>
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<td>Sales and Transaction Thresholds</td>
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<tr>
<td>Hawaii</td>
<td>S.B. 2514, 29th Leg. (Haw. 2018)</td>
<td>July 1, 2018</td>
<td>Sales: <strong>$100,000</strong> or more in gross income or gross proceeds from the sale of tangible personal property in the previous or current calendar year; OR Transaction: <strong>200</strong> or more sales of tangible personal property, services, or intangible property in the previous or current calendar year.</td>
</tr>
<tr>
<td>Illinois</td>
<td>35 Ill. Comp. Stat. §§ 105/2, 110/2</td>
<td>Oct. 1, 2018</td>
<td>Sales: <strong>$100,000</strong> or more in gross receipts from the sale of tangible personal property in the previous or current calendar year; OR Transaction: <strong>200</strong> or more sales of tangible personal property, services, or intangible property in the previous or current calendar year. Note: Retailer must determine on a quarterly basis whether it meets either of the thresholds for the preceding twelve-month period.</td>
</tr>
<tr>
<td>Indiana</td>
<td>Ind. Code § 6-2.5-2-1(c)</td>
<td>Oct. 1, 2018</td>
<td>Sales: More than <strong>$100,000</strong> in gross revenue from the sale of tangible personal property, a product delivered electronically, or a service in the previous or current calendar year; OR Transaction: <strong>200</strong> or more sales of tangible personal property, services, or intangible property in the previous or current calendar year.</td>
</tr>
<tr>
<td>Iowa</td>
<td>Iowa Code § 423.14A</td>
<td>Jan. 1, 2019</td>
<td>Sales: <strong>$100,000</strong> or more in gross revenue from sales in the previous or current calendar year; OR Transaction: <strong>200</strong> or more separate transactions in the previous or current calendar year.</td>
</tr>
<tr>
<td>Kentucky</td>
<td>H.B. 487, 2018 Gen. Assemb. (Ky. 2018)</td>
<td>Oct. 1, 2018</td>
<td>Sales: More than <strong>$100,000</strong> in gross revenue from the sale of tangible personal property or digital property in the previous or current calendar year; OR Transaction: <strong>200</strong> or more sales of tangible personal property, services, or intangible property in the previous or current calendar year. Note: Retailer must determine on a quarterly basis whether it meets either of the thresholds for the preceding twelve-month period.</td>
</tr>
<tr>
<td>State</td>
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<td>Effective Date</td>
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| Louisiana  | H.B. 17, 2nd Spec. Sess. (La. 2018)                                       | Jan. 1, 2019   | Sales: More than $100,000 in gross revenue from the sale of tangible personal property, digital products or services in the previous or current calendar year; **OR**  
Transaction: 200 or more separate transactions in the previous or current calendar year. |
| Maine      | 36 Me. Code R. § 1951-B                                                    | July 1, 2018   | Sales: More than $100,000 in gross revenue from the sale of tangible personal property, digital property, or services in the previous or current calendar year; **OR**  
Transaction: 200 or more separate transactions in the previous or current calendar year. |
| Maryland   | MD. Code Regs. 03.06.01.33 (proposed Aug. 2, 2018)                         | Oct. 1, 2018   | Sales: More than $100,000 in gross revenue from the sale of tangible personal property or services in the previous or current calendar year; **OR**  
Transaction: 200 or more separate transactions in the previous or current calendar year. |
| Massachusetts | 830 Mass. Code Regs. 64H1.7                                            | Oct. 1, 2017   | Sales: More than $500,000 in sales from transactions completed over the Internet during the preceding calendar year; **AND**  
Transaction: 100 or more separate transactions during the preceding calendar year. |
Transaction: 200 or more separate transactions in the previous calendar year. |
| Minnesota  | H.F. 1, 1st Spec. Sess., Minn. House of Rep. (Minn. 2017)                  | Oct. 1, 2018   | Sales: More than $100,000 in 10 or more transactions in any consecutive twelve-month period; **OR**  
Transaction: 100 or more separate retail transactions in any consecutive twelve-month period. |
<table>
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<tr>
<th>State</th>
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<tbody>
<tr>
<td><strong>Mississippi</strong></td>
<td>35-09 Miss. Code R. § 35.4.03.09</td>
<td>Sept. 1, 2018</td>
<td><strong>Sales:</strong> More than $250,000 in sales for the prior twelve months.</td>
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<td><strong>Transaction:</strong> N/A</td>
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<td><strong>Other:</strong> A seller must also “purposely or systematically” exploit the Mississippi market.</td>
</tr>
<tr>
<td><strong>Nebraska</strong></td>
<td>Press Release, Neb. Dep't of Rev., Statement from the Nebraska Department of Revenue Regarding the South Dakota v. Wayfair United States Supreme Court Decision (July 27, 2018)</td>
<td>Jan. 1, 2019</td>
<td><strong>Sales:</strong> More than $100,000 in sales annually; OR</td>
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<td></td>
<td><strong>Transaction:</strong> 200 or more separate transactions annually.</td>
</tr>
<tr>
<td><strong>Nevada</strong></td>
<td>Nev. Admin. Code § R189-18 (proposed Aug. 9, 2018)</td>
<td>Pending</td>
<td><strong>Sales:</strong> More than $100,000 in gross revenue from the sale of tangible personal property in the previous or current calendar year; OR</td>
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<td><strong>Transaction:</strong> 200 or more retail sales of tangible personal property in the previous or current calendar year.</td>
</tr>
<tr>
<td><strong>New Jersey</strong></td>
<td>Press Release, N.J. Dep't of Treasury, Sales and Use Tax Information for Remote Sellers (Aug. 14, 2018)</td>
<td>Oct. 1, 2018</td>
<td><strong>Sales:</strong> $100,000 or more in gross revenue from the sale of tangible personal property, specified digital products, or services in the previous or current calendar year; OR</td>
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<td></td>
<td><strong>Transaction:</strong> 200 or more separate transactions in the previous or current calendar year.</td>
</tr>
<tr>
<td><strong>North Carolina</strong></td>
<td>Press Release, N.C. Dept. of Rev., Sales and Use Tax Collections on Remote Sales Directive (Aug. 7, 2018)</td>
<td>Nov. 1, 2018</td>
<td><strong>Sales:</strong> $100,000 or more in gross sales in the previous or current calendar year; OR</td>
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<td><strong>Transaction:</strong> 200 or more separate transactions in the previous or current calendar year.</td>
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</table>
| North Dakota| S.B. 2298, 65th Leg. Assemb. (N.D. 2017)                 | Oct. 1, 2018   | **Sales:** $100,000 or more in gross sales from the sale of tangible personal property and other taxable items in the previous or current calendar year; **OR**  
**Transaction:** 200 or more separate transactions in the previous or current calendar year.                          |
| Ohio        | H.B. 49, 132nd Gen. Assemb. (Ohio 2017)                  | Jan. 1, 2018   | **Sales:** $500,000 or more of gross receipts in the previous or current calendar year from the sale of tangible personal property or services.                                                                                     
**Transaction:** N/A 
**Other:** A seller must also use in-state software to sell or lease taxable tangible personal property or services. |
| Oklahoma    | H.B. 1019, 2nd Ex. Sess. (Okla. 2018)                    | Apr. 10, 2018  | **Sales:** $10,000 or more in aggregate sales of tangible personal property during the immediately preceding twelve month period.                                                                                             
**Transaction:** N/A 
**Note:** Sellers have the option to instead abide by notice and reporting requirements.                                |
**Transaction:** N/A 
**Note:** Sellers have the option to instead abide by notice and reporting requirements.                                |
<table>
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<tr>
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</thead>
</table>
| **Rhode Island** | H.B. 5175, State Leg. (R.I. 2017)                                         | Aug. 17, 2017 (Retroactive Enforcement) | **Sales**: $100,000 or more in gross revenue from the sale of tangible personal property, prewritten computer software or services in the immediately preceding calendar year; **OR**  
**Transaction**: 200 or more separate transactions in the immediately preceding calendar year.  
**Note**: Sellers have the option to instead abide by notice and reporting requirements. |
| **South Dakota** | S.B. 106, 2016 Reg. Sess. (S.D. 2016)                                      | Nov. 1, 2018   | **Sales**: More than $100,000 in gross revenue from the sale of tangible personal property, any product transferred electronically or services in the previous or current calendar year; **OR**  
**Transaction**: 200 or more separate transactions in the previous or current calendar year.  
**Note**: South Dakota cannot begin enforcing economic nexus until an injunction issued against the South Dakota Department of Revenue is lifted. |
**Transaction**: N/A  
**Other**: Seller must also engage in regular or systematic solicitation of in-state customers through any means. |
| **Utah**      | S.B. 2001, 2018 2nd Spec. Sess. (Utah 2018)                              | Jan. 1, 2019   | **Sales**: More than $100,000 in gross revenue from the sale of tangible personal property, any product transferred electronically, or services in the previous or current calendar year; **OR**  
**Transaction**: 200 or more separate transactions in the previous or current calendar year. |
<table>
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| Vermont  | H.B. 873, 2015–2016 Reg. Sess. (Vt. 2016)          | July 1, 2018   | **Sales**: $100,000 or more in sales during any twelve-month period; **OR**
|          |                                                     |                | **Transaction**: 200 or more individual transactions in any twelve-month period. |
|          |                                                     |                | **Other**: Seller must also engage in regular, systematic or seasonal solicitation of sales of tangible personal property in the state. |
|          |                                                     |                | **Threshold 2**: $10,000 or more in retail sales (no transaction threshold). Under Threshold 2, out-of-state sellers have the option to instead abide by notice and reporting requirements. |
|          |                                                     |                | **Transaction**: 200 or more separate transactions. |
| Wyoming  | H.B. 119, 2017 Reg. Sess. (Wyo. 2017)               | Pending        | **Sales**: More than $100,000 in gross revenue from the sale of tangible personal property, admissions or services in the previous or current calendar year; **OR**
|          |                                                     |                | **Transaction**: 200 or more separate transactions in the previous or current calendar year. |
System Standards and Franchisee Innovation: Striking a Balance

Mark J. Burzych

In 1972, Ray Kroc was in southern California at the request of one of his most trusted franchisees, Herb Peterson, who asked Kroc to come right away to see something (which he declined to identify in advance) at Peterson’s store.¹ When he arrived at Peterson’s McDonald’s restaurant in Santa Barbara, Kroc was presented with an innovative new menu item of Peterson’s creation: the Egg McMuffin.² Peterson apparently felt he had to proceed under that kind of secrecy to get Kroc, a stickler for the McDonald’s system standards,³ to even consider adopting such a radical departure from the lunch and dinner menu that made McDonald’s a household name.⁴ The rest, as they say, is (QSR) history.

The Egg McMuffin is not the only breakthrough product that originated in the mind of a franchisee. For example, in 2004, a Subway franchisee operating within Jackson Memorial Hospital in Miami, Florida, was struggling with sales on the weekend.⁵ His solution was to sell foot-long submarine sandwiches for just five dollars on those slow weekends.⁶ Sales at the Jackson Memorial Hospital Subway location skyrocketed during those weekend promotions and, four years later, Subway officially adopted the “Five Dollar Footlong” as a nationwide campaign. Not long after, in 2009, the promotion

². Id.
⁴. Rothman, supra note 1.
⁶. Id.
was generating $3.8 billion in sales. Similarly, years before, a McDonald’s franchisee named Jim Delligatti, who could not satisfy the appetites of Pittsburgh steelworkers with McDonald’s standard cheeseburgers, took the initiative to improve the standard offering by adding another beef patty, lettuce, pickles, and onions, all stabilized with a middle bun. The newly created “Big Mac” was introduced systemwide in 1968, and, a year later, “the burger was generating nineteen percent of McDonald’s revenue.” The “Big Mac,” a franchisee innovation, is now the flagship sandwich for the McDonald’s brand. Finally, a franchisee’s innovative marketing concept, a low-price pizza ready within five minutes of order dubbed the “Hot-N-Ready,” was “a promotion some say saved” the Little Caesars restaurant chain.

While these origin stories are telling, the story of the Egg McMuffin, in particular, illustrates the tension at play when a franchisee takes affirmative steps to improve, innovate, or reinvent the system standards of a franchisor. Franchisors need to enforce standards and specifications to ensure uniformity throughout their systems; however, enforcing system standards too strictly has the consequence of stifling franchisee innovation and improvement to the current system. Peterson’s coy means of getting Kroc in the door illustrates Peterson’s reluctance to violate system standards, but Kroc’s ultimate adoption of the Egg McMuffin evidenced a flexibility to allow franchisee innovation to help push the system forward.

But when a franchisee innovation is adopted system-wide, who owns that innovation or improvement to the system? Who owns that intellectual property in the absence of controlling contractual terms? Are such contractual terms even enforceable? And, if so, what are the best practices for ensuring that the franchisor retains ownership of innovations adopted to its system while producing a franchise culture that is intent on enforcement of system standards yet flexible enough to encourage improvements?

I. Background: Copyright and Trademark Law

A. Copyright

Copyright law, at its most basic, protects the intellectual property of those who create “original works of authorship.” These creations often include works of literature, music, drama, dance choreography, pictures, graphics,
sculptures, movies, sound recordings, and architecture.\textsuperscript{12} Importantly, copyright law includes neither protection of the underlying ideas of the work, nor the “procedure, process, system, method of operation,” nor the concept embodied in the work.\textsuperscript{13} Copyright protection affords the owner of the copyright the right to exclude others from using the work without first obtaining permission or paying for the right.\textsuperscript{14} Protection of qualifying works includes exclusive rights to reproduce the work, to distribute the work through sale, “rental, lease, or lending,” and to perform works capable of performance.\textsuperscript{15} That protection takes hold as soon as the work is “fixed in any tangible medium of expression.”\textsuperscript{16} The copyright owner need not take any additional action to gain the legal protection provided by the statute.\textsuperscript{17}

Copyright is held by the original “author or authors of the work.”\textsuperscript{18} Works created by employees, in the course of their work, are considered the work of their employers unless an express agreement states otherwise.\textsuperscript{19} Notably, ownership of a tangible object in which the work is embodied does not constitute ownership of the copyright; those two rights of ownership are distinct.\textsuperscript{20} Ownership of a copyright can be transferred by assignment in part or in whole\textsuperscript{21} so long as the assignment “is in writing and signed by the owner of the rights conveyed or such owner’s duly authorized agent.”\textsuperscript{22} This writing requirement is strictly enforced.\textsuperscript{23} Thus, when a franchisee creates system improvements, does that franchisee own the copyright to such improvements?

\section*{B. Trademark}

Fundamentally, a trademark is “any word, name, symbol, or device, or any combination thereof . . . to identify and distinguish his or her goods . . . from those manufactured or sold by others and to indicate the source of the goods.”\textsuperscript{24} To qualify as a trademark, the “word, name, symbol, or device”

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\textsuperscript{12} Id.

\textsuperscript{13} 17 U.S.C. § 102(b). Instead, trade-secret law might be the best way to protect a franchisor’s ideas, processes, and operating system. See Jay Conison, Copyright and the Franchise, 14 \textit{Franchise L.J.} 69, 69 (1995).

\textsuperscript{14} 17 U.S.C. § 106.

\textsuperscript{15} Id.

\textsuperscript{16} 17 U.S.C. § 102(a).

\textsuperscript{17} See Mark S. Vanderbroek & Jennifer M. D’Angelo, Copyright Protection: The Forgotten Stepchild of a Franchise Intellectual Property Portfolio, 28 \textit{Franchise L.J.}, 84, 85 (2008). However, Vanderbroek and D’Angelo recommend that copyright holders display a copyright notice or symbol to maximize protection of the work and to deter infringers. Id. at 85–86.

\textsuperscript{18} 17 U.S.C. § 201(a).

\textsuperscript{19} 17 U.S.C. § 201(b). Given the current National Labor Relations Board position on “joint employer liability” (\textit{see generally} Browning-Ferris Indus. of Calif., 362 NLRB No. 186 (2015)), I hesitate to analogize the franchise and employment relationships; however, in this limited context, the treatment of employee-created works may be illustrative.


\textsuperscript{21} 17 U.S.C. § 201(d)(1).

\textsuperscript{22} 17 U.S.C. § 204(a).

\textsuperscript{23} See Conison, \textit{supra} note 13, at 69.

\textsuperscript{24} 15 U.S.C. § 1127.
must be used in commerce by a person, or that person must have a “bona
fide intention” to do so.25 Trademarks distinguish goods sold by one seller
from those of another seller, tell consumers that all products under a given
mark are from a common source, inform consumers that all goods with that
mark are “of an equal level of quality,” and thereby perform a key function in
the marketing and sale of products and services.26 Further, trademarks func-
tion as a symbol of the “good will and reputation that a business has built up
in a product or service.”27

A trademark is a property right.28 The ownership of a trademark is, in
essence, the right to exclude others from its use in commerce.29 Trademark
rights necessarily entail the right to prevent others from misleading the buy-
ing public by using the same—or a confusingly similar—mark.30

Trademark rights, under common law, are acquired by whoever is the
“first to use” the mark in commerce.31 Generally, showing a prior use requires
evidence of adoption and of use of the mark “in a way sufficient to iden-
tify or distinguish the marked goods” so that the public comes to associate
the marked products with the adopter of the mark.32 Trademark rights are
assignable by written instrument.33 Trademarks may also be licensed, mean-
ing that the owner can give a “limited permit to another to use the mark.”34

Once a trademark is used in commerce, the trademark owner perfects its
trademark rights. If a franchisee creates a new product for the system and
uses a new trademark in relation to that good or service in commerce, does
the franchisee perfect its trademark rights?

II. Ownership of Franchisee-Created Intellectual
Property Absent Contractual Terms

When a franchisee deviates from system standards and thereby improves
a franchisor’s system or creates an entirely new product or marketing
scheme, both the franchisor and franchisee may claim ownership of the

25. Id.
26. J. Thomas McCarthy, McCarthy on Trademarks and Unfair Competition § 3.2 (5th
ed. 2017).
27. Id.
28. Id. § 2.10.
666, 667 (1999) (“The hallmark of a constitutionally protected property interest is the right to
exclude others.”).
30. See McCarthy, supra note 26, § 2.10.
31. See, e.g., Commodores Entm’t. Corp. v. McClary, 879 F.3d 1114, 1131 (11th Cir. 2018)
quoting Columbia Mill Co. v. Alcorn, 150 U.S. 460, 463–64 (1893) (“[T]he exclusive right to
the use of the mark or device claimed as a trademark is founded on priority of appropriation;
that is to say, the claimant of the trade-mark must have been the first to use or employ the same
on like articles of production.”).
32. FN Herstal SA v. Clyde Armory, Inc., 838 F.3d 1071, 1081 (11th Cir. 2016); see also Am.
Foods, Inc. v. Golden Flake, Inc., 312 F.2d 619, 625 (5th Cir. 1963) (“The right to a particular
mark grows out of its use and not its mere adoption.”).
34. McCarthy, supra note 26, § 18.1.
innovation. In many cases, the franchisor will have secured ownership rights to improvements or innovations created by the franchisee through terms in the franchise agreement. However, absent such agreement, ownership of franchisee-created innovations to a franchisor’s system is less clear.

A. Copyright

The law is fairly straightforward concerning ownership of created materials. United States Code Title 17, Section 201, provides the bases for obtaining copyright ownership. Again, the original author of a copyrightable work is automatically vested with copyright protections upon the creation being “fixed in any tangible medium of expression.” 35 Copyright may also be obtained by the employer of the original author if the creation is a “work made for hire.” 36 Additionally, copyright can be obtained for the contribution to a collective work, but those rights are only coextensive with the amount contributed. 37 Finally, copyright protection can be transferred “by any means of conveyance,” either in part or in whole. 38

Perhaps not surprisingly, Title 17 is silent as to the respective rights of franchisors and franchisees when a franchisee creates copyrighted material that is adopted by its franchisor. As indicated earlier, copyright protection is secured by the original author of a copyrightable work. 39

The statute provides little basis upon which franchisors can assert that, absent agreement, they own the copyright to the creations of their franchisees. First, a franchisor cannot assert that it is the “author” of a work created by an entirely separate entity. Second, given the potential risks of vicarious and direct liability arising from the exertion of too much control over its franchisees, a franchisor cannot safely assert that it is the franchisee’s employer and that the creation was a “work made for hire.” 40 Next, unless the franchisor actually contributed to the creation of the copyrighted work, the franchisor cannot assert that it should have partial copyright to a “collective work.” Therefore, unless a franchisee is willing to transfer or assign entire or partial copyright ownership to the franchisor, the franchisor

35. See 17 U.S.C. § 201(a); see also id. § 102(a).
36. See id. § 201(b).
37. See id. § 201(c).
38. See id. § 201(d).
39. Id. § 201(a) (“Copyright in a work protected under this title vests initially in the author or authors of the work.”).
40. Again, this result is largely due to the decision in Browning-Ferris Indus. of Calif., 362 NLRB No. 186 (2015). See infra note 42 for an explanation of the current status of the decision in Browning-Ferris. Notably, absent the problems of joint employer liability, this analogy would be a useful one. The factors for determining work-for-hire map neatly onto the franchise relationship. In the event that Browning-Ferris is reversed, this analysis would be a potential avenue through which franchisors could asserting control over the copyrightable materials of their franchisees. Although a franchisor could still use a “work-for-hire” argument to receive copyrights, it would almost certainly leave the franchisor exposed to joint employer liability. There is virtually no way to argue the franchisee can make “work-for-hire” while simultaneously avoiding being considered a joint employer.
cannot obtain copyright to a work that could have the potential to drastically improve the franchisor’s system.41

With these premises in mind, and given the current legal landscape surrounding franchisor-franchisee relationships,42 it is apparent that, absent agreement to the contrary, franchisees own the copyrights to copyrightable works that they produce, even when such works were meant to improve the franchisor’s system.

Using Delligatti’s creation of the Big Mac as an example, absent some arrangement as contemplated in 17 U.S.C. § 201(d), McDonald’s would not be able to control the copyright to any “literary expression,”43 such as “a description, explanation, or illustration, for example—that accompanies a recipe or formula or to a combination of recipes, as in a cookbook.”44 Although the Big Mac recipe is not copyrightable,45 if Delligatti created an original literary expression (such as “two all-beef patties, special sauce, lettuce, cheese, pickles, onions, on a sesame bun”), without contractual obligations owed to McDonald’s or other arrangement identified in 17 U.S.C. § 201(d), McDonald’s may be out of luck.46 McDonald’s, at least in today’s legal landscape, would be unwise to assert that Delligatti made the Big Mac as a “work made for hire,” despite a strong argument that the analogy fits. Finally, McDonald’s has no claim to be a contributor to the “collective work” of the Big Mac recipe, particularly with Kroc’s reputation of being a stickler to the meticulous adherence to system standards.

Franchisees are generally reluctant to approach franchisors about system improvements when the improvements are not consistent with the system standards. And in the case of the Subway “Five Dollar Footlong,” the franchisee purportedly approached the franchisor with the idea and was rebuked.47 Although, to our knowledge, the issue was never litigated, the authors would assume that Delligatti at least initially should have owned the copyrights

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41. See supra notes 4, 8, and 11 for examples of franchisee creations that vastly improved, or even saved, the franchisor’s system.
42. See generally Browning-Ferris, 362 NLRB No. 186. As noted supra note 41, this NLRB ruling may discourage franchisors from using the “work-for-hire” schema to claim ownership of franchisee copyrightable material. Notably, however, the NLRB has shown clear signs that it is looking to reverse this decision. See generally Hy-Brand Indus. Contractors, Ltd., 365 NLRB No. 156 (2017) (reversing the decision in Browning-Ferris). The Browning-Ferris ruling was later reinstated for reasons other than the merits of the decision. See Adam C. Ahramns et al., NLRB Reinstates Browning-Ferris Joint-Employer Standard . . . For Now, MANAGEMENT MEMO (Feb. 28, 2018), https://www.managementmemo.com/2018/02/28/nlrb-reinstates-browning-ferris-joint-employer-standard-for-now; see also In re Jimmy John’s Overtime Litig., 2018 WL 3231273 (N.D. Ill. 2018) (providing an example of a federal court rejecting the argument that a franchisor is a joint employer of its franchisee’s employees).
43.See U.S. Copyright Office FL-122.
44. Id.
45. Id.; see also 37 C.F.R. § 202.1(a).
46. See Klara, supra note 3 (detailing the origin story of Delligatti’s Big Mac sandwich).
47. See Boyle, supra note 7.
related to the Big Mac. So, even McDonald’s, one of the most successful franchisors in history, did not (or should not have), at least initially, own the copyrights associated with the Big Mac—one of its most iconic products.

B. Trademark

Generally, the first entity to use the mark in commerce is the owner of the trademark. Much like copyright law, trademark statutes make no express mention of the rights of franchisees or franchisors absent relevant terms in a franchise agreement. It is not clear how the principle of first use applies when a franchisee first uses a mark in commerce that is first registered by the franchisor.

Unlike copyright, there is some basis for a franchisor to assert ownership of a franchisee-created trademark. The Lanham Act provides that “[w]here a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or applicant for registration.” “Related companies” is a defined term in the statute and requires that one of those companies exercise control over the other to constitute sufficiently related companies. Courts have acknowledged that the term “related companies” includes trademark licensees, licensors, franchisees, and franchisors. In fact, the United States Patent and Trademark Office’s Trademark Manual of Examination Procedure instructs examining attorneys to inquire no further into the relatedness of the companies when a trademark application indicates that a franchise agreement exists between the parties unless other evidence to the contrary is presented.

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50. Commodores Entm’t Corp. v. McClary, 879 F.3d 1114 (11th Cir. 2018).

51. See Pinnacle Pizza Co. v. Little Caesar Enters., Inc., 598 F.3d 970 (8th Cir. 2010).

52. 15 U.S.C. § 1055 (“Where a registered mark or a mark sought to be registered is or may be used legitimately by related companies, such use shall inure to the benefit of the registrant or applicant for registration, and such use shall not affect the validity of such mark or of its registration, provided such mark is not used in such manner as to deceive the public. If first use of a mark by a person is controlled by the registrant or applicant for registration of the mark with respect to the nature and quality of the goods or services, such first use shall inure to the benefit of the registrant or applicant, as the case may be.”).

53. 15 U.S.C. § 1127 (“The term ‘related company’ means any person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used.”).

has been presented. Therefore, even absent franchise agreement terms, so long as the franchisor registers the franchisee’s trademark first, the franchisor is the owner of the mark.

Instructive on this point is *Pinnacle Pizza Co. v. Little Caesar Enterprises.* In *Pinnacle Pizza*, the plaintiff, a franchisee who owned three Little Caesar stores in the Sioux Falls, South Dakota area, brought suit against Little Caesar Enterprises for, among other things, breach of the parties’ franchise agreement. The franchisee also sought a cancellation of Little Caesar’s “Hot-N-Ready” trademark. The plaintiff, Pinnacle Pizza, was the originator of the Hot-N-Ready business concept, whereby customers may arrive at a Little Caesar store and purchase a large pepperoni pizza for a low price with virtually no wait. Beginning in May of 1997, Pinnacle started using the “Hot-N-Ready” term in its advertising. After some success with the promotion, Pinnacle shared the concept with other franchisees, and, in 2000, Little Caesar adopted the concept systemwide. Two years later, Little Caesar registered “Hot-N-Ready” as a trademark and listed May 1997, the first time Pinnacle used the mark, as the first use in commerce.

Under the traditional “first in use” principle, Pinnacle would be entitled to trademark ownership of the Hot-N-Ready mark. However, pursuant to 15 U.S.C. § 1055, because Little Caesar and Pinnacle are “related” companies under the definition in 15 U.S.C. § 1127, the benefit of the mark “shall inure to the benefit of the registrant or applicant for registration” of the mark. Given that Pinnacle had never registered Hot-N-Ready as a trademark, Little Caesar was free to register that mark, even if the mark’s acknowledged first use in commerce was by Pinnacle. While Little Caesar did reserve rights to system improvements made by Pinnacle as franchisee, it is difficult to imagine that the court would have decided any differently in the absence of any franchise agreement terms because the franchise agreement largely mimics the statutory language of 15 U.S.C. § 1055 and there is no reason to believe that 15 U.S.C. § 1055 would not have already applied.

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55. USPTO, *Trademark Manual of Examination § 1201.03(f) (2017).*
56. *Pinnacle Pizza*, 598 F.3d 970.
57. *Id.* at 971.
58. Little Caesar disputes that Pinnacle developed the concept independently, but that dispute is immaterial to this discussion. *See id.* at 972.
60. *See Pinnacle Pizza*, 598 F.3d at 972.
61. *Id.* at 973.
62. *Id.*
63. The court assumed that the parties were related companies through the franchise agreement without actually addressing it.
64. 15 U.S.C. 1055; *see also Pinnacle Pizza*, 598 F.3d at 980.
65. *Pinnacle Pizza*, 598 F.3d at 980 (“The relevant sections make clear that use of such marks inure to Little Caesar Enterprises upon Pinnacle’s use. Thus, LCE had reason to believe, notwithstanding Pinnacle’s assertions to the contrary, that it could properly trademark the phrase ‘Hot–N–Ready.’ Pinnacle presented no other evidence to show bad faith on LCE’s part.”).
to the situation. The Lanham Act clearly allows franchisors to benefit from a franchisee’s creation of a trademark.

The approach taken by Little Caesar in *Pinnacle Pizza* is a very successful way to secure trademark rights. The problem with putting too much emphasis on *Pinnacle Pizza* is that it is a decision prior to the National Labor Relations Board’s expansion of the joint employer concept. As explored previously, the joint employer analysis looks to see whether the franchisor exerts even “indirect control” over franchisees, particularly as it relates to employment matters. If the “indirect control” test is met, a franchisor could be considered a joint employer of a franchisee’s employees and could therefore be liable for the actions of a franchisee’s employees. Such expansive liability could be a costly challenge for franchisors who exert “indirect control.” So a franchisor attempting to obtain ownership of a trademark initially used by a franchisee faces a dilemma. On the one hand, 15 U.S.C. § 1055 gives a franchisor the ability to assert that it is a “related company” and can adopt a franchisee’s first use in commerce as its own, assuming the franchisor is first to register the mark. On the other hand, establishing sufficient control over a franchisee to be considered a “related company” may make it difficult to later assert that the franchisor is not a joint employer of its franchisee’s employees.

The statutory definition of “related company” depends on the assertion of some control. “The term ‘related company’ means any person whose use of a mark is controlled by the owner of the mark with respect to the nature and quality of the goods or services on or in connection with which the mark is used.” This definition strikes more at the control over the goods or services of another company, whereas vicarious liability generally emphasizes the control over the day-to-day operations and joint employer liability generally focuses more on the control over employment matters. Although these types of control are distinguishable, if control over the quality of the goods or services or control over the way in which the mark is used extends into more

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66. See supra note 41.
68. A franchisor asserting that it is a “related company” that exercises sufficient control to have franchisee trademarks inure to its benefit may have a difficult time later asserting that it is not the joint employer of a franchisee’s employees. In other words, the concept of “joint employer” and “related company” do not directly conflict with one another, but the assertion of relatedness may pose problems in future legal disputes. What is important to consider is that franchisors that use the “related company” argument alone to secure trademark rights must be conscious that they are running the additional risks of joint employer liability. Further, to the extent that the *Browning-Ferris* decision does not survive the current presidential term, the assertion that the franchisor is a related company would then be an excellent argument for franchisors to pursue to gain control of franchisee trademarks.
70. Id. § 1127.
pervasive control over the day-to-day operations of the other company, a “related company” could find itself vicariously liable or be a joint employer. 71

III. Enforceability of Franchise Agreement

Assignments of Intellectual Property

As explored previously, with the state of intellectual property law and the current risks of joint employer liability, franchisors are left with few good options in obtaining the intellectual property related to, or arising from, important system innovations created by franchisees. Assignment of intellectual property rights to franchisee creations in the franchise agreement is, of course, the best option for franchisors to pursue for securing the intellectual property rights arising from its own system. Franchisors need to draft assignment provisions with care however, as these provisions may run the risk of being held unenforceable in court if they overstep certain bounds. Additionally, statutory prohibitions against restraint of trade may pose a problem for imprecisely drafted or overly broad assignment provisions.72

In their treatise, William Finkelstein and James Sims reference California’s Business and Professions Code § 16600 as a potential pitfall for franchisor assignment provisions.73 Section 16600 states that “[e]xcept as provided in this chapter, every contract by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void.”74 A court could conclude that a total assignment of a franchisee’s intellectual property rights to a franchisor is an impermissible restraint on the lawful business of the franchisee.75

However, although case law on this issue is scarce, courts seem generally willing to enforce advance assignment of intellectual property rights arising from franchisee innovations. For example, in Little Caesar, the parties’ franchise agreement provided that “Franchise Owner [franchisee] expressly acknowledges that any and all goodwill associated with said Proprietary Marks, including any goodwill which might be deemed to have arisen or to arise in the future through the activities of any Licensee of LITTLE CAESAR, inures directly and exclusively to the benefit of LITTLE CAESAR.”76 The Eighth Circuit held that such an assignment was an enforceable assignment of a trademark created by the franchisee.77 While this provision

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71. See, e.g., Huntington Nat’l Mattress Co. v. Celanese Corp. of Am., 201 F. Supp. 938, 944 (D. Md. 1962) (determining that Huntington could only be a related company “provided it exercises supervision and control over the operations of its licensees”). If courts are committed to language such as “supervision and control over the operations,” then related company analysis may become synonymous with vicarious/joint employer liability.


73. Id.


75. See, e.g., Commodores Entm’t. Corp. v. McClary, 879 F.3d 1114 (11th Cir. 2018).

76. Pinnacle Pizza Co. v. Little Caesar Enters., Inc., 598 F.3d 970, 980 (8th Cir. 2010).

77. Id.
does not explicitly assign franchisee’s intellectual property rights, the court enforced it as such without serious analysis.

Due to the lack of case law relating specifically to intellectual property assignments in franchise agreements, we may also consider employment contracts that feature such assignments, as courts are perhaps likely to draw an easy analogy between the two areas of law.78 It is common for employers to include in employment contracts particular provisions that assign intellectual property rights arising from employee inventions or innovations to the employer.

Where an assignment is overly broad or could be construed as an impediment to doing legal business, courts may find such assignment provisions unenforceable. For example, in GTI Corp. v. Calhoon, the employer, GTI, required certain employees with technical knowledge to sign employment agreements that provided, in relevant part, that the employee shall “promptly disclose and assign to GTI any and all ideas, improvements and inventions, patentable or unpatentable, which [the employee] ha[s] made or may hereafter make, alone or jointly with others, relating to or suggested by GTI’s business between the date of . . . employment by GTI and the date of termination of . . . employment.”79 When an employee attempted to start a competing business, GTI sued, contending that the employee had no right to start such a business using the knowledge and ideas acquired during his employment with GTI.80

The district court disagreed, determining that the “terms ‘ideas’ and ‘improvements’ as used in the employment agreement are broad and ambiguous.”81 The court restricted the meaning of those terms to include only trade secrets, because to hold these terms to include any and all intellectual property rights “would unreasonably restrict the rights of defendants to utilize their general knowledge and skill upon termination of their employment.”82 The court further noted that an assignment provision could be void as contrary to public policy if (1) the restraint is unreasonable in that it goes beyond what is necessary to protect the employer in some legitimate interest; (2) the restraint is unreasonable in that it is unduly harsh and oppressive to the employee; and (3) the restraint is unreasonable in that it is injurious to the public.83

78. See Finkelstein & Sims, supra note 72 at 335 (suggesting that intellectual property assignments between employers and employees may be a useful source of information for how to accomplish such assignments in the realm of franchising).
80. Id. at 767.
81. Id. at 772.
82. Id.
83. Id. at 773 (holding that the employer’s provision was void as contrary to public policy because (1) the employee’s prohibition on using employee’s expertise at another firm went beyond what employer had a legitimate interest in; (2) the prohibition was an unreasonable restraint on employee’s ability to make a living and unreasonably oppressive to his career prospects; and (3) public policy weighs heavily against restricting an employee’s ability to “improve his socio-economic status based upon personal skill”).
More precise drafting, such as the *Little Caesar* provision discussed previously, should ameliorate the deficiencies that the *GTI Corp.* court identified. In other words, focusing and limiting the contractual assignment to critical intellectual property, which would include copyrights and trademarks used in connection with the franchise system, should enable a franchisor to enforce such provisions to protect its own intellectual property and its control over its system.

**IV. Best Practices**

Given the inability to assert control over a franchisee’s copyrighted materials absent contractual terms, and given the legal dilemma presented to a franchisor when seeking to assert control over franchisee trademarks, it is in a franchisor’s best interest to ensure that its franchise agreement contains explicit provisions that assign to the franchisor all intellectual property rights in franchisee inventions, innovations, and discoveries that improve the franchisor’s system, whenever such innovations arise or are created. When a franchisor secures assignments to intellectual property at the beginning of the franchise relationship, the problems and confusion explored earlier can be avoided almost entirely.

Again, however, precise drafting that gracefully balances securing substantial rights for the franchisor, while not eliminating the franchisee’s ability or motivation to innovate, is the key to successful intellectual property assignments in franchise agreements. A franchisor must keep in mind its general strategy for balancing system adherence and willingness to have the system improved. Franchisors that prefer to strictly enforce system standards may be less wary of strong assignment provisions that leave no doubt in a franchisee’s mind about the results of innovation. Yet franchisors that are eager to see what their franchisees can do to improve the system should steer more toward allowing some rights or benefits arising therefrom for their franchisees.

Certainly, countless ways exist to secure intellectual property rights from a franchisee in a franchise agreement. West’s American Jurisprudence Legal Forms, in its chapter on Business Franchises, recommends a provision entitled “Improvements in franchise system—After termination franchisee may continue to use any improvement that franchisee has developed.” That sample provision reads:

Any and all improvements in the system developed by franchisee, franchisor, or other franchisees, shall be and become the sole and absolute property of franchisor, and franchisor may incorporate such improvements in the system and shall have the sole and exclusive right to copyright, register, and patent such improvements in franchisor’s own name. Franchisee shall have no right to copyright,

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84. *See, e.g.*, Pinnacle Pizza Co. v. Little Caesar Enters., Inc., 598 F.3d 970, 972 (8th Cir. 2010).
register, or patent such improvements in his or her name. Franchisee shall have no right to use such improvements, except as set forth in this agreement, provided, however, that if this agreement is terminated, franchisee may continue to use any improvement that franchisee has himself or herself developed, provided franchisee does not represent or indicate that he or she is a franchisee or member of the system, or operator of a [name of franchise unit].

Notably, this provision quite deftly avoids the problems that plagued the ill-fated assignment provision in *GTI Corp.* The author has utilized a slightly different form, with good results:

Franchise Owner [franchisee] hereby permanently and irrevocably assigns to Franchisor any and all rights and interests (including intellectual property rights and interests) to any and all of the following which is developed by Franchise Owner, or on behalf of Franchise Owner, if developed in whole or in part in connection with the Franchise Store: all products or services; all variations, modifications and/or improvements on products or services; your means, manner and style of offering and selling products and services; management techniques or protocols Franchise Owner may develop (or have developed on its behalf); all sales, marketing, advertising and promotional programs, campaigns, or materials developed by Franchise Owner or on its behalf; and all other intellectual property developed by Franchise Owner or on behalf of the Franchise Store. Franchisor may authorize Franchisor or its affiliates or other franchise stores to use and exploit any such rights which are assigned to Franchisor hereunder. The sole consideration for Franchise Owner’s assignment to Franchisor of all of the foregoing rights shall be the grant of the franchise conferred upon Franchise Owner by this Agreement.

Again, no single right way exists for a franchisor to gain ownership rights to franchisee innovations. Franchise agreements should include language that makes it clear that anything a franchisee develops as it relates to the franchisor's system will be the exclusive property of the franchisor. These provisions should be clear not to stray into innovations or inventions that are beyond the scope of the franchise relationship. Nevertheless, these provisions must still be strong enough to ensure that improvements to system standards belong only to the franchisor.

V. Conclusion

Imagine McDonald's without the Big Mac, Little Caesar without the “Hot-N-Ready,” or Subway without the “Five Dollar Footlong.” Had the franchisors in those respective cases not taken affirmative steps to secure the intellectual property rights to such innovations, it is possible that they

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86. AM. JUR. LEGAL FORMS 2d, Business Franchises § 50.302, Improvements in Franchise System—After Termination Franchisee May Continue to Use Any Improvement That Franchisee Has Developed (2018).
87. See *GTI Corp.*, 309 F. Supp. at 773–74. The cited franchise agreement, supra note 86, does not attempt to restrict franchisee’s use of its own innovation and in doing so avoids some of the aspects that plagued the plaintiff’s employment agreements.
88. See generally, e.g., *GTI Corp.*, 309 F. Supp. at 772–74 (holding that a restriction on intellectual property rights of an employee well past the termination of employment was void as contrary to public policy).
could have missed out on the billions of dollars in revenue that these franchisee-created innovations have generated.\textsuperscript{89} No matter how a franchisor wants to strike the balance between strict adherence to system standards and fostering an environment conducive to innovation, it is imperative that the franchisor secure rights to any improvements to the system made by franchisees.

\textsuperscript{89} See Klara, \textit{supra} note 3; \textit{see also} Boyle, \textit{supra} note 7; Skid, \textit{supra} note 10.
Constructive Termination in Franchise Law: When Manufacturers Own Appreciating Dealership Facilities

Henry I. Lowe

It is an economic fact of life for franchised automobile dealerships that prices and rents for commercial real estate tend to rise, especially in densely populated areas.1 When dealers must extend or renew the terms of their leases, increased rents demanded by property owners may materially affect the profitability of those dealerships.2

Dealers may believe themselves constrained to pay higher rents because relocation of automobile dealerships is difficult.3 In many jurisdictions, zoning designations limit the number of sites that permit automobile-dealership use.4 Franchise agreements typically provide that a dealer must obtain manufacturer approval of any relocation.5 If approved by the manufacturer, relocation to a new facility may impose prohibitive costs on a dealer (e.g., brokerage

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2. Ryan Kerrigan, The Implications of Rising Dealership Real Estate Values, Kerrigan Advisors, reprinted from Dealer Magazine (June 1, 2016), https://www.kerriganadvisors.com/the-implications-of-rising-dealership-real-estate-values (“As a benchmark, the average dealership, according to NADA, has a rent factor that is ~1.2% of sales or 7% of gross profit. As a rule of thumb, dealers should strive for a rent factor that does not surpass 10% of total gross profit.”).

3. The strength of the landlord’s bargaining position may be limited by the number of other franchised dealerships available as a replacement tenant. Bradley R. Carter, The Rise of the Market for Auto Dealerships: Bad News for Landlords?, REAL ESTATE ISSUES, no. 3, 2014, at 33, 37, http://www.cre.org/wp-content/uploads/2016/05/39_3.pdf (“There are a limited number of manufacturers, and . . . each grants their dealers an exclusive territory; therefore, there is a finite number of auto dealerships that can operate in a given area.”).

4. See, e.g., Restigouche, Inc. v. Town of Jupiter, 59 F.3d 1208, 1214 (11th Cir. 1995).

5. But see, e.g., N.Y. Veh. & TRAF. LAW § 463(2)(dd) (limiting a manufacturer’s discretion to refuse approval of a dealer’s relocation request).

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Henry I. Lowe (Henry.Lowe@KutakRock.com) is of counsel in the Denver, Colorado, office of Kutak Rock LLP.
commissions for the purchase or lease of the new site, costs of advertising the new location, and moving expenses).  

State law may also expressly limit the ability of dealerships to relocate. For example, under New York law, unless exempt, another dealer may protest a dealer’s relocation to a new site within the protesting dealer’s “relevant market area.”

State statutes typically require the manufacturer to notify affected dealers of a proposed relocation. If a dealer with standing protests the relocation, the manufacturer bears the burden of proof that “good cause” exists to justify it.

In some instances, manufacturers own dealership facilities and lease them to dealers. Leases between manufacturers and their dealers raise legal issues not present when dealers lease from third parties. In particular, a manufacturer may, among other things, increase rent to reflect then current conditions in the local real estate market. This situation is especially notable in densely populated areas where available property is scarce and high demand has caused property values to soar. A dealer may object that an increase in rent would reduce profitability to an extent that threatens its viability. Among the causes of action a dealer-tenant may consider in such an instance is a claim for constructive or de facto termination.

This article will present, first, a recent example of how exploding property values may impact a dealer-tenant. The article will next review generally the law of constructive or de facto termination in the manufacturer-dealer context. It will then discuss the extent to which constructive termination principles might be implicated in leasing transactions between manufacturers and dealers in the current national real estate market.

I. Surf City—A Recent Example of Constructive Termination

A recent unpublished opinion, Surf City Corporation v. Mitsubishi Motors North America, Inc., involved a manufacturer’s decision to sell property then occupied by its franchised dealer. The dealer, Surf City, operated a Mitsubishi dealership in Huntington Beach, California, pursuant to a dealer agreement with Mitsubishi Motors North America, Inc. (MMNA). MMNA owned the dealership facility and leased it to Surf City. The term of the lease and the term of the dealer agreement were scheduled to expire concurrently in December 2015.

In 2013, MMNA sold the property to a real estate

6. Manufacturers also frequently request that dealers renovate new facilities to incorporate new trademarks, trade dress, or brand-image features, including the exterior appearance of the facility, signs, and interior finishes. See Carter, supra note 3, at 33. Even if a manufacturer is willing to pay or provide financing for some or all of the cost of renovation, a reassessment of the facility may result in higher ad valorem taxes.


8. See, e.g., N.Y. Veh. & Traf. Law § 469.


10. MMNA and Surf City entered into two dealer agreements. The first, dated 2007, expired in 2010. Although Surf City continued to operate, the dealer agreement was not extended or
developer for $8.6 million, approximately twice the value estimated in an appraisal that MMNA had recently requested. The developer subsequently notified Surf City that it would not extend or renew Surf City’s lease.

In December 2013, Surf City sued MMNA for breach of contract and breach of the implied covenant of good faith and fair dealing. Surf City claimed that MMNA’s sale of the leased property constructively terminated, and thereby breached, the dealer agreement. Surf City further claimed that MMNA’s constructive termination of the dealer agreement breached its implied covenant of good faith and fair dealing. Surf City continued to operate its dealership on the property even following its commencement of the suit.

The California Court of Appeal affirmed the trial court’s grant of summary judgment to MMNA. The court looked to the express terms of the dealer agreement and concluded that there had not been a breach of contract. Neither the lease nor the dealer agreement prohibited MMNA’s sale of the property. Further, because there was no evidence of MMNA’s failure to abide by the terms of the agreements, the court affirmed the grant of summary judgment on Surf City’s claim that MMNA breached the implied covenant of good faith and fair dealing.

Surf City’s claims in this case did not, strictly speaking, include a cause of action for constructive termination. Surf City claimed, rather, that MMNA breached the parties’ contract and violated the implied covenant of good faith and fair dealing by selling the property and thereby constructively terminating the dealer agreement. As a result, the opinion does not disclose the principle on which Surf City alleged that sale of the dealership property amounted to constructive termination of the dealer agreement. Instead the court disposed of both the breach of contract and the breach of good faith claims and, by extension, the underlying allegation of constructive termination, by concluding that MMNA had no contractual obligation to retain ownership of the property.

Perhaps the court’s opinion simply failed to reflect a more fully pleaded and argued allegation of constructive termination. Perhaps, too, Surf City intentionally chose not to plead constructive termination as an independent cause of action. In any case, the court’s opinion does raise a question about the basis of Surf City’s assertion of constructive termination. More broadly, it raises the question how rising real estate values and rents may affect the rights and obligations of manufacturers and dealers who are parties to both a dealer agreement and a lease.

renewed until 2012, when the parties entered into a new dealer agreement having a three-year term. Id. at *2. Surf City’s complaint alleged breach of the 2007 dealer agreement only, but the court concluded that its opinion would be the same if Surf City had pleaded breach of the 2012 agreement. Id. at *6.
II. Constructive Termination Generally

Courts addressing constructive termination claims refer to them as both common law claims and statutory claims. Neither federal nor state statutes specifically provide for a constructive termination cause of action. Courts have instead recognized constructive termination claims as arising out of express statutory provisions. For example, under the Federal Automobile Dealer Day in Court Act (ADDCA), courts have inferred a constructive termination claim if a dealer’s “voluntary” termination was coerced or otherwise forced or necessitated by the manufacturer. Similarly, in the absence of any state statutes expressly providing for dealers’ constructive termination claims, courts have permitted dealers to assert claims alleging that certain manufacturer conduct effectively terminated the dealer agreement. Courts construe termination under these circumstances to be “constructive” because it occurs outside of any statutory framework for termination requiring good cause, notice, and an opportunity to contest.

A. Federal Law—Automobile Dealer Day in Court Act

Under certain circumstances, a manufacturer’s bad-faith conduct may support a claim under the ADDCA for constructive termination. “Constructive termination may serve as the basis for violation of the [ADDCA] if it is the result of actions taken by a manufacturer with the intent to intimidate, threaten or coerce.” A successful claim of constructive termination under the ADDCA requires a showing that the manufacturer’s coercion or intimidation (or the threat of either) caused the alleged harm.

The ADDCA authorizes suits by dealers to recover damages incurred as a result of a manufacturer’s failure to act in good faith in (a) performing its obligations under the franchise dealer agreement, or (b) terminating or not renewing a franchise. The ADDCA defines “franchise” as “the written agreement or contract between any automobile manufacturer engaged in commerce and any automobile dealer which purports to fix the legal rights

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14. See Am. Motors Sales Corp. v. L.G. Semke, 384 F.2d 192, 195 (10th Cir. 1967) (terming the dealer’s cause of action “wrongful termination” rather than constructive termination).
15. See, e.g., Bob Robinson Chevrolet-Oldsmobile-Cadillac, Inc. v. Gen. Motors Corp., No. 5:01CV145, slip op. at 9 (N.D. W. Va. June 13, 2003) (noting that eleven percent decline in net income or sales “may or may not rise to the level of ‘substantial decline’ in net income required to justify a finding of constructive termination”); Jay Auto. Grp., Inc. v. Am. Suzuki Motor Corp., No. 4:11–CV–129, 2012 WL 425984, at *7 (M.D. Ga. Feb. 9, 2012) (“[I]f a franchisor forces the termination of a franchise agreement in bad faith or without good cause and/or notice, the Court finds the franchisee has a claim.”).
18. Id. at 1315; Semke, 384 F.2d at 195.
and liabilities of the parties to such agreement or contract.”\textsuperscript{20} Furthermore, the ADDCA narrowly defines good faith to mean “the duty of each party to any franchise . . . to act in a fair and equitable manner toward each other so as to guarantee the one party freedom from coercion, intimidation, or threats of coercion or intimidation from the other party.”\textsuperscript{21}

In a 1967 case, \textit{American Motors Sales Corporation v. L.G. Semke},\textsuperscript{22} the Tenth Circuit stated that no court previously had recognized a cause of action for wrongful termination under the ADDCA. Semke claimed that American Motors had coerced it into an apparently voluntary termination of its dealer agreement by (a) refusing to honor its orders for vehicles unless it also ordered models it did not want, and (b) refusing to authorize warranty repairs. At trial, a jury awarded the dealer lost future profits resulting from the termination. In affirming the jury award, the court held that the ADDCA provided a cause of action for wrongful termination “where the dealer was forced to terminate because of the coercive and intimidative acts of the manufacturer.”\textsuperscript{23} Although the court referred to “wrongful termination” in making its ruling, subsequent opinions have cited \textit{Semke} for the proposition that the ADDCA authorizes a cause of action for “constructive termination.”\textsuperscript{24}

The U.S. District Court for the District of Massachusetts, in \textit{Imperial Motors, Inc. v. Chrysler Corp.}, cites \textit{Semke} for the proposition that “[c]onstructive termination may serve as the basis for a violation of the [ADDCA] if it is the result of actions taken by a manufacturer with the intent to intimidate, threaten or coerce.”\textsuperscript{25} In \textit{Imperial Motors}, a dealer objected to Chrysler’s approval of the relocation of a competing dealer to a location closer to the plaintiff. Following the “vigorous protest,” Chrysler’s subsidiary, Chrysler Credit, reduced the dealer’s line of credit and demanded an additional $70,000.00 dealer investment before it would reinstate the full amount of the loan.\textsuperscript{26} When the dealer was unable to contribute additional capital to the dealership (or to sell the dealership), it gave the business back to the prior dealership owner. The court held that the dealer’s allegations were sufficient to survive the manufacturer’s motion for summary judgment because whether Chrysler Credit reduced the dealer’s line of credit to intimidate or coerce the dealer was an issue of fact.\textsuperscript{27}

\begin{itemize}
  \item \textsuperscript{20} 15 U.S.C. § 1221(b). “Franchise” is not necessarily limited to the dealer agreement alone. “If other written agreements are so interwoven with the document ostensibly designated as the franchise as to affect materially the legal significance of the latter, they must be regarded as part of the franchise agreement.” See Kavanaugh v. Ford Motor Co., 353 F.2d 710, 715 (7th Cir. 1965).
  \item \textsuperscript{21} 15 U.S.C. § 1221(d).
  \item \textsuperscript{22} \textit{Semke}, 384 F.2d 192.
  \item \textsuperscript{23} \textit{Id.} at 195.
  \item \textsuperscript{25} \textit{Imperial Motors}, 559 F. Supp. at 1315.
  \item \textsuperscript{26} \textit{Id.} Of note, the line of credit was necessary for the dealer to order and have on site new and potentially popular vehicle models for the showroom. \textit{Id.}
  \item \textsuperscript{27} \textit{Id.} at 1314
\end{itemize}
In *Grimes Buick-GMC, Inc. v. GMAC, LLC*, the plaintiff-dealer claimed that GMAC, as General Motors’ agent, acted “wrongfully and in bad faith” in violation of the ADDCA and, in so doing, coerced the dealer into terminating its franchise. Grimes had made a check to GMAC that was returned for insufficient funds. Grimes claimed that the insufficiency was small and that it had remedied the shortfall within seventy-two hours. According to Grimes, GMAC used the insufficiency to exercise remedies under its loan documents intending to force Grimes to cease operation of its dealership business as part of a general plan to reduce the number of GM dealers. Those remedies included reducing the dealer’s floorplan, increasing the interest rate on the loan, and controlling the dealer’s cash receipts. Grimes claimed that GMAC thereby forced it to sell its dealership at a deflated price. The U.S. District Court for the District of Montana, citing *Semke* and *Imperial Motors*, held that the dealer’s claim for constructive termination under the ADDCA would survive GMAC’s motion to dismiss. Claims of constructive termination under the ADDCA are necessarily “fact intensive because they must focus on the motivations and intentions of the manufacturer to intimidate, threaten, or coerce a dealer in violation of the [ADDCA].” If the evidence is sufficient, a jury should resolve the factual questions.

These cases make clear that the successful prosecution of an ADDCA claim requires a dealer to show that a manufacturer acted in bad faith and that those actions forced the dealer to terminate its franchise. Bad faith under the ADDCA means threats, intimidation, or coercion. The ADDCA “is not as concerned with what the parties did as it is concerned with why they did it.”

**B. Other Theories of Constructive Termination**

Outside of the ADDCA, theories of constructive termination vary. Those theories may generally be described, however, as terminations occurring (a) because a manufacturer’s unilateral modification of the franchisee’s dealer agreement resulted in a substantial decline in a franchisee’s income, (b) because a manufacturer unilaterally modified a franchisee’s dealer agreement causing a substantial interference with the benefits of the franchise, or (c) by reason of the manufacturer’s bad-faith conduct as defined under state law. Underlying each of these theories of constructive termination is the

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29. Id.
30. Id.
31. Id.
32. Id. at *6.
33. Id. at *4.
34. Id. (citing *Imperial Motors*, Inc. v. Chrysler Corp., 599 F. Supp. 1312, 1315 (10th Cir. 1967)).
35. *Imperial Motors*, 599 F. Supp. at 1314 (citing *York Chrysler-Plymouth, Inc. v. Chrysler Credit Corp.*, 447 F.2d 786, 791–92 (5th Cir. 1971)).
threshold issue of whether the court requires that the dealer have actually abandoned its business and ceased operations.

1. Abandonment Requirement

Some courts have held or assumed that constructive termination claims may proceed even if the dealer remains in business.37 Other courts have held, however, that no constructive termination can occur if a dealer continues to operate under the terms of the dealer agreement.38 The latter proposition, sometimes referred to as the abandonment requirement, reflects the common-sense point of view that there can exist no constructive termination in the absence of an actual termination.39

An oft-cited precedent for the abandonment requirement is *Mac’s Shell Service, Inc. v. Shell Oil Products Co. LLC*, 40 a case decided under the Petroleum Marketing Practices Act (PMPA).41 Under their franchise agreements, Shell’s franchisees leased their service station facilities from Shell. Historically, Shell had subsidized rents under the franchise agreements for each gallon of fuel sold in excess of a monthly target. Shell provided the rent subsidy, which was not part of the franchise agreement, by annual notices expressly providing that Shell could withdraw the subsidies in its discretion.42

In 1998, Shell assigned its rights under its franchise agreements to Motiva Enterprises, a joint venture among Shell and other oil companies. Motiva subsequently rescinded the subsidy arrangements for franchisees and required, in newly executed franchise agreements, that a majority of franchisees pay higher rents.43 The franchisees claimed that withdrawal of the subsidies constructively terminated their franchise agreements in contravention of the PMPA and that the revised terms of the new franchise agreements amounted to constructive nonrenewal.44

The U.S. Supreme Court held that a “necessary element” of a constructive termination claim is that the “complained-of conduct forced an end to the franchisee’s use of the franchisor’s trademark, purchase of the franchisor’s...
fuel, or occupation of the franchisor's service station.”45 The PMPA prohibits a franchisor's termination of a franchise except in specific circumstances and then only after notice. Under the PMPA, “[t]he term ‘termination’ includes cancellation,”46 but it does not define either term. The Supreme Court, therefore, looked to their “ordinary meanings.”47

To determine ordinary meaning, the Supreme Court relied, among other things, on the dictionary definition and the Uniform Commercial Code (UCC) treatment of the term “termination.” In ordinary usage, “terminate” means “to put an end to” something.48 Under the UCC, a termination “occurs only when a terminating party 'puts an end to the contract.’”49 The Court also analogy the doctrine of constructive termination to constructive discharge in employment law and constructive eviction in landlord-tenant law, both of which require termination of the relationship at issue, either employment or tenancy. Termination in these contexts is “constructive” for the reason that it is the plaintiff (employee or tenant) “who formally puts an end to the particular legal relationship.”50

The Supreme Court further addressed the plaintiffs’ claim that the changed terms of the franchise agreement offered to renewing franchisees amounted to constructive nonrenewal. Some of the Shell plaintiffs had entered into new franchise agreements providing for higher rents. In the view of the Supreme Court, just as they could not claim constructive termination without ceasing their business, the plaintiffs could not claim constructive nonrenewal if the franchise agreement had been renewed.51

Two cases in the manufacturer-dealer context, each decided earlier than Mac’s Shell, refused to recognize constructive termination claims.52 In both cases, the courts held no constructive termination could occur in the absence

45. Mac’s Shell, 559 U.S. at 181.
46. Id. at 182.
47. Id.
48. Id.
49. Id. at 183.
50. Id. at 185.
51. The franchise agreement at issue in Mac’s Shell expressly included a landlord-tenant relationship between the franchisor and its franchisees. Id. at 180. Thus, the Supreme Court did not have to confront the question whether a lease between franchisor and franchisee was part of the franchise relationship to which the PMPA was addressed. Surf City, however, presented that very question to the California Court of Appeal, either directly or implicitly. There, the court held in effect that, because the dealer agreement did not refer to it, the dealer's lease of the property was not part of the franchise relationship governed by California law. Surf City Corp. v. Mitsubishi Motors N. Am., Inc., No. G052053, 2017 WL 3662382, at *11 (Cal. Ct. App. Nov. 27, 2017). The court reasoned that the dealer was able to remain in possession of the property until expiration of the franchise agreement, and nothing in the franchise agreement or lease prohibited sale of the property to a third party. Id. Thus, unless the franchise agreement explicitly refers to the lease of the dealership facility, it is likely that a court will find that no breach occurs when the lease is not renewed.
of an actual cessation of the business. In *Bright Bay GMC Truck, Inc. v. General Motors Corp.*, the plaintiff was a single-line GMC dealer. General Motors had announced a strategy of “dualing” GMC with Pontiac and Buick dealerships, but the plaintiff alleged that GM refused to grant the dealer, or subsidize the dealer’s purchase of, a Pontiac or Buick franchise.\(^{53}\) The U.S. District Court for the Eastern District of New York held that, because the dealer continued to conduct dealership operations under the GMC dealer agreement, no constructive termination occurred.\(^{54}\) GM had “merely encouraged” dealers to align their Pontiac, Buick, and GMC franchises with each other, and GM’s failure to give to the plaintiff, or assist in plaintiff’s purchase of, additional franchises did not operate to terminate the plaintiff’s GMC franchise.\(^{55}\)

In *L&B Truck Services, Inc. v. Daimler Trucks North America LLC*, a dealer purchased the assets of a Sterling, Western Star, and Freightliner dealership for $6 million.\(^{56}\) Before purchasing the assets, the dealer “engaged in extensive discussions and meetings” with Daimler and Sterling (a subsidiary of Daimler) concerning the dealer’s plan to undertake a $700,000 expansion of its existing facility to accommodate the new truck lines. The dealer began construction in September 2008. In October 2008, Daimler announced that it would cease production of Sterling trucks in January 2009. The plaintiff alleged that Daimler’s cessation of production of Sterling trucks constituted a termination of the dealer agreement. The termination was “constructive,” the dealer claimed, because Daimler failed to comply with provisions of Vermont Motor Vehicle Manufacturers, Distributors & Dealers Franchising Practices Act (MVFPA)\(^{57}\) prohibiting termination without notice to the dealer and good cause for termination. The U.S. District Court for the District of Vermont noted that, under the MVFPA, a franchise agreement between a manufacturer and dealer may consist in part of dealer’s agreement to provide service to the manufacturer’s vehicles. Here, despite losing the ability to sell new Sterling trucks, the dealer retained the right under the dealer agreement to sell Sterling parts and perform service on Sterling trucks. The court held that the dealer agreement, therefore, remained in effect. Because there had been no actual termination of the franchise, the dealer failed to state a claim under the MVFPA.\(^{58}\)

In a case decided after *Mac’s Shell*, the U.S. District Court for the Northern District of Ohio, in *Bedford Nissan, Inc. v. Nissan North America, Inc.*,...
addressed constructive termination claims, among others, by several dealers.\(^{59}\) The dealers alleged that Nissan had paid upfront cash and quarterly incentive payments to a preferred dealer group in Northeast Ohio. Those payments allowed the preferred dealers to sell new vehicles at a lower price than the plaintiffs could offer, having not received such incentive payments. The plaintiffs further alleged that, “by employing a discriminatory pricing scheme, Nissan sought to eliminate intra-brand competition among its dealers in Northeast Ohio, reconfigure its dealer network in Northeast Ohio, and drown the plaintiffs, thus causing the constructive or actual termination of the plaintiffs’ franchises.”\(^{60}\) Citing Bright Bay and L&B Truck Services, the court held that, because the plaintiffs’ dealer agreements remained in effect, the manufacturer had not constructively terminated them.\(^{61}\)

Accordingly, to support a constructive termination claim, many courts will require a dealer show that it is no longer in business—of any kind—with the manufacturer.

2. Reduction in Income

When evaluating the issue of constructive termination, several manufacturer-dealer cases\(^ {62}\) follow the reasoning of the Second Circuit in *Petereit v. S.B. Thomas, Inc.*\(^ {63}\) In *Petereit*, decided under the nonautomotive Connecticut Franchise Act,\(^ {64}\) the court articulated a standard for determining whether constructive termination occurs:

“[I]t appears that something greater than a *de minimis* loss of revenue—and less than the stark scenario of driving a franchisee out of business—must be shown in order to justify a finding of constructive termination. We think such may be found when a franchisor’s actions result in a *substantial decline* in franchisee net income.”\(^ {65}\)

The court in *Petereit* expressly did not require that a franchisee be driven out of business as a condition of maintaining a constructive termination claim.

The dispute in *Bob Robinson Chevrolet-Oldsmobile-Cadillac, Inc. v. General Motors Corp.* arose from GM’s decision to phase out its Oldsmobile brand—an action the dealer claimed would eliminate eleven percent of its sales.\(^ {66}\) Although the dealer remained in business, it claimed that, by eliminating

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60. Id. at *10.
61. Id. The court ultimately did not dismiss the count of which the constructive termination claim was a part because the plaintiffs also alleged breach of Nissan’s implied covenant of good faith and fair dealing. Id.
64. Id. at 1181 (citing CONN. GEN. STAT. § 42–133c et seq.).
65. Id. at 1183.
the Oldsmobile brand, GM constructively terminated the Oldsmobile dealer agreement. In response to GM’s motion to dismiss for failure to state a claim, the U.S. District Court for the Northern District of West Virginia stated that, although West Virginia courts had not addressed de facto or constructive termination, it was persuaded by the *Petereit* reasoning. The court held that failure to recognize constructive termination under the West Virginia manufacturer-dealer statute would allow manufacturers to “accomplish indirectly what the statute plainly prohibits them from accomplishing directly—that is, terminating a dealer agreement through unilateral action without appropriate notice to the dealer and without good cause shown.”

Because the dealer pleaded more than a *de minimis* loss of revenue, the court found that it had stated a claim for constructive termination.

The plaintiff in *Grimes Buick-GMC* brought a claim for constructive termination under state law in addition to its claim under the ADDCA. The U.S. District Court for the District of Montana denied the defendant’s motion to dismiss the plaintiff’s claims for constructive termination under the Montana Motor Vehicle Dealer Act (MMVDA). Citing *Petereit*, the court found that one purpose of the MMVDA is to protect the dealer in instances when a manufacturer may unfairly exercise economic leverage. It “seems reasonable to believe that the legislature intended that MMVDA dealer protections would extend to indirect terminations.” The court also approvingly cited *Petereit* for the proposition that a “franchise need not be completely ruined but must be greatly reduced in value to evidence constructive termination of franchise.”

The cases holding or suggesting that constructive termination occurs when acts of the franchisor cause the franchisee to incur a substantial decline in income do not provide much guidance as to what would constitute a “substantial” decline. *Bob Robinson Chevrolet-Oldsmobile-Cadillac* alone suggests that a certain percentage decline (eleven percent) may, as a factual matter, represent a “substantial decline” in net income required to justify a finding.

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67. Id. at *8.
68. Id. at *9. In *Robert Basil Motors, Inc. v. General Motors Corp.*, No. 03–CV–315A, 2004 WL 1125164 (W.D.N.Y. Apr. 17, 2004), another plaintiff claimed constructive termination due to the GM’s decision to phase out the Oldsmobile brand. The court approvingly cited *Petereit* for the proposition that the intent of the New York Franchised Motor Vehicle Dealer Act was to protect the dealer from the manufacturer’s unfair exercise of economic leverage. *Id.* at *3. The court held that the dealer’s constructive termination claim survived a motion to dismiss without articulating a standard for determining whether constructive termination occurred. *Id.* at *5* (“At this stage of the proceedings the Court cannot conclude that the plaintiff can prove no set of facts which would entitle the plaintiff to relief under the [constructive termination] claim.”).
70. The court also denied the defendant’s motion to dismiss an ADDCA claim. See discussion supra Part III.A; *Grimes Buick-GMC*, 2013 WL 5348103, at *4.
72. *Id.*
of constructive termination.\textsuperscript{73} The court held that eleven percent is “something greater than a de minimus [sic] loss of revenue” sufficient to state a claim of constructive termination.\textsuperscript{74}

3. Unilateral Modification of Franchised Business

Another approach to constructive termination appears in two cases, both from Florida federal courts.\textsuperscript{75} Each sets forth a standard for constructive termination that would liberalize the already generous Petereit standard. Although each articulated a standard for constructive termination, each ultimately held that no constructive termination occurred.

First, in \textit{Bert Smith Oldsmobile, Inc. v. General Motors Corp.}, another case arising from GM's decision to phase out its manufacture of the Oldsmobile line in 2000, the dealer argued that GM's notice of intent not to renew the dealer agreement following phaseout constituted a \textit{de facto} termination.\textsuperscript{76} The U.S. District Court for the Middle District of Florida stated that \textit{de facto} or constructive termination occurs when the manufacturer unilaterally modifies the terms of the dealer agreement in a way that “substantially interferes” with the dealer’s realization of the benefits of the original dealer agreement.\textsuperscript{77} The court found that the plaintiff had not alleged facts sufficient to find that GM unilaterally modified the dealer agreement. As support for that finding, the court stated that the “parties continue to perform under the Dealer Agreement, even during the pendency of this lawsuit.”\textsuperscript{78} Further, GM did not initiate a \textit{de facto} termination by giving notice of its intent not to renew at expiration.\textsuperscript{79}

Second, in \textit{Hopkins Pontiac GMC, Inc. v. Ally Financial Inc.}, the plaintiff, a single-line GMC dealer, alleged that, beginning in 2009, GM led it to think it would also become a Buick franchisee. The dealer expected that GM would permit it to conduct jointly its GMC and Buick operations. The dealer claimed that, relying on GM's representations, it refinanced its dealership facility and obtained from its shareholders commitments to contribute additional equity to the corporation. In March 2010, GM advised that it would not grant the dealer a Buick franchise but that it would assist the dealer in selling its GMC business to another dealer and pay a portion of

\textsuperscript{73} Bob Robinson Chevrolet-Oldsmobile-Cadillac, No. 5:01CV145, slip op. at 9 (N.D. W. Va. June 13, 2003).
\textsuperscript{74} \textit{Id.}
\textsuperscript{76} \textit{Bert Smith Oldsmobile}, 2005 WL 1210993, at *3.
\textsuperscript{77} \textit{Id.} (citig Banc One Fin. Servs., Inc., v. Advanta Mortg. Corp. USA, No. 00 C 8027. 2002 WL 88154 (N.D. Ill. Jan. 23, 2002) (where constructive termination of a loan servicing agreement was at issue)). The \textit{Banc One} case, in turn, cites \textit{Petereit.}
\textsuperscript{78} \textit{Bert Smith Oldsmobile}, 2005 WL 1210993, at *3.
\textsuperscript{79} The dealer appears to have argued only that GM's notice of its intent not to renew the dealer agreement constituted constructive termination. The court discusses constructive termination more broadly under the standard of unilateral modification, in addition to addressing the plaintiff's specific allegation.
the sale price. The dealer claimed that GM reneged on its agreement to pay a portion of the GMC sale price. As a result of this alleged series of events, the dealer was forced to sell its GMC business to another dealer at a reduced sale price.

The U.S. District Court for the Northern District of Florida dismissed the dealer’s constructive termination claim. Citing *Bert Smith Oldsmobile*, the court stated that constructive termination occurs when one party unilaterally modifies the franchise agreement in a manner substantially interfering with the benefits otherwise available to the other party. The court found that the dealer failed to allege that GM unilaterally modified the GMC dealer agreement at all. In the court’s words, the dealer “has not alleged that General Motors did anything other than fail to make good on its promise to give [the dealer] a Buick franchise, an allegation that has nothing to do with the [GMC dealer agreement].”

In addition to these two cases, a recent decision by a New York administrative law judge, *Wide World of Cars, LLC dba Wide World Maserati v. Maserati North America, Inc.*, also addressed a dealer’s claim that the manufacturer unilaterally modified the existing franchise agreement. Maserati changed its pricing of vehicles by reducing dealers’ holdback from four percent to two percent, and offering dealers an opportunity to earn bonuses of up to three-and-a-half percent, of a vehicle’s price. The administrative law judge found that Maserati’s determinations whether dealers qualified for bonuses were inherently subjective. Maserati’s substitution of the bonus program for the historical holdback had significant impacts on the dealer’s return on investment and, therefore, represented an unlawful modification of the existing franchise arrangement.

Finally, although *Wide World Maserati* apparently did not allege constructive termination of the Maserati dealer agreement, in *Brentlinger Enterprises v. Volvo Cars of North America, LLC*, a plaintiff did plead constructive termination based on Ford’s newly established bonus system that rewarded dealers operating exclusive facilities. Nonetheless, the U.S. District Court for the District of Ohio held that, because Ford’s program was functionally available to the plaintiff, it was not the proximate cause of an alleged destruction of the dealer’s business sufficient to constitute constructive termination. The holding in *Brentlinger* does suggest that a constructive termination claim might succeed if a manufacturer’s bonus program is not

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81. Id.
83. Id. at 2.
84. Id. at 5–6.
85. Id. at 6 (citing *Beck Chevrolet Co., Inc. v. Gen. Motors LLC*, 27 N.Y.3d 379 (2016)).
87. Id. at *8.
88. Id.
functionally available to a plaintiff-dealer and is the proximate cause of significant economic losses.

4. Bad Faith Claims Under State Law

Several cases hold that a dealer can maintain a constructive termination claim if it can show economic detriment caused by a manufacturer’s bad-faith actions—as “bad faith” is defined under state law. In *Carrol Kenworth Truck Sales, Inc. v. Kenworth Truck Co.*, the manufacturer offered the plaintiff-dealer a one-year renewal of the three-year dealer agreement previously offered to the dealer.89 One reason for the reduced term was that the dealer had failed to meet its sales quota after Kenworth changed its method of computing quotas. Rather than fix quotas based on the dealer’s actual percentage of sales in its local market, Kenworth began calculating the dealer’s quota based on Kenworth’s target for market penetration.90 In addition, Kenworth recommended that the dealer employ additional personnel.91

The dealer claimed that the manufacturer’s offer of a one-year dealer agreement, along with its recommended additions to the dealer’s sales staff, constructively terminated the franchise relationship in bad faith.92 The Eleventh Circuit concluded that there was insufficient evidence of bad faith as defined under the ADDCA.93 The applicable Alabama law, however, defined the term “good faith,” with reference to the UCC definition, as “[h]onesty in fact and the observation of reasonable commercial standards of fair dealing.”94 Under this more liberal definition, the court held that the record included evidence sufficient for a jury to conclude that the manufacturer did not act in good faith.95

Similarly, in *Jay Automotive Group, Inc. dba Jay Suzuki v. American Suzuki Motor Corp.*, the dealer claimed that Suzuki’s fraudulent conduct over a number of years imposed on the dealer economic loss, loss of reputation, and the inability to continue operations profitably.96 The U.S. District Court for the Middle District of Georgia, interpreting Georgia law, concluded that the Georgia statute prohibiting franchise termination unless a manufacturer acts in good faith was “essentially indistinguishable” from the Alabama statute at issue in *Carroll Kenworth Truck Sales*.97 Consequently, the district court held the dealer’s assertion that the manufacturer’s bad-faith conduct forced the constructive termination of the franchise agreement stated a claim upon

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89. *Carrol Kenworth Truck Sales, Inc. v. Kenworth Truck Co.*, 781 F.2d 1520, 1523 (11th Cir. 1986).
90. Id.
91. Id. at 1524.
92. Id.
93. Id. at 1528.
94. Id. (citing Ala. Code § 8-20-3(8)).
95. Id. at 1528–29.
97. Id. at *6.
which relief could be granted. In the court’s words, “if a franchisor forces the termination of a dealer agreement in bad faith or without good cause and/or notice, the court finds that the franchisee has a claim even if the franchisor did not explicitly use the magic words: ‘we terminate the franchise.’”

5. A Note on Uses and Meanings of “Bad Faith”

Constructive termination cases note at least four contexts in which a manufacturer’s good faith may be at issue: a manufacturer’s general obligation to act in good faith in the franchise relationship, the requirement that any modification of a franchise be undertaken in good faith, the requirement that a manufacturer terminate a franchise in good faith, and the manufacturer’s implied covenant of good faith and fair dealing. In Carroll Kenworth Truck Sales, the court apparently was concerned only with the Alabama statute that “requires that a manufacturer act in good faith when terminating a dealership.” In Jay Suzuki, the court found that the dealer had sufficiently pled under Georgia statutes requiring that a manufacturer must act in good faith in terminating a franchise and that a franchisor must act in good faith “in connection with the operation of a dealer’s business pursuant to a franchise” or “in any of its business transactions with a dealer.”

To complicate matters further, definitions of “good faith” under State law vary significantly. Under the Alabama and Georgia statutes discussed in Carroll Kenworth Truck Sales and Jay Suzuki, good faith is defined in accordance with the UCC standard. In New York, “good faith” is defined to mean the UCC standard plus “any common law definitions of that term.” The Colorado statute imports the language from the ADDCA. One New Hampshire case interpreting Michigan law defines bad faith as “arbitrary, reckless, indifferent or intentional disregard of the interests of the person owed a duty.”

It is beyond the scope this article to review the law of dealer claims of manufacturers’ bad-faith conduct. The limited observation here is that,

98. Id. at *7.
99. Id.
104. See Carrol Kenworth Truck Sales, Inc. v. Kenworth Truck Co., 781 F.2d 1520, 1528 (11th Cir. 1986); Ala. Code § 8-20-5.
given the uses and definitions of “good faith” in manufacturer-dealer law, the bad-faith theory of constructive termination could lead to a Pandora’s box of variations, inconsistent results across jurisdictions, and a lack of certainty for manufacturers conducting interstate commerce.

IV. Manufacturer-Dealer Lease Negotiations and Constructive Termination

As discussed earlier, the opinion in Surf City does not address directly a constructive termination cause of action. The dealer’s fundamental claims were breach of contract and breach of the implied covenant of good faith and fair dealing. The dealer pleaded constructive termination as the basis of the principal causes of action. The facts of Surf City do, however, suggest a question concerning application of constructive termination principles in lease negotiations between a manufacturer and a dealer. The value of the Surf City site appreciated considerably between the time of MMNA’s last appraisal and the date of sale. MMNA presumably concluded that it could realize a greater economic benefit by selling the Surf City site than by selling automobiles from it. Another manufacturer might have come to a different conclusion. Sales of a high-volume brand could theoretically offer a greater return to a manufacturer than selling appreciated real estate. As leases by manufacturers to dealers mature and renew, however, manufacturers will reasonably request increased rents from their dealers. As with the Shell dealers in Mac’s Shell, a dealer might object that renewal rents, if sufficiently high, could adversely affect the dealer’s business.

Assuming that relocation of its dealership is not a realistic possibility, the prospect of increased rent under a proposed new lease from a manufacturer presents a dealer with limited options. The dealer could enter into the new lease and, assuming no significant change in the dealership’s business, continue less profitable operations. If the dealer decides not to execute the new lease, the dealer could sell its dealership business to a new operator or simply terminate. Given these choices, most dealers’ natural preference would be sale of the dealership business. Unless the successor dealer already owns or leases a dealership facility in an area exempt from risk of protest by other dealers, however, purchase of the dealership will require that the successor enter into the new lease with the manufacturer.111

If the dealer elects to execute the new lease and stay in business, no constructive termination claim would be available to the dealer under the ADDCA, even if the dealer could show that the manufacturer acted in bad faith as narrowly defined in the ADDCA. An ADDCA constructive termination claim is possible only if actual termination occurs.

111. Higher rent will tend to reduce the value of the dealership business. See Kerrigan, supra note 2 (“At some threshold, the risk of high rent will push down the market value of a dealership.”).
No matter the course chosen by the dealer, any state-law claim for constructive termination would initially have to survive the objection that it fails to satisfy the abandonment requirement articulated in *Mac’s Shell*. Assuming that the dealer’s claim survives assertion of the abandonment requirement, the dealer’s options for pursuing a state-law constructive termination claim require the dealer to show that (a) the manufacturer acted in bad faith under state-law definitions, or (b) the manufacturer unilaterally modified the terms of the franchise relationship resulting in either a substantial reduction in the dealer’s income from operations (*Petereit*) or (satisfying the lower standard articulated in *Bert Oldsmobile*) a substantial interference with the dealer’s realization of the benefits of the dealer agreement.\(^{112}\)

Moreover, for a unilateral-modification claim to succeed, a court would have to conclude that the lease is part of the franchise relationship.\(^{113}\) The revised lease would not amend the dealer agreement itself. As suggested by *Wide World of Cars*, some courts take an expansive view of what, in addition to the dealer agreement, is included in the franchise. A court’s determination, however, that a lease between a manufacturer and a dealer is integral to the franchise would, as a practical matter, obligate the manufacturer to retain ownership of the property so long as the dealer is in business. By selling, a manufacturer would relinquish control of an important component of the franchise relationship, and no potential purchaser would assume an obligation to lease to a dealer. Although not expressly stated, these considerations may have influenced the court in *Surf City*, when it refused to hold that sale of dealership property worked a constructive termination.

The dealer could attempt to claim that the manufacturer’s request for more rent rises to the level of bad faith under provisions of the ADDCA. To maintain a claim under the ADDCA, however, the dealer would have to voluntarily terminate and allege that the manufacturer sought intentionally to force the termination through coercion, intimidation, or threats of either. Without more, a manufacturer’s request for market-level rents would not satisfy the ADDCA definition of bad faith.

The dealer could consider a claim of bad-faith constructive termination under state law whether or not it remains in business. Under the *Carrol Kenworth Truck Sales* test, the dealer would have to show that the manufacturer’s conduct was not honest in fact or consistent with reasonable commercial

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112. In *Grimes Buick-GMC*, for example, the court allowed a constructive termination claim to proceed although the dealer had sold its business to a third party at what it claimed to be a deflated price. *Grimes Buick-GMC, Inc. v. GMAC, LLC*, No. CV 12–73–H–CCL, 2013 WL 5348103, at *2 (D. Mont. Sept. 23, 2013).

113. *Bethesda Ford, Inc. v. Ford Motor Co.*, 572 F. Supp. 623 (D. Md. 1983), provides modest support for the proposition that the lease is part of the franchise relationship. Faced with a dealer’s assertion that the “franchise” excluded a lease between the manufacturer and the dealer, the court stated that it “perceives no reason for such a restrictive definition of the term ‘franchise,’ the term should instead encompass all oral or written understandings between the franchisor and franchisee.” *Id.* at 630.
standards of fair dealing. The considerations regarding the manufacturer's subjective intent would be similar to those pertinent to a claim under the ADDCA. But in response to the dealer's contention that a rise in rents is not consistent with reasonable commercial standards of fair dealing, the manufacturer can justifiably respond that real-estate market conditions support a rise in rents to market levels. As noted earlier, the range of definitions and applications of "bad faith" in manufacturer-dealer law creates the risk that the Carrol Kenworth Truck Sales approach could be expanded in ways creating uncertainty for both dealers and manufacturers.

The dealer's best tactical alternative may be to sell its dealership assets to a transferee dealer and attempt thereafter to claim constructive termination. Voluntary termination of the dealer agreement in connection with the sale to a third party leaves open the possibility of a claim under the ADDCA and avoids the uncertainty presented by the abandonment requirement. Without evidence of intent to coerce or intimidate, however, a claim under the ADDCA will fail. Because considering a lease to be integral to the franchise leads to an untenable result, state-law causes of action available to the dealer would be limited to an attempt to show that the manufacturer's bad-faith conduct forced termination of the dealer agreement. In the final analysis, however, the dealer's enemy is the rising value of commercial property, a condition attributable to economic conditions, not a manufacturer's request for market rents.

115. See cases and statutes cited supra notes 100–10.
117. Although not a constructive termination claim, in certain jurisdictions a dealer might contend that a manufacturer's conduct deprived the dealer of the opportunity to realize fair value or reasonable compensation for its franchise. See N.Y. Veh. & Traf. Law § 466(2) ("It shall be deemed an unreasonable restriction upon the sale or transfer of a dealership for a franchisor (i) directly or indirectly to prevent or attempt to prevent a franchised motor vehicle dealer from obtaining the fair value of the franchise or the fair value of the dealership business as a going concern."). But see JJM Sunrise Auto., LLC v. Volkswagen Grp. of Am., Inc., 997 N.Y.S.2d 270 (Sup. Ct. 2014) (noting that court dismissed plaintiff's claim because the defendant's alleged attempts to prevent realization of fair value were statutorily permitted under New York law); Schieffelin & Co. v. Piaggio Grp. Ams., Inc., No. 5:01CV145, slip op. 33085(U) (N.Y. Sup. Ct. Dec. 9, 2013) (indicating that the court dismissed the plaintiff's claim because it was based on the unsupportable premise that the defendant had an obligation to award the plaintiff additional franchises, thereby enhancing the value of the plaintiff's existing franchise).
Trademark Exemptions to Business Opportunity Laws: A Puff of Smoke in the Marijuana Industry?

Alice Kelly, Christina Fugate & Kelsey Weyhing

Alice Kelly practices in Ice Miller’s Intellectual Property Group. Based in Chicago, Alice handles all aspects of trademark law and global brand management, from global clearance and registration to enforcement of those rights through litigation in United States federal courts. She has tried cases in federal, state, and arbitral forums and routinely handles matters before the Trademark Trial and Appeal Board of the U.S. Patent and Trademark Office. Alice’s practice includes trademarks, copyrights, trade secrets, franchise enforcement, and licensing. Alice represents clients in a wide range of industries, including manufacturing, travel, entertainment, hospitality, food and beverage, and beauty and wellness. Despite a busy litigation practice, Alice has always devoted significant time to her community, including extensive pro bono representation of children and children’s rights advocates. Alice is licensed in Illinois, California, and Missouri and has lived in Chicago, San Francisco, and St. Louis. Alice obtained her J.D. cum laude from St. Louis University School of Law and her B.A. magna cum laude from St. Louis University.

Christina Fugate is a franchise and litigation partner in the Indianapolis, Indiana, office of the law firm Ice Miller LLP. Christina leads the firm’s franchise practice, providing franchise and entrepreneurial clients with counseling and litigation services, from the initial creation of a franchise system and negotiation of the franchise relationship through dispute resolution. In addition to her franchise practice, Christina provides risk management and litigation services for a wide-range of commercial matters and clients. Christina is an active member of the ABA Forum on Franchise and International Franchise Association. She has written several articles for the ABA Franchise Journal and was a speaker at the ABA Forum on Franchise’s annual meeting in October 2015. Christina has been recognized as an Indiana Super Lawyers “Rising Star” from 2012–2018 and was selected as the award recipient of Junior Achievement of Central Indiana’s “Indy’s Best and Brightest in Law” in 2016.

Kelsey Weyhing is an associate in Ice Miller’s Litigation Group, concentrating her practice in the area of business litigation. In 2017, Kelsey graduated cum laude from Chicago-Kent College of Law, where she received the distinguished Bar and Gavel Society Award. Kelsey obtained her Bachelor of Arts in English literature from Michigan State University.
Marijuana or “pot” is a growing industry (no pun intended). As more states legalize marijuana for medical and recreational use, entrepreneurs will look to expand, and even franchise, their business. Marijuana legalization is not limited to lifting the criminal and civil penalties for consumers; it also extends to marijuana businesses and the benefits, protections, and burdens of many state regulations, including various federal and state franchise and business opportunity laws. Undoubtedly, as these growing businesses become entwined with these regulations, legal practitioners will be called upon to untangle them and to advise their clients on their compliance obligations. This task of untangling is complicated by the reality of the continuing federal prohibition of marijuana.

Split into three sections, this article will help to address one thread of a complicated web of regulations: state business opportunity laws. First, this article will define what a business opportunity is and the various standards that apply across the country. Second, this article will explain how the federal trademark exception provides a potential bypass around state business opportunity laws, with a state-by-state survey of the trademark exception. Third, this article takes a deep dive into the world of trademark registrations, as they apply to marijuana businesses. Due to the federal prohibition on marijuana, marijuana businesses are not currently able to take advantage of some of the trademark exception bypasses around state business opportunity laws. However, there are certain steps that businesses can take to position themselves to capitalize on the exception, should the federal marijuana prohibition go up in smoke (pun intended), making future federal trademark registration possible. Importantly, this article provides some general practice pointers and takeaways that explain how marijuana business entrepreneurs can potentially use a trademark registration to avoid getting caught up in state disclosure requirements.1

I. Business Opportunity Laws: An Overview

A. The FTC Business Opportunity Rule versus State Regulation

From their meager origins of providing a legal framework for regulating vending machine use and sales, business opportunity laws have grown to include a wide variety of business relationships and transactions. How a particular law or regulation defines a business opportunity necessarily implicates which types of business relationships or transactions benefit from or are burdened by the business opportunity regulatory regime. Both the federal and state governments provide definitions of business opportunities. However, business opportunity laws generally involve sellers that:

1. provide or help find locations for vending machines, racks, or displays;
2. purchase all products that the purchaser makes using supplies sold by [the seller] to the purchaser;

1. This article focuses exclusively on the application of business opportunity laws to the marijuana industry. For a discussion on franchising in the marijuana industry more generally, see Shannon L. McCarthy & Dawn Newton, Franchising a Marijuana Business: It’s Not Quite Mission Impossible, 35 Franchise L.J. 357 (Winter 2016).
(3) guarantee that the purchaser will derive income exceeding the price paid or the seller will return the purchase price or repurchase any products, equipment, or supplies; or

(4) will provide, upon payment of some minimum sum, a sales or marketing program that will enable the purchaser to derive income from the business opportunity.²

On the federal level, the Federal Trade Commission (FTC) regulates business opportunities pursuant to the FTC Business Opportunity Rule, 16 C.F.R. § 437.1. But many states impose additional regulations encompassing a broader scope of business opportunities. A brief survey of the federal and state definitions and their corresponding regulations provides a better understanding of how these laws interact.

The FTC Business Opportunity Rule defines “business opportunity” as “a commercial arrangement” in which

(1) A seller solicits a prospective purchaser to enter a new business; and
(2) The prospective purchaser makes a required payment; and
(3) The seller, expressly or by implication, orally or in writing, represents that the seller or one or more designated persons will:
   (i) Provide locations for the use or operation of equipment, displays, vending machines, or similar devices, owned, leased, controlled, or paid for by the purchaser; or
   (ii) Provide outlets, accounts, or customers, including, but not limited to, Internet outlets, accounts, or customers, for the purchaser’s goods or services; or
   (iii) Buy back any or all of the goods or services that the purchaser makes, produces, fabricates, grows, breeds, modifies, or provides, including but not limited to providing payment for such services as, for example, stuffing envelopes from the purchaser’s home.³

The FTC Business Opportunity Rule requires sellers to make certain disclosures to prospective buyers to ensure that a prospective buyer can adequately evaluate the risks of a business opportunity.⁴ In March 2012, the FTC expanded its definition of a “business opportunity” to include protections for buyers of work-at-home schemes in addition to traditionally understood business opportunities, such as vending machines or rack displays.⁵

Under the FTC Business Opportunity Rule, a seller must disclose five categories of information, including (1) identifying information; (2) whether the seller makes an earnings claim; (3) whether the seller, its affiliate, or officers have been the subject of “any civil or criminal action for misrepresentation, fraud, securities law violations, or unfair or deceptive practices,

including violations of any FTC Rule, within the 10 years immediately preceding the date that the business opportunity is offered”; (4) the seller’s cancellation or refund policies; and (5) a list of “references,” including purchasers who purchased the business opportunity within the last three years.6

State business opportunity laws regulate a more expansive set of “business opportunities,” which are defined in each state’s respective statute. Several state statutes also contain heightened disclosure requirements. The result is a complicated patchwork of federal and state regulation, particularly for multistate business opportunity sellers who must understand and comply with varying business opportunity requirements.

For example, among other programs, the Illinois Business Opportunity Sales Law of 1995 defines “business opportunity” to include not only vending machines, rack displays, or comparable schemes, but also opportunities involving the seller’s guarantee that the purchaser will “derive income from the business,” or the seller’s promise to refund the price paid by the purchaser in the event that the purchaser is dissatisfied.7 Similarly, the Florida Sale of Business Opportunity Act includes within its definition of “business opportunity” the seller’s representation that “the seller will provide a sales program or marketing program that will enable the purchaser to derive income from the business opportunity.”8 The preceding statutes are typical of state business opportunity laws, which may bring unsuspecting sellers within the ambit of regulation.

II. Trademark Exceptions to State Business Opportunity Laws

In some states, programs that might otherwise be characterized as “business opportunities” are exempt from disclosure requirements if the opportunity is associated with a registered trademark. This “trademark exception” provides an avenue by which potential sellers who qualify can sidestep complicated business opportunity regulations. State business opportunity laws differ as to whether federal or state trademark registration is required in order to fall within the trademark exception.

A. State-by-State Treatment of the Trademark Exception: A Survey

The following overview of express trademark exceptions examines the different regulations among state business opportunity laws. Of the current state regulations affecting business opportunities, twenty-one states contain trademark exceptions to the definition of “business opportunity,” thereby excluding sales in connection with a licensed registered trademark from business opportunity disclosure requirements.9

6. 16 C.F.R. § 437.3.
7. 815 ILL. COMP. STAT. ANN. 602/5-5.10.
<table>
<thead>
<tr>
<th>State</th>
<th>Title of Law</th>
<th>Reference to Trademark Exception</th>
<th>Statutory Language</th>
<th>Does the Trademark Exception Explicitly Require Registration Under Federal Law?</th>
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<tbody>
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<td>Alaska</td>
<td>Sale of Business Opportunities</td>
<td>Alaska Stat. § 45.66.220</td>
<td>This chapter does not apply to a sale of or an offer to sell ... a business opportunity that involves a marketing plan made in conjunction with the registration of a trademark or service mark under 15 U.S.C. §§ 1051–1127 (Trademark Act of 1946) if the seller has a minimum net worth of $1,000,000 as determined on the basis of the seller's most recent audited financial statement prepared within 13 months of the first offer to sell in this state[,]</td>
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<td>Arizona</td>
<td>Located in Chapter 9, Trade Practices Generally, Article 6. Telephone Solicitations</td>
<td>Ariz. Rev. Stat. Ann. § 44-1271</td>
<td>“Business opportunity” . . . [i]ncludes a solicitation of customers in which the seller represents . . . [t]hat the seller or an entity associated with the seller will provide a sales program or marketing program to the consumer unless the marketing program is offered in conjunction with the licensing of a registered trademark or service mark, if the trademark or service mark has been effectively registered under federal law.</td>
<td>Yes</td>
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</table>
| California | Seller Assisted Marketing Plan Act                | Cal. Civ. Code § 1812.201        | A “seller assisted marketing plan” shall not include . . . [a] license granted by a general merchandise retailer that allows the licensee to sell goods, equipment, supplies, products, or services to the general public under the retailer's trademark, trade name, or service mark if all of the following criteria are satisfied:  
(A) The general merchandise retailer has been doing business in this state continually for five years prior to the granting of the license.  
(B) The general merchandise retailer sells diverse kinds of goods, equipment, supplies, products, or services.  
(C) The general merchandise retailer also sells the same goods, equipment, supplies, products, or services directly to the general public.  
(D) During the previous 12 months the general merchandise retailer's direct sales of the same goods, equipment, supplies, products, or services to the public account for at least 50 percent of its yearly sales of these goods, equipment, supplies, products, or services made under the retailer's trademark, trade name, or service mark. | No                              |
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<td>Connecticut</td>
<td>Business Opportunity Investment Act</td>
<td>Conn. Gen. Stat. § 36b-61</td>
<td>[S]ections 36b-60 to 36b-80 [of the Business Opportunity Investment Act], inclusive, shall not apply to the sale of a marketing program made in conjunction with the licensing of a registered trademark or service mark, provided (i) such trademark or service mark has been effectively registered under federal law; and (ii) for such trademark or service mark initially registered under federal law on or after October 1, 1996, the seller files with the commissioner a copy of the trademark or service mark certificate prior to any offer or sale in the state, provided further that failure to file such certificate shall not, in and of itself, preclude reliance on this exclusion.</td>
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<td>Florida</td>
<td>Sale of Business Opportunities Act</td>
<td>Fla. Stat. § 559.801</td>
<td>“Business opportunity” . . . does not apply to the sale of a sales program or marketing program made in conjunction with the licensing of a trademark or service mark that is registered under the laws of any state or of the United States if the seller requires use of the trademark or service mark in the sales agreement.</td>
<td>No</td>
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<tr>
<td>Georgia</td>
<td>Sale of Business Opportunities Law</td>
<td>Ga. Code Ann. § 10-1-410</td>
<td>[T]his subparagraph shall not apply to the sale of a sales program or a marketing program made in conjunction with the licensing of a registered trademark or service mark.</td>
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<td>Illinois</td>
<td>Business Opportunity Sales Law of 1995</td>
<td>815 Ill. Comp. Stat. 602/5-5.10</td>
<td>[T]his Law shall not apply to the sale of a marketing plan made in conjunction with the licensing of a federally registered trademark or federally registered service mark.</td>
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<td>Iowa</td>
<td>Business Opportunity Promotions Law</td>
<td>Iowa Code § 551A.1</td>
<td>“Business opportunity” does not include . . . [a]n offer or sale of a business opportunity which involves a marketing plan made in conjunction with the licensing of a federally registered trademark or federally registered service mark provided that the seller has a minimum net worth of one million dollars as determined on the basis of the seller’s most recent audited financial statement prepared within thirteen months of the first offer in this state.</td>
<td>Yes</td>
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<td>Louisiana</td>
<td>Business Opportunity Sellers and Agents</td>
<td>La. Stat. Ann. § 51:1821</td>
<td>This provision shall not apply to the sale or lease of a sales plan or marketing program made in conjunction with the licensing of a registered trademark or service mark.</td>
<td>No</td>
</tr>
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<td>Maine</td>
<td>Regulations of the Sale of Business</td>
<td>Me. Stat. § 4691</td>
<td>[T]his subsection does not apply to a marketing program provided in conjunction with the licensing of a federally registered trademark or service mark.</td>
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<td>Maryland</td>
<td>Business Opportunities</td>
<td>Md. Code Ann., Bus. Reg. § 14-104 (West)</td>
<td>This subtitle does not apply to . . . an offer to sell or sale of a business opportunity with a marketing plan made in conjunction with the licensing of a federally registered trademark or service mark, provided that the seller has a minimum net worth of $1,000,000 as determined on the basis of the seller’s most recent audited financial statement prepared within 13 months of the first offer that the seller makes in the State.</td>
<td>Yes</td>
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<td>Michigan</td>
<td>Michigan Consumer Protection Act</td>
<td>Mich. Comp. Laws § 445.902</td>
<td>This subparagraph does not apply to the sale of a marketing program made in conjunction with the licensing of a federally registered trademark or a federally registered service mark, or to the sale of a business opportunity for which the purchaser pays less than $500.00 in total for the business opportunity from any time before the date of sale to anytime within 6 months after the date of sale.</td>
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<td>Nebraska</td>
<td>Seller-Assisted Marketing Plan Act</td>
<td>Neb. Rev. Stat. § 59-1717</td>
<td>A seller-assisted marketing plan shall not include a license granted by a general merchandise retailer which allows the licensee to sell goods, equipment, supplies, products, or services to the general public under the retailer’s trademark, trade name, or service mark when the general merchandise retailer has been doing business continuously for five years prior to the granting of the license.</td>
<td>No</td>
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<tr>
<td>North Carolina</td>
<td>Business Opportunity Sales</td>
<td>N.C. Gen. Stat. § 66-94</td>
<td>[T]his subsection shall not apply to the sale of a marketing program made in conjunction with the licensing of a federally registered trademark or a federally registered service mark, or when the purchaser pays less than two hundred dollars ($200.00).</td>
<td>Yes</td>
</tr>
</tbody>
</table>
| Ohio       | Business Opportunity Plans | Ohio Rev. Code Ann. § 1334.12 (West) | “Exempt matters” include:  
(C) An agreement for the use of a trademark, service mark, trade name, seal, advertising, or other commercial symbol designating a person who offers a bona fide service for the evaluation, testing, or certification of goods, commodities, or services;  
(D) An agreement between a licensor and a single licensee to license a trademark, trade name, service mark, advertising, or other commercial symbol where such license is the only one of its general nature and type to be granted by the licensor with respect to that trademark, trade name, service mark, advertising or other commercial symbol; . . .  
(H) A license granted by a general merchandise retailer that allows the licensee to sell goods or services to the general public under the retailer’s trademark, trade name, or service mark, advertising, or other commercial symbol if the general merchandise retailer has been doing business in this state continuously for five years prior to the granting of the license and the general merchandise retailer also sells the same goods or services directly to the general public; . . . and  
(M) The sale or lease of goods or services to a purchaser who has for at least six months previously, bought goods or services which were sold under the same trademark or trade name, or which were produced by the seller and received on resale of such goods or services an amount at least equal to the amount of the initial payment or promissory note. | No                                 |
<table>
<thead>
<tr>
<th>State</th>
<th>Title of Law</th>
<th>Reference to Trademark Exception</th>
<th>Statutory Language</th>
<th>Does the Trademark Exception Explicitly Require Registration Under Federal Law?</th>
</tr>
</thead>
<tbody>
<tr>
<td>Oklahoma</td>
<td>Business Opportunity Sales Act</td>
<td>Okla. Stat. tit. 71, § 802</td>
<td>“Business opportunity” does not include . . . [a]ny offer or sale of a business opportunity which involves a marketing plan made in conjunction with the licensing of a federally registered trademark or federally registered service mark provided that the seller has a minimum net worth of One Million Dollars ($1,000,000.00) as determined on the basis of the seller's most recent audited financial statements prepared within thirteen (13) months of an offer or sale in accordance with generally accepted accounting principles and audited in accordance with generally accepted auditing standards.</td>
<td>Yes</td>
</tr>
<tr>
<td>South Carolina</td>
<td>Business Opportunity Sales Act</td>
<td>S.C. Code Ann. § 39-57-20</td>
<td>[T]his subsection does not apply to the sale or a marketing program made in conjunction with the licensing of a registered trademark or service mark.</td>
<td>No</td>
</tr>
<tr>
<td>South Dakota</td>
<td>Business Opportunities</td>
<td>S.D. Codified Laws § 37-25A-2</td>
<td>For the purposes of this chapter, the term, business opportunity, does not include . . . [a]ny offer or sale of a business opportunity involving a marketing plan made in conjunction with the licensing of a federally registered trademark or federally registered service mark if the seller had a minimum net worth of one million dollars as determined by the seller's most recent audited financial statement, prepared within thirteen months of the first offer in this state.</td>
<td>Yes</td>
</tr>
<tr>
<td>Utah</td>
<td>Business Opportunity Disclosure Act</td>
<td>Utah Code Ann. § 13-15-2 (West)</td>
<td>“Assisted marketing plan” does not include . . . the sale of a package franchise or a product franchise defined by and in compliance with Federal Trade Commission rules governing franchise and business opportunity ventures.</td>
<td>No</td>
</tr>
<tr>
<td>State</td>
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<tr>
<td>Virginia</td>
<td>Business Opportunity Sales Act</td>
<td>Va. Code Ann. § 59.1-263</td>
<td>Such definition of “business opportunity” shall not include . . . [a] license granted by a general merchandise retailer which allows the licensee to sell goods, equipment, supplies, products or services to the general public under the retailer’s trademark, trade name or service mark, provided that such general merchandise retailer has been doing business in the Commonwealth continuously for five years prior to the granting of such license and such general merchandise retailer also sells the same goods, equipment, supplies, products or services directly to the general public.</td>
<td>No</td>
</tr>
<tr>
<td>Washington</td>
<td>Business Opportunity Fraud Act</td>
<td>Wash. Rev. Code § 19.110.040</td>
<td>Nothing in this chapter applies to . . . [a] marketing program made in conjunction with licensing of a registered trademark or service mark for which no consideration is paid.</td>
<td>No</td>
</tr>
</tbody>
</table>
B. Interpretation of the Trademark Exception by Some Courts

A handful of courts have examined the intersection of the federal trademark exception with state business opportunity laws. For example, United States district courts in both Florida and Georgia have addressed this issue as it applies to the respective business opportunity laws in each of those two states, including what types of businesses qualify under the respective state statutes, and why. For example, the Florida Sale of Business Opportunities Act contains a typical trademark exception within its definition of “business opportunity.” The Act provides that the paragraph relating to a “business opportunity” does not apply to the sale of a sales program or marketing program made in conjunction with the licensing of a trademark or service mark that is registered under the laws of any state or of the United States if the seller requires use of the trademark or service mark in the sales agreement.” As illustrated by the following cases, when interpreting trademark exceptions, courts have typically adopted a plain reading of the state’s business opportunity statute to apply the exemption.

1. *Barnes v. Burger King Corp.*

*Barnes v. Burger King Corporation* involved an alleged violation of Florida’s Sale of Business Opportunities Act based on franchisor Burger King Corporation’s alleged failure to disclose that it planned to permit other Burger King franchises to open in the vicinity of the plaintiff’s franchise restaurant. Burger King Corporation moved for summary judgment, asserting that its program is exempt from the Act’s disclosure requirements because it was “made in conjunction with the licensing of a trademark or service mark that is registered under the laws of any state or the United States” and therefore does not meet the definition of “business opportunity.”

The Southern District of Florida rejected the plaintiff’s argument that the trademark exception did not apply in this case, indicating that while the exception “does not apply to all franchise sales as not all are made in conjunction with the licensing of a registered trademark or service mark,” Burger King’s program, and associated registered trademark, fell within the exception. *Barnes* demonstrates both the importance of carefully reading applicable state business opportunity laws, as well as how the trademark exception can be used to protect and advance a business’s interests.

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12. Id.
13. Id. at 1434.
2. American Casual Dining, L.P. v. Moe’s Southwest Grill, LLC

In American Casual Dining, L.P. v. Moe’s Southwest Grill, LLC, a restaurant franchisee sued the franchisor for violation of Georgia’s Sale of Business Opportunity Law, among other claims. The franchisee alleged that Moe’s Southwest Grill, a company that franchises fast-food Mexican restaurants, failed to truthfully disclose initial investment expenses and food and labor costs prior to executing a Market Development Agreement and a Franchise Agreement with the franchisee. In connection with these agreements, the franchisee opened several Moe’s Southwest Grill restaurants in the Dallas/Fort Worth area.

Moe’s Southwest Grill filed a motion to dismiss, alleging that its franchises fell within the trademark exception of Georgia’s state business opportunity statute and therefore Moe’s was not required to make disclosures under the Sale of Business Opportunity Law. Georgia’s statute defines “business opportunity” as follows:

[T]he sale or lease of, or offer to sell or lease, any products, equipment, supplies, or services for the purpose of enabling the purchaser to start a business and in which the seller or company represents . . . [t]hat the company, in conjunction with any agreement which requires a total initial payment of an amount exceeding $500.00, will provide a sales program or marketing program; provided, however, that this subparagraph shall not apply to the sale of a sales program or a marketing program made in conjunction with the licensing of a registered trademark or service mark.

The Northern District of Georgia held that the trademark exception applied, stating that the court “need not decide whether franchises are per se exempted” from Georgia’s business opportunity law, because “[e]ven if the exemption was limited, . . . [i]t is undisputed that the sales and marketing programs associated with the Moe’s franchise system were provided to the franchisee, American Casual, in conjunction with the licensing of registered trademarks and service marks.” Thus, the court granted Moe’s Southwest Grill’s motion to dismiss the franchisee’s Business Opportunity Sales Law claim.

Like in Barnes and Moe’s, businesses should be aware of whether their state’s business opportunity law provides a trademark exception, thereby protecting them from disclosure requirements that might otherwise apply.

III. Trademarks & the Marijuana Industry—Can the Exception Apply?

An important consideration in choosing a business model tied to a registered trademark is whether the trademark can be registered in the first place. This issue begs the question of whether marijuana entrepreneurs can

15. Id. at 1362.
16. GA. CODE ANN. § 10-1-410 (emphasis added).
take advantage of the various trademark exceptions when the federal government has not yet legalized marijuana at the federal level. The Lanham Act is the primary federal trademark statute in the United States that regulates both registration and enforcement of trademarks.\textsuperscript{18} Section 1051(a)(1) of the Lanham Act allows a party to apply to register on the principal register a trademark “used in commerce.”\textsuperscript{19} As noted later, Trademark Trial and Appeal Board (TTAB) precedent consistently interprets this section as requiring \textit{lawful} use in commerce.\textsuperscript{20} As discussed later, applications to register marijuana industry trademarks consistently are refused registration as marijuana is still illegal at the federal level. However, franchisors can take several steps to preserve the right to invoke the exception should federal registration become possible in the future.

A. Recent TTAB Rulings

1. \textit{In re Morgan Brown}

Applicant Morgan Brown sought to register the mark HERBAL ACCESS for “retail services featuring herbs” in Class 035.\textsuperscript{21} At first glance, the application does not appear to be for use in relation to marijuana. As noted by the examining attorney though, marijuana was among the herbs sold in Applicant’s retail store. Registration was refused under Section 1051 of the Lanham Act because marijuana “cannot be lawfully distributed or dispensed under federal law.”\textsuperscript{22} Applicant appealed.

In a precedential opinion, the Board noted it has consistently held “to qualify for a federal service mark registration, the use of the mark in commerce must be ‘lawful.’”\textsuperscript{23} As such, “\textit{any} goods or services for which the mark is used must not be illegal under federal law.”\textsuperscript{24} Because Applicant sold marijuana in violation of the federal Controlled Substances Act (CSA), its services were an “unlawful” use in commerce. “The mere fact that a lawful use is also contemplated by the identification [of services] does not aid Applicant’s cause.”\textsuperscript{25}

In affirming the refusal, the Board found it proper for the examining attorney to look to evidence such as Applicant’s specimen of use and website to ascertain that the word “herbs” in the description of services encompassed marijuana. Accordingly, even if an applicant uses the mark, in part, for lawful goods and services, evidence of use with regard to unlawful goods and services will defeat the application. And whether a product or service is lawful within a state is irrelevant to the question of federal registration.\textsuperscript{26}

\textsuperscript{18} See 15 U.S.C. § 1051 \textit{et seq}.
\textsuperscript{19} 15 U.S.C. § 1051.
\textsuperscript{20} See cases cited infra Section III.A.
\textsuperscript{22} Id. at *1.
\textsuperscript{23} Id.
\textsuperscript{24} Id. (emphasis added).
\textsuperscript{25} Id. at *5.
\textsuperscript{26} Id. at *4.
2. In re JJ206, LLC, DBA Juju Joints

Applicant filed two applications to register the standard character marks, POWERED BY JUJU and JUJU JOINTS, in Class 034 covering vaporizers for marijuana.\(^\text{27}\) The examining attorney refused the intent-to-use application to register POWERED BY JUJU based upon an absence of a bona fide intent to use the mark in lawful commerce under Section 1051 of the Lanham Act.\(^\text{28}\) Similarly, the use based application to register JUJU JOINTS was refused for a lack of a lawful use in commerce.\(^\text{29}\)

On appeal, Applicant acknowledged that its vaporizers were to be used with marijuana, which the Board reasoned violates the CSA.\(^\text{30}\) Applicant, however, argued that its products should be characterized as “in support of the marijuana industry” and not in violation of the CSA.\(^\text{31}\) The Board, in another precedential opinion, disagreed and rejected the further argument that legality by certain states does not overcome illegality at the federal level.\(^\text{32}\) The Board refused to rely on the memorandum written by James Cole, the deputy attorney general, providing guidance on enforcement (Cole Memo)\(^\text{33}\) to support the legality of Applicant's use.\(^\text{34}\) Applicant appealed to the U.S. Court of Appeals for the Federal Circuit but moved to dismiss the appeal, which was granted on April 30, 2018.

3. In re Ultra Trimmer, LLC

Applicant filed to register ULTRA TRIMMER in Class 007 for goods identified as “agricultural machines, namely, a trimming machine for trimming leaves, plants, flowers and buds.”\(^\text{35}\) Applicant appealed the final refusal based on the lack of lawful use in commerce as the products are considered drug paraphernalia in violation of the CSA.\(^\text{36}\)

Evidence on appeal included Applicant's specimen, website excerpts, articles, third-party registrations ostensibly covering marijuana related goods


\(^{28}\) Id. at *1.

\(^{29}\) Id. (citing TMEP § 907).

\(^{30}\) Id. at *3.

\(^{31}\) Id.

\(^{32}\) Id. (citing In re Morgan Brown, 119 U.S.P.Q.2d 1350, 2016 WL 4140917, at *4 (T.T.A.B. 2016)).


\(^{34}\) In re JJ206, LLC, DBA Juju Joints, 120 U.S.P.Q.2d 1568, 2016 WL 7010624, at n.18 (T.T.A.B. 2016) (noting that the Cole Memo “provides no support for the registration of a trademark used on goods whose sale is illegal under federal law”).


\(^{36}\) Id. at *1 (citing 15 U.S.C. § 1051).
and services, and the Cole Memo. The Application did not reveal a per se violation of the CSA, but the Board held (as it has in the past) that a violation may be adduced from extrinsic evidence. Here, the extrinsic evidence from Applicant’s website showed that the product was used to trim marijuana buds, which the Board held is “drug paraphernalia” in violation of the CSA. Applicant did not dispute the intended use but argued that “lawful” use in commerce is not contemplated by the Lanham Act. This argument was resoundingly rejected by the Board based on over fifty years of precedent.

Applicant next argued for an “exemption” under § 863 of the CSA based upon certain States legalizing marijuana or paraphernalia in some form. However, Applicant failed to demonstrate how its products were exempted under the CSA. The Board specifically found that the Cole Memo does not create a blanket exception under the CSA. Applicant’s Fifth Amendment claim based on the “promise of fair procedure” likewise failed. Although not a precedential opinion, the Board took the opportunity to confirm its stance on applications related to the marijuana industry.

4. In re PharmaCann LLC

Applicant filed intent-to-use applications to register PHARMACANN and PHARMACANNIS in Class 035 covering “retail store services featuring medical marijuana” and in Class 044 covering “dispensing of pharmaceuticals featuring medical marijuana.” The applications were again refused based upon lack of a bona fide lawful intent to use in commerce. Applicant appealed.

Relying on In re Brown, the Board again held that “any goods and services for which the mark is used must not be illegal under federal law.” The Board again held that the Cole Memo lacks the force of law and “does not and cannot override the CSA,” even where the products involve medical as opposed to recreational marijuana. The Board also rejected the

37. Id.
38. Id. at *3.
39. Id. at *4.
40. Id.
41. Id. at *5.
42. Id.
43. Id. at *6.
44. Id. Applicant argued that there was a two-tiered system where the U.S. Patent and Trademark Office would allow certain marijuana-related applications to register but not others. This theory was rejected as Applicant provided no evidence that the registered marks violated the CSA but were still allowed to register.
45. Id. at *7; see also id. at *3 n.4 (“Marijuana is a controlled substance that is unlawful to possess under the CSA.”).
47. Id. at *1.
48. Id. at *3 (quoting In re Morgan Brown, 119 U.S.P.Q.2d 1350, 2016 WL 4140917, at *1 (T.T.A.B. 2016)).
49. Id. at *5 (quoting In re JJ206, LLC, DBA Juju Joints, 120 U.S.P.Q.2d 1568, 2016 WL 7010624, at n.18 (T.T.A.B. 2016)).
argument that certain Appropriations Acts signed by Congress between 2014 and 2016 that prevented the Department of Justice from using funds to prevent individual States from implementing laws legalizing medical marijuana permitted registration of the mark.\textsuperscript{50} These Acts and their amendments simply did not legalize marijuana of any type under the CSA.

B. \textit{Takeaways—How Can Clients Position Themselves?}

Obtaining a registration for a federal trademark in marijuana seems to be unlikely at this point. As a result, businesses in this industry looking to expand their model may not be able to avail themselves of the trademark exceptions to the various state business opportunity laws because they will be unable to obtain a federal trademark registration. As shown in the table preceding, many states require a federal trademark registration for the trademark exception to apply.

While there are Principal Register registrations for goods and services ancillary to marijuana, Section 1051 of the Lanham Act continues to be a bar to applications that relate to the sale of marijuana and paraphernalia. And even if a lucky application is able to obtain a registration through strategic drafting of the goods and services or the like, enforcement will continue to be an issue. A court will be tasked with determining the scope of protection to be afforded a registered trademark, which would necessarily include whether the owner uses the mark lawfully in commerce under Section 1051.

Trademark registrations at the state level—and which states might allow for marijuana trademark registrations—is beyond the scope of this article. However, state trademark registrations could be a potential avenue for invoking the trademark exception in some states. California, which does not expressly require a federal trademark registration for its exception to apply, recently stated that it would start accepting applications for trademark registrations in the marijuana industry in limited circumstances. As states continue to legalize marijuana, more secretaries of state may expressly provide for state trademark registrations of marijuana trademarks. At the very least, a state trademark registration can aid in establishing priority and trademark rights at the state level.

In addition, while it may still be several years before a federal registration of a marijuana-related trademarks is possible, a trademark owner can take steps to establish a source-identified mark in the marijuana industry and establish priority for the future. First, the owner should chose a distinctive trademark. Trademarks are classified by levels of distinctiveness with increasing levels of protection afforded the mark based on how unique and distinctive the mark is. Generic marks can never be trademarked, and descriptive marks can only acquire distinctiveness over time. More importantly though, overly descriptive marks are not unique and, thus, hard to enforce, even if distinctiveness is acquired. The more unique a mark is, the stronger it is.

\textsuperscript{50} \textit{Id.} (citations omitted).
Clients should choose several possible marks and clear them prior to use. Clearance ensures that the trademark is not already in use by someone else. This review is especially important for the marijuana industry where an established trademark may only exist at common law or on a state registry. A comprehensive search report will reflect uses of the proposed mark at common law as well as the federal and state registries.

Clients should also begin using their trademarks with the the “TM” symbol to denote that it is a source identifier. While federal registration remains difficult for marijuana marks, the United States accords priority to trademark holders who are the first to use a mark, not the first to file. Federal and state registrations are also available for ancillary marijuana goods and services. The owner should be sure that the specimen shows use for an ancillary good or service and not an illegal one.

Finally, clients should police and enforce their trademarks. Many trademark watch services will watch filings with the U.S. Patent and Trademark Office, the states, and domain registries. Vigilance can be crucial in stopping infringement in its tracks. And enforcement is key because trademark owners can lose their rights if they do not enforce and protect their marks. Taking these steps can help to preserve the future availability of a federal registration for marijuana marks.

IV. Conclusion

Entrepreneurs seeking to take advantage of the growing marijuana industry should be cognizant of applicable “business opportunity” regulations in their respective states. Trademark exceptions to state “business opportunity” statutes exempt certain business owners from compliance with the complicated disclosure process. However, because marijuana remains illegal at the federal level, applications to register marijuana industry trademarks are consistently refused registration. Several recent TTAB decisions demonstrate the difficulty of obtaining a federally registered trademark, even for products that merely support the marijuana industry.

Luckily, business owners can take steps such as carefully choosing a distinctive trademark or obtaining clearances in order to establish a source identifier in the marijuana industry, thereby establishing priority for the future. As the number of states that legalize the sale of marijuana grows, business owners who prioritize and plan for trademark registration can aspire to successfully navigate the complicated web of business opportunity laws at both the state and federal levels.
Ivars Repins was a Subway franchisee in Wisconsin. The Subway franchisor was Doctor’s Associates, Inc. (DAI). In 2015, Subway Real Estate, LLC (SRE) obtained a judgment of eviction against Repins in Wisconsin state court following an alleged breach of the franchise agreement. The franchise agreement included an arbitration clause. Repins filed a pleading in the Wisconsin state court suit stating that DAI was an indispensable party that had to be joined. But Repins did not actually seek that relief from the court. DAI responded by filing suit in the U.S. District Court for the District of Connecticut seeking to compel arbitration. Repins responded with a motion to dismiss stating that he had not actually decided yet whether to join DAI in the Wisconsin suit. DAI thereafter voluntarily dismissed the federal suit stating that, “given the current limbo state of Repins’s claims and his apparent indecisiveness, DAI does not believe the continued prosecution of the Petition [to Compel Arbitration] warrants further use of the Court’s, or the parties’, time and resources.”

In February 2017, Repins filed another pleading in the Wisconsin suit making clear that he would be seeking damages from either SRE or DAI. DAI responded by filing a new suit in the U.S. District Court for the District of Connecticut seeking to compel arbitration. In May 2017, the court entered an order granting DAI’s motion to compel. In October 2017, Repins contacted

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Jason Binford (jbinford@foley.com) is a partner in the Dallas, Texas, office of Foley & Lardner LLP. Bill Bryner (bbryner@kilpatricktownsend.com) is a partner in the Winston-Salem, North Carolina, office of Kilpatrick Townsend & Stockton LLP. Marlén Cortez Morris (mcortez@btlaw.com) is a partner in the Chicago, Illinois, office of Barnes & Thornburg LLP.
the clerk of the court asking about the outcome of the case and asserting he had never received notice of the May 2017 order. Repins also, pro se, filed a new motion to dismiss. Despite evidence that the May 2017 order was entered on the docket and mailed to Repins, DAI stated that it had no objection to the court vacating the May 2017 judgment and taking up the October 2017 motion to dismiss.

Repins made five arguments in his motion to dismiss: (1) the court lacked subject matter jurisdiction because the amount in controversy allegedly was less than $75,000; (2) the arbitration clause was unenforceable because the entire franchise agreement was unconscionable; (3) DAI was not a party to the Wisconsin suit, and therefore the Wisconsin suit did not violate the arbitration agreement; (4) DAI waived the arbitration agreement by attempting to litigate the matter previously; and (5) the defense of laches prevented DAI from bringing suit based on DAI’s alleged delay that prejudiced Repins.

The court first analyzed the proper legal framework for the motion to dismiss. The court determined that the subject matter jurisdiction argument would be addressed as a Federal Rule of Civil Procedure 12(b)(1) motion, but that the appropriate analytical framework for the remaining arguments was the standard for motions to compel arbitration, rather than Rule 12(b)(6) motions to dismiss.

Regarding subject matter jurisdiction, the court noted that it was a diversity jurisdiction case and there was no dispute that the parties had the requisite diversity of citizenship. As to the amount in controversy, Repins sought approximately $670,000 in damages in the Wisconsin suit. Repins argued the $75,000 threshold nevertheless and based his statement as follows: “Even though I’ve made a damages claim which is greater, if you look at the facts, I’ll probably not be able to prove much more than $50,000.” The court stated that there was a presumption that the amount in controversy was sufficient and that rebutting the presumption required Repins to show “to a legal certainty” that the actual amount in controversy did not meet the threshold. The court concluded that, based on Repins’s own statements regarding damages in the Wisconsin suit, he was unable to rebut the presumption.

The court next turned to the unconscionability argument. The court noted that, under controlling Supreme Court precedent, where a challenge is made to the contract as a whole, rather than to the arbitration provision specifically, the challenge must be reserved for the arbitrator. Therefore, because Repins had challenged the unconscionability of the entire franchise agreement, the court concluded that it had no authority to decide the issue. In addition, the court noted that, even if Repins’s argument could be construed as an attack on the arbitration provision specifically, the parties agreed that the issue must be determined by the arbitrator.

The court also ruled that Repins’s remaining claims were matters delegated to the arbitrator by the delegation clause in the franchise agreement. Finally, the court determined that DAI was not entitled to costs and attorneys fees absent a ruling from an arbitrator as to the applicability of the
arbitration clause. As such, the court granted DAI’s motion to compel arbitration and denied DAI’s motion for costs and fees.


On June 30, 2014, Samaca, LLC (Samaca) entered into a series of franchise agreements with Cellairis Franchise, Inc. (Cellairis), pursuant to which Samaca would undertake to operate franchises located in the Dolphin Mall in Miami, Florida. These agreements (each, a Franchise Agreement) contained an arbitration clause in which the parties agreed to arbitrate any disputes between them relating to (a) the Franchise Agreements or any other agreements between the parties; (b) the relationship between Cellairis and Samaca; (c) the scope and validity of the agreements, including arbitrability questions; and (d) the offer or sale of the franchise opportunity.

Effective on that same date, Samaca also entered into sub-license agreements (the Sub-License Agreements) with a Cellairis affiliate pursuant to which Samaca acquired a predecessor franchisee’s sub-licenses to operate the four franchises in the Dolphin Mall. These sub-license agreements contained a similar arbitration provision.

In the same time frame, Samaca, Cellairis, and the predecessor franchisee entered into an assignment and assumption agreement (the AA Agreement) reflecting the parties’ various assignments and assumptions pertaining to the franchise. The AA Agreement contained a choice-of-law and choice-of-forum provision identifying Georgia and Georgia law as the forum and governing law for adjudicating any case or controversy arising under the AA Agreement.

In late 2014, Dolphin Mall notified the parties that it would not be renewing the licenses for the franchise locations within the mall. As a result, Samaca sued Cellairis and its affiliate, seeking to rescind the Franchise Agreement and the Sub-License Agreement. Cellairis and its affiliate moved to dismiss and to compel arbitration. Despite Samaca’s argument that the AA Agreement’s choice-of-forum provision superseded the Franchise Agreement and the Sub-License Agreement, the trial court disagreed and granted the motion to compel arbitration. Samaca appealed, and the Georgia Court of Appeals affirmed.

In so holding, the Georgia Court of Appeals assessed whether the AA Agreement superseded the Franchise Agreement and the Sub-License Agreement under Georgia law. The court determined that the AA Agreement was not a successive agreement to the Franchise Agreement and Sub-License Agreement and that the AA Agreement was not inconsistent with those agreements. Instead, the AA Agreement was part of a series of documents designed to effect the transfer of the franchises, and the AA Agreement specifically incorporated by reference the Franchise Agreement and Sub-License Agreement. Furthermore, the terms of the AA Agreement were not inconsistent with the other agreement and therefore did not reflect
the parties’ intention that the AA Agreement’s choice-of-forum provision would supersede the arbitration clauses.

Finally, the appellate court held that the arbitration provisions of the Franchise Agreement and Sub-License agreement contained a “delegation provision,” namely, a provision that assigned responsibility for the arbitrability question to the arbitrator. The court therefore determined that the parties had agreed to arbitrate even threshold questions about the scope of the arbitration provision. As a result, the court affirmed the motion to compel arbitration and the dismissal of Samaca’s lawsuit with prejudice.

ATTORNEYS FEES

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

BUSINESS OPPORTUNITY

This case is discussed under the topic heading “Choice of Law.”

CHOICE OF FORUM

Office supply company Brown & Saenger, Inc. (Brown) was headquartered in South Dakota, but had operations in North Dakota. In 2011, Brown hired Dawn Osborne as a sales representative in Fargo, North Dakota. Osborne signed an employment agreement that included both choice of law and non-compete clauses. The choice of law clause provided that the agreement was governed by South Dakota law and that the state circuit court located in Minnehaha County, South Dakota, was the exclusive jurisdiction for any disputes.

Brown terminated Osborne in January 2017. Osborne sued Brown in North Dakota state court, alleging retaliation, improper deductions, and breach of contract. Osborne also sought a preliminary injunction seeking to prevent Brown from enforcing the covenant not to compete. Osborne moved to dismiss for improper venue, arguing that the choice of law provision required the matter to have been brought in North Dakota. The South Dakota state district court ruled in Brown’s favor. Osborne appealed to the North Dakota Supreme Court.

The court noted that forum selection clauses are normally enforceable, unless the clause would contravene a strong public policy of the state where
the action was brought. The court further noted North Dakota’s strong public policy—codified in N.D.C.C. § 9-08-06—that non-compete agreements are not enforceable. In fact, the court noted that the statute could be traced to 1865 and represented “one of the oldest and most continuous applications of public policy in contract law.” The court further noted that South Dakota did not have such a prohibition on non-compete agreements and that, if the action were brought in South Dakota, Brown likely would be able to enforce that provision.

The court concluded that enforcing the choice of law provision would be unfair and unreasonable because the effect would be to allow Brown to enforce a provision based on actions taken in North Dakota that were manifestly contrary to North Dakota public policy. The court stated: “Simply put, one may not contract for application of another state’s law or forum if the natural result is to allow enforcement of a non-compete agreement in violation of North Dakota’s longstanding public policy against non-compete agreements.” The court therefore reversed the lower court decision and remanded.

**CHOICE OF LAW**


The U.S. District Court for the Western District of Washington granted a painting business franchisor’s motion for summary judgment on all claims asserted against it by one of its franchisees, namely claims for (1) intentional misrepresentation; (2) violation of Connecticut’s Unfair Trade Practices Act (UTPA); and (3) violations of Connecticut’s Business Opportunity Investment Act (BOIA).

Wow 1 Day Painting LLC (Wow) and Val DiNardo (DiNardo) entered into a franchise agreement in May 2014. By Fall 2015, DiNardo had stopped operating his franchise. In May 2016, he filed suit against Wow in state court in Connecticut. Wow removed the action to the U.S. District Court for the District of Connecticut, which then transferred the case to the U.S. District Court for the Western District of Washington.

As an initial matter, the court considered which law applied to each of DiNardo’s claims. Wow asserted that the choice of law provision in the franchise agreement required the court to apply Washington law to all of DiNardo’s claims. DiNardo argued that Connecticut law applied to his statutory claims. The choice of law provision stated: “This Agreement shall be construed and interpreted according to the laws of the state of Washington, except that no Washington statute or regulation shall apply or shall give rise to any right or claim unless the Territory is in the State of Washington and such statute or regulation would apply to this Agreement by its own terms in the absence of any choice of law provision.” The court determined that
Washington law provides that a contractual choice of law provision does not govern tort claims arising out of a contract. Because DiNardo did not assert any breach of contract claims, the choice of law provision was not determinative of the law that should apply to DiNardo’s claims. Washington choice of law principles required the application of Washington law unless there was an actual conflict with another state’s laws. In the event of a conflict, Washington uses the “most significant relationship test” wherein the court will determine which law to apply based on the place where the injury occurred, the residence of the parties, and the place in which the parties’ relationship is centered.

Applying these principles, the court found no conflict between Connecticut and Washington law for DiNardo’s misrepresentation claim; thus Washington law applied. And, even though DiNardo argued there was a conflict between Connecticut and Washington law for his UTPA claim, the court found Connecticut’s UTPA comparable to Washington’s Consumer Protection Act (CPA). The court determined that the statutes served the same public policy concerns, namely to proscribe unfair methods of competition and unfair or deceptive acts or practices in the conduct of trade or commerce. Also, under both statutes, injured parties are entitled to bring a civil action and recover damages and injunctive relief. Moreover, the court found the outcome of Wow’s motion for summary judgment on DiNardo’s UTPA claim would be the same regardless of the law applied. Claims under both state laws rested solely on the alleged misrepresentations being the proximate cause of DiNardo’s injury, and Wow’s motion was based on the premise that DiNardo could not prove that any alleged misrepresentation was the proximate cause of his harm. The court therefore applied Washington law to Wow’s motion for summary judgment on the UTPA claim. For the BOIA claims, Washington did not have a comparable law; thus an actual conflict existed between Connecticut and Washington law. Wow conceded in its motion for summary judgment that Connecticut law applied by citing only Connecticut law in opposition to the BOIA claims. Further, the court concluded that the most significant relationship test necessitated application of Connecticut law. Based on the limited record before the court, there was no indication that any of the alleged tortious conduct occurred in Washington, but there was some indication that the alleged misrepresentations and the alleged injury occurred in Connecticut because DiNardo was a Connecticut resident and operated his franchised business there.

Having decided which law applied to each claim, the court moved on to the merits of Wow’s motion for summary judgment. First, the court granted summary judgment on DiNardo’s misrepresentation claim. During his deposition, DiNardo testified that all of the alleged misrepresentations occurred after he entered into the franchise agreement. In response to the motion, DiNardo filed an affidavit in which he asserted that the misrepresentations were made “during initial meetings and telephone conversations prior to the signing of the franchise agreement.” In that same affidavit, he asserted that the franchise
agreement itself contained misrepresentations upon which he relied. But the court determined that DiNardo could not now assert that he relied upon any alleged misrepresentation in the franchise agreement itself. During his deposition, he testified that he did not read the agreement prior to signing it. Further, based on the “sham” affidavit rule, DiNardo could not now rely on statements in the affidavit that contradicted his deposition testimony for the purpose of manufacturing an issue of fact to defeat Wow’s motion for summary judgment.

The deposition testimony was carefully focused on specific misrepresentations and the timing of those alleged misrepresentations. In each instance, DiNardo specifically identified the time period for the alleged misrepresentations as occurring after May 21, 2014—the day that he executed the franchise agreement. Despite this testimony, in his affidavit submitted in opposition to Wow’s summary judgment motion, DiNardo testified to an entirely new and much earlier time period. And DiNardo made no attempt in his affidavit to “elaborate[,] upon, explain[,] or clarify[]” his prior testimony. Accordingly, the court concluded that the affidavit was submitted “for the purpose of manufacturing an issue of fact to defeat Wow’s motion for summary judgment and is, therefore, a sham.” The court then granted summary judgment on DiNardo’s misrepresentation claim in favor of Wow.

Next, the court considered DiNardo’s UTPA claim. The claim required DiNardo to show that he suffered an injury caused by alleged misrepresentations. For the same reasons that his misrepresentation claim failed, the UTPA claim failed. The court granted summary judgment on the claim in favor of Wow as well.

Last, the court analyzed DiNardo’s claims under the BOIA. Wow argued that it was exempt from these claims because BOIA exempted the “sale of a marketing program made in conjunction with the licensing of a registered trademark or service mark, provided . . . such trademark or service mark has been effectively registered under federal law.” DiNardo disputed that Wow was entitled to the exemption, contending that the franchise agreement only permitted use of pending trademarks, not other trademarks that were not even registered by Wow until six months after the franchise agreement was executed. The court noted that, although the marks were not registered at the time the agreement was signed, they were registered six months after, and DiNardo operated the franchise for approximately a year after the registration. Additionally, Wow was the owner of additional trademarks that were registered at the time the franchise agreement was executed. DiNardo, in his affidavit opposing the motion, attempted to argue that he was never granted the right to use any of the registered marks and that Wow never discussed with him any marks beyond those that were not registered. However, the court noted that this directly contradicted the franchise agreement, which granted DiNardo a license to use the other trademarks that were already registered. DiNardo could not create a factual issue by providing parol evidence contradicting the plain language of the franchise agreement. The franchise agreement clearly granted to DiNardo a license to use all of the
trademarks owned by Wow, not just those that were registered at the time the franchise agreement was signed. Wow was therefore exempt from the BOIA requirements, and the court granted summary judgment in favor of Wow on this claim.

Although the court resolved DiNardo’s claims in favor of Wow, it went on to order the parties to show cause why Wow’s counterclaims should not be dismissed without prejudice for possible re-filing in state court. Wow asserted damages claims for breach of the franchise agreement and payment of accounts receivable, as well as an injunction barring DiNardo from further violations of his non-competition obligations under the franchise agreement. Wow’s removal of the action to federal court was on the basis of diversity jurisdiction. Because the counterclaims were compulsory, and the case lost its federal substance with the disposition of DiNardo’s claims, the court was within its discretion to decline jurisdiction over the remaining state law compulsory counterclaims. The court did not have sufficient information before it to conclude that the minimum jurisdictional amount was satisfied and, by extension, that the court had the authority to exercise subject matter jurisdiction.


This case is discussed under the topic heading “Injunctive Relief.”

**CLASS ACTIONS**


A putative class of patrons at two New York City Applebee’s restaurants brought suit in the U.S. District Court for the Southern District of New York, arguing that they were unlawfully overcharged by having tips automatically added to their bill. The franchisee owners of the locations (the defendants) filed a motion for summary judgment.

The case was based on the fact that, at the restaurants, patrons placed their orders on tabletop computer tablets that did not give the patron the option of not leaving a tip. At one location, an eighteen percent tip was automatically added. And a fifteen percent tip was automatically added at the other location. The plaintiffs argued that the menu prices were therefore misleading and brought claims under New York law for unfair business practices, false advertising, breach of contract, negligent misrepresentation, and unjust enrichment.

The defendants made five arguments in support of their motion for summary judgment: (1) the tipping structure was adequately disclosed; (2) the tips were not truly mandatory; (3) tipping is an accepted social norm; (4) the plaintiffs did not properly allege that they were injured; and (5) there was no unjust enrichment because the tips went to the waitstaff, rather than to management.
The court ruled that the first argument failed because the plaintiffs had plausibly alleged the disclosure provided on the menu was inadequate. The court acknowledged that adequate disclosure could defeat the plaintiffs’ claims. However, the menu language at issue stated that prices did not include beverages, dessert, taxes, or gratuity. This was in contrast to other cases where disclosure was considered adequate where the menu clearly stated that a specific gratuity would be added to all checks. The court noted that the defendants’ logic would suggest that Applebee’s could serve each customer a mandatory ice cream sundae based on its disclosure that the meal price did not include dessert. The court thus determined that the plaintiffs’ complaint adequately alleged that the tipping structure was not fully disclosed.

Second, the court determined that whether tipping was actually mandatory could not be determined on summary judgment because it was an issue of fact. For example, it was not clear whether customers knew the option of not tipping was permitted.

Third, the court noted that tipping is not necessarily a social norm because the restaurants served many tourists and tipping is not common in many other countries. In fact, the defendants admitted that the reason the mandatory structure was put into place was because the restaurants served many customers unaccustomed to tipping.

Fourth, the court addressed whether any customers were actually harmed, given the defendants’ arguments that customers would have tipped anyway. The court noted that under New York General Business Law § 349, a plaintiff must establish that the defendant intended to deceive and that the customers were deceived to their detriment. The court acknowledged that a large percentage of customers likely were not harmed based on the defendants’ argument. But the court recognized a “narrow slice of people who would have tipped less than fifteen or eighteen percent but left a larger tip solely because of Applebee’s payment system.” Based on that group, the court held that the plaintiffs could survive summary judgment.

Fifth and finally, the court ruled that management could have been unjustly enriched even if the tips went to waitstaff. The court noted that “a restaurant’s management and its waitstaff do not exist on separate economic planes [and that if] the waitstaff makes more in tips, the management might have to pay them less, particularly if the waitstaff makes less than minimum wage.” The court therefore denied the defendants’ motion for summary judgment.

CONTRACT ISSUES


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


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

DAMAGES


The U.S. District Court for the Western District of Wisconsin held that a distribution agreement’s remedy limitation provisions were unenforceable under Wisconsin law, denying three dairy silo manufacturers’ motion for summary judgment.

The parties entered into a distribution agreement in April 2013 under which the plaintiffs, Sanchelima International, Inc. and Sanchelima International S. De R.L. De C.V., would be the exclusive distributor of dairy silos manufactured by the defendants, Walker Stainless Equipment Company, LLC, Bulk Solutions, LLC, and Bulk Tank International, S. De R.L. De C.V., in twelve Latin American countries, including Mexico. The plaintiffs alleged that the defendants sold dairy silos directly in Mexico, in violation of the exclusive distribution agreement. They claimed damages of at least $650,000 in lost profits, plus loss of goodwill and damage to their business reputation. The defendants argued that the distribution agreement barred the plaintiffs from recovering any damages and moved for summary judgment on that basis. The first of two relevant provisions, titled “Manufacturer Liability Limitations,” limited the plaintiffs’ recovery for claims arising “out of any purchase order, the products manufactured or delivered under such purchase order or any accompanying documentation” to “the amount(s) paid by” the plaintiffs to the defendants under the purchaser order. The second provision, titled “Liability Exclusions,” provided that the plaintiffs could not recover from the defendants “any special, indirect, incidental or consequential losses or damages including, without limitation, any lost profits or punitive damages, arising out of or in connection with the agreement.” The plaintiffs countered that the damages limitation provisions did not actually prevent recovery of consequential damages or lost profits and that, even if they did, the provisions were unenforceable.

The court focused its analysis on “the ultimate question: if the limitations provisions do bar plaintiffs from recovering lost profits, are they enforceable?” It concluded that they were not enforceable because the provisions effectively “deprive[d] plaintiffs of any remedy of the breach of the
exclusivity provisions in the distribution agreement.” Under Wisconsin’s version of the Uniform Commercial Code (UCC) § 2-719, Wisconsin Statutes § 402.719, the contractual provisions limiting or excluding consequential damages would be enforceable unless “circumstances cause an exclusive or limited remedy to fail of its essential purpose” or “the limitation or exclusion is unconscionable.” Although parties have wide latitude to fashion their breach of contract remedies, “the UCC disfavors limitations on remedies and provides for their deletion where they would effectively deprive a party of reasonable protection against breach.” Because the damages limitations provisions would have had that exact result on the plaintiffs, they “must give way to general remedy provisions’ of the UCC.”

The defendants argued that both parties were sophisticated and, therefore, the provisions could not be unconscionable, but the court disagreed, noting that unconscionability can exist even between sophisticated parties. The court also rejected the defendants’ argument that the limitations provisions still provided the plaintiffs with a minimum adequate remedy in the form of recovery of amounts paid under the purchase order for the silos. The remedy provided no relief for any breach of the defendants’ main obligations under the distribution agreement because the defendants’ breach of the exclusivity provision would not result in a purchase order, and therefore the plaintiffs could never recover for such a breach. The court found that the limitation was exactly the type that § 402.719 rendered unenforceable and denied the defendants’ motion for summary judgment.

ETHICS


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

FRAUD


Plaintiff Broward Motorsports of Palm Beach LLC was a motor vehicle dealer, while defendant Polaris Sales, Inc. (Polaris) was a manufacturer of various lines of motor vehicles, including the Victory Motorcycles line. The plaintiff entered into an asset purchase agreement with a third party, by which the plaintiff sought to acquire, among other things, the third party’s franchise dealership agreement with Polaris. On November 14, 2016, Polaris notified the Florida Division of Motor Vehicles (DMV) that it approved the plaintiff as a new dealer of the Victory Motorcycles line. Thereafter, on December 8, 2016, the plaintiff and Polaris entered into a dealership agreement that authorized the plaintiff to act as a dealer for Victory Motorcycles
from July 1, 2016 to June 30, 2017. The next day, Polaris sent the plaintiff a congratulatory letter, stating that the plaintiff had been approved as a dealer for the Victory Motorcycles line and other lines of Polaris products and that Polaris looked forward to a “long and profitable relationship” with the plaintiff. On December 13, 2016, the plaintiff closed its asset purchase with the third party.

Three months later, on March 14, 2017, Polaris notified the plaintiff that Polaris would be discontinuing the Victory Motorcycles line and would not renew the dealership agreement for that particular line in July 2018. On May 18, 2017, the plaintiff and Polaris entered into an agreement governing the Victory Motorcycles for the time period from July 1, 2017 to June 30, 2018.

The plaintiff then sued Polaris in the U.S. District Court for the Southern District of Florida, alleging claims for fraudulent concealment, fraudulent inducement, and unfair and deceptive trade practices. Among other things, the plaintiff alleged that Polaris knew by the date that it notified the DMV that it had approved plaintiff’s acquisition of the franchised business that it would be discontinuing its Victory Motorcycles line within the next two months. The Defendant moved to dismiss these claims under Federal Rule of Civil Procedure 12(b)(6), and the court granted the motion, applying Florida substantive law.

With regard to the plaintiff’s claim for fraudulent concealment, the court determined that the plaintiff’s reliance on Florida Statutes § 320.641(2), which provides for the continuing nature of motor vehicle franchises, was not reasonable, as a matter of law. In particular, the court noted that a different provision of Florida Statutes, § 320.641, contains a procedure by which a franchisor may discontinue a franchise agreement so long as it provides ninety days’ notice to the dealer and the DMV. There was no dispute that Polaris complied with the provision. In addition, the terms of the 2016–17 dealer agreement contained provisions disclosing that it was subject to non-renewal, which is precisely the fact that the plaintiff alleged that Polaris had concealed from it fraudulently.

In addition, the court held that Polaris did not owe a duty to disclose to the plaintiff that Polaris intended to discontinue the Victory Motorcycles line. Because Polaris gave notice to the plaintiff of the nonrenewal of the Victory Motorcycles portion of the dealer agreement fifteen months in advance, and provided a copy to the DMV, Florida statutory law did not therefore impose a duty to disclose. As to any common-law duty to disclose, that circumstance arises under Florida law only when there is a fiduciary relationship between the parties. Florida law is well-settled, however, that a franchisor is not in a fiduciary relationship with a franchisee. Consequently, the plaintiff’s fraudulent concealment claim failed, as a matter of law, on that basis as well.

With regard to the plaintiff’s claim for fraudulent inducement, the only false statement that the plaintiff alleged was that Polaris “look[ed] forward to a long and profitable relationship.” But that statement was made in a letter
in which Polaris welcomed the plaintiff as a new dealer for six lines of products. Polaris only subsequently discontinued one of those lines (the Victory Motorcycles line), and not the other five. Moreover, because Polaris did not say that it was looking forward to a “long and profitable relationship” with regard specifically to the Victory Motorcycles line, the plaintiff failed to allege that Polaris had a specific intent not to perform the promise it made, namely, to have a “long and profitable relationship” generally with the plaintiff. Furthermore, the court ruled that it would have been impossible for the plaintiff to have relied to its detriment on the statement, even if false, in entering the 2016–17 dealer agreement because Polaris’s statement was not made until afterwards. The plaintiff’s fraudulent inducement claim therefore failed as a matter of law.

Finally, the court also dismissed the plaintiff’s unfair and deceptive trade practices claim for similar reasons. In particular, the court ruled that Polaris’s failure to disclose its intent not to renew the Victory Motorcycles portion of the dealer agreement eighteen months in advance, when Florida’s statute only requires ninety days’ notice, would not mislead a reasonable consumer. Consequently, the court held that, as a matter of law, Polaris’s statements were not unfair or deceptive.


This case is discussed under the topic heading “Choice of Law.”

**INJUNCTIVE RELIEF**


The U.S. District Court for the Southern District of Alabama granted the franchisor’s and licensor’s motion for a preliminary injunction and enjoined a former franchisee of three IHOP-branded restaurants in Alabama from continuing to use IHOP’s trademarks after termination. The court held that the injunction was necessary and proper given the many food safety deficiencies and consumer complaints that the franchisor received for those restaurants.

IHOP Franchisor, LLC, as franchisor, and IHOP Restaurants, LLC, as licensor, entered into three franchise agreements with Moeini Corporation (Moeini), as franchisee, for the operation of three franchised IHOP restaurants in Alabama. The agreements all required Moeini to strictly comply with IHOP’s operational standards, including menu items, appearance and cleanliness of the premises, and food safety standards. IHOP’s franchise business consultants performed periodic unannounced operations evaluations to evaluate franchisee’s compliance with IHOP’s operational standards. Starting at the end of 2016, all three of Moeini’s franchised IHOP restaurants began to perform poorly, failing multiple operations evaluations and accumulating
many customer complaints—the highest number of complaints in the IHOP system. The complaints covered various aspects of the restaurants’ operations, including, in relevant part, complaints related to food preparation, service, storage, and safety, as well as overall cleanliness and sanitation. In June and again in early August of 2017, IHOP informed Moeini of its operational failures and the restaurants’ “F” ratings on IHOP’s operation rating system. Both times IHOP also offered assistance to improve the restaurants.

On August 23, 2017, IHOP sent Moeini a notice of default for all three franchise agreements for failure to operate each of the three franchised restaurants according to IHOP’s operational standards. The default notice provided Moeini with the required thirty days’ opportunity to cure and informed Moeini that failure to cure would result in termination of the franchise agreements. All three restaurants failed the operational evaluations that IHOP conducted on September 19–20, 2017. When Moeini failed to cure the defaults after the expiration of the cure period, IHOP sent Moeini a written notice of termination on September 27, 2017, terminating all three franchise agreements, effective October 27, 2017. In its notice of termination, IHOP demanded that Moeini de-brand and de-identify all three restaurants within sixty days of receipt of the notice, in accordance with its post-termination obligations under the franchise agreements. Despite the termination, Moeini continued to operate all three restaurants as IHOP restaurants and used IHOP’s trademarks without IHOP’s permission. IHOP continued to inspect the restaurants for food safety and cleanliness because its trademarks were still being used at the restaurants. Although Moeini allowed IHOP to conduct certain operational assessments in late September and in October 2017, it denied IHOP access to the restaurants in December 2017. On October 26, 2017, the day before the franchise agreements would effectively terminate, Moeini filed for Chapter 11 bankruptcy protection. On December 6, 2017, the bankruptcy court granted IHOP’s motion for relief from the automatic stay. IHOP then filed its lawsuit against Moeini alleging breach of the franchise agreements for failure to comply with IHOP’s operational standards and for failure to perform post-termination obligations, as well as trademark infringement pursuant to Section 1114 of the Lanham Act. IHOP also filed a motion for a preliminary injunction to enjoin Moeini’s trademark infringement. The court considered the four factors for establishing entitlement to injunctive relief: (1) likelihood of success on the merits; (2) irreparable harm; (3) balance of the hardships; and (4) the public interest.

The court first considered whether IHOP was likely to succeed on the merits of its case. It noted that to prevail on its trademark infringement claim IHOP was required to make a threshold showing that the franchise agreements were properly terminated such that any use of the trademarks by Moeini after termination was in fact unauthorized. To assess the propriety of the franchise agreements’ termination—under California law because the franchise agreements contained a California choice of law provision—the court evaluated whether Moeini breached the franchise agreements,
thus providing IHOP with grounds for termination. The franchise agreements gave IHOP the right to terminate the agreements based on a material breach by Moeini, but only after it provided Moeini an opportunity to cure the breach and Moeini failed to cure within the cure period. The court found that Moeini’s repeated failure to pass the operational evaluations, even after being afforded notice and an opportunity to cure, was a material breach of the franchise agreements. IHOP was therefore likely to succeed in proving that the franchise agreements were properly terminated and that Moeini’s continued use of IHOP’s trademarks post-termination was unauthorized. However, to show a likelihood of success on the merits of its trademark infringement claim, IHOP still needed to show that Moeini actually used IHOP’s trademarks in commerce without authorization and that the unauthorized use was likely to cause consumer confusion. The court found that IHOP presented sufficient evidence of both. First, Moeini continued to operate its three former franchised restaurants using IHOP’s trademarks after termination of the franchise agreements. Second, there was sufficient evidence of consumer confusion. IHOP presented post-termination customer complaints and reviews on social media indicating that the public continued to believe that the three restaurants were affiliated with IHOP. Additionally, Moeini’s owner admitted at the preliminary injunction hearing that he continued to use the IHOP’s trademarks and that he expected customers to believe his restaurants were authorized IHOP restaurants.

Next, the court determined that IHOP would suffer irreparable injury because of Moeini’s unauthorized trademark use following termination of the franchise agreements. IHOP presented significant customer complaints and negative reviews on social media or Internet-based restaurant review websites concerning Moeini’s three restaurants. In fact, Moeini’s three restaurants had the highest number of average monthly customer complaints in the IHOP system for the year 2017. The complaints related to sanitation, food preparation, cleanliness of the restrooms, insects, and food safety. The defendant’s restaurants and actions were therefore harming IHOP’s reputation and goodwill. The food safety concerns particularly “put the IHOP brand at great risk”; indeed, “the impact to the IHOP brand could be catastrophic” if a food-safety related issue arose and guests were infected. Moreover, because Moeini denied IHOP access to the restaurants for evaluations in December 2017, IHOP had “no method to monitor the restaurants and protect its brand”; the consuming public would simply continue to believe that the restaurants were authorized IHOP restaurants when they were not. Based on that evidence, the court concluded that IHOP would suffer irreparable injury unless the injunction issued.

With respect to the third preliminary injunction factor, the court found that the balance of the hardships tipped in favor of IHOP because any injury to IHOP outweighed any harm to the franchisee. Although Moeini was in bankruptcy and would suffer from de-branding the restaurants because it would hinder Moeini’s ability to improve the restaurants for purposes of
securing a sale to a buyer, the many food safety deficiencies and customer complaints for the three restaurants irreparably harmed IHOP and outweighed the damage to Moeini.

Finally, the court found that the public interest would be served by a preliminary injunction. IHOP's evidence that Moeini repeatedly failed operational evaluations and evidence of “critical product safety violations involving pests, temperature control involving food storage, and cleanliness of food preparation equipment and food service equipment” at the three restaurants demonstrated that “customer safety was at risk at each of these restaurants.” Each of the four prerequisites having been met, the court granted IHOP’s motion for preliminary injunction and enjoined Moeini’s trademark infringement.

JURISDICTION


This case is discussed under the topic heading “Choice of Law.”

LABOR AND EMPLOYMENT


Roshan Bhandari was a clerk at a 7-Eleven store in Bellflower, California, and was employed by 7-Eleven franchisee Daan & Daya, Inc. (D&D). On October 23, 2010, the store was robbed, and the assailant held a gun to Bhandari’s head. Jahmal Ladale Frazier was later charged for committing the robbery. In January 2011, Bhandari testified at a preliminary hearing in the criminal case against Frazier. In April 2011, Bhandari testified at the criminal jury trial. He did not finish his testimony that day and was scheduled to testify further the next time after working in the morning. When Bhandari finished work the next day, he was murdered in an alley behind the 7-Eleven. Evidence showed that Bhandari was killed either by Frazier—who was not in custody during his trial—or by Frazier's girlfriend. Bhandari's parents and representatives of Bhandari's estate filed suit in California state court against D&D and 7-Eleven alleging that the defendants were negligent for failing to provide a security guard at the store. The trial court granted summary judgment in favor of D&D and 7-Eleven. The plaintiffs then appealed to the California Court of Appeal.

The court discussed the issue in the context of whether defendants owed a duty to Bhandari. The court noted the general rule that a person does not have a duty to protect others from the conduct of third parties. However, there is an exception to the general rule when a “special relationship” exists between the parties. In the business context, the proprietor of a business has
a duty to patrons and tenants to “take reasonable steps to secure common areas [of the business] against foreseeable criminal acts of third parties that are likely to occur in the absence of such precautionary measures.” However, such a duty is imposed only where the criminal acts can be “reasonably anticipated.” The court cited to California Supreme Court precedent holding that the requisite degree of foreseeability can rarely, if ever, be proven in the absence of prior similar incidents of violent crime on the premises.

The court applied these standards to the facts of the case. There was conflicting testimony as to whether the store had previously been robbed or whether there had only been minor incidents of shoplifting. Moreover, it was not clear from the testimony whether Bhandari’s supervisor knew that Bhandari left the store that morning to go testify against Frazier. It was clear, however, that no employee had previously been injured in any store robbery. It was also clear that Bhandari was murdered in the alley behind the store, rather than on the store premises. The court concluded that the premeditated murder of Bhandari was not sufficiently similar to past robberies to impose a duty on the defendants. Moreover, the court found that, even if it presumed that Bhandari’s supervisor knew he was going to testify, that would not have been sufficient to establish the foreseeability of Bhandari’s murder, given the fact that witnesses frequently testify in criminal trials without incident. For those reasons, the court determined there was no applicable duty and affirmed the trial court’s summary judgment in favor of the defendants.


This case is discussed under the topic heading “Vicarious Liability.”


In the latest development in the ongoing saga concerning the circumstances under which franchisors might be found to be “joint employers,” on February 26, 2018, the National Labor Relations Board (NLRB) vacated the NLRB’s December 14, 2017, decision that overruled its controversial 2015 opinion in Browning-Ferris Industries of California, Inc. (Browning-Ferris Ruling).

Toward the end of the Obama administration, the Browning-Ferris Ruling had significantly expanded the scope of joint-employer liability by setting a new legal standard for determining when two employers (such as a franchisor and a franchisee) are joint employers for purposes of the National Labor Relations Act. Following the election and the change in administrations, on December 14, 2017, the NLRB issued a decision in Hy-Brand Industrial Contractors, Ltd., Bus. Franchise Guide (CCH) ¶ 16,101 (the December 2017 Decision), that overturned the Browning-Ferris Ruling. The December 2017 Decision was made by a panel that included NLRB Member William Emanuel.

An ethical issue arose, however, because one of the parties implicated in the Browning-Ferris Ruling was a company that was a client of Emanuel’s
former law firm. Although Emanuel had agreed to recuse himself from matters involving his former firm’s clients, he nonetheless participated in the December 2017 Decision. The NLRB was therefore asked to reconsider the December 2017 Decision in light of Emanuel’s participation. The NLRB’s Designated Agency Ethics Official determined that Emanuel should have been disqualified from participating in the December 2017 Decision. Following briefing of the issue, the NLRB ruled that Emanuel’s participation warranted vacatur of the December 2017 Decision. Consequently, the NLRB held that the December 2017 Decision is of no force or effect, thereby effectively reinstituting the Browning-Ferris Ruling as the operative legal standard, at least for the time being.

NON-COMPETE AGREEMENTS

This case is discussed under the topic heading “Choice of Forum.”

STATUTORY CLAIMS

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

This case is discussed under the topic heading “Choice of Law.”

TERMINATION AND NONRENEWAL

This case is discussed under the topic heading “Injunctive Relief.”

Jos. A. Bank (JAB) is a men’s clothing store with more than 500 locations, fourteen of which were franchised as of 2017. JAB initially began franchising locations in the early 1990s. In 2014, JAB was acquired by The Men’s Wearhouse, Inc., and made clear that its ultimate goal was to “get out of franchising.”
J.A.B.-Columbia, Inc., J.A.B.-Harbison, Inc., and J.A.B.-Forest Drive, Inc. (Defendants) own three of the franchised locations in South Carolina pursuant to franchise agreements executed in 2005. The initial terms of the agreements expired on August 31, 2015. In February 2015, the Defendants advised JAB that they wished to renew the agreements for another ten-year term. JAB responded by providing the Defendants with a form agreement providing for a ten-year term, but not permitting any additional renewals after that. The Defendants argued that they were entitled to a different form of agreement (one allegedly provided to other franchisees) that allowed for additional term renewals, referred to as “rolling renewals.” JAB filed a complaint in the U.S. District Court for the District of Maryland seeking a declaratory judgment that the agreement at issue permitted the Defendants only one renewal and not rolling renewals, that the Defendants’ failure to execute a new agreement constituted an election not to buy a successor franchise, and that JAB was permitted to terminate the Defendants’ franchises. The Defendants responded with counterclaims not only seeking a declaratory judgment that they were entitled to renew on the same terms as the original agreement but also alleging breach of contract by JAB. JAB responded by seeking summary judgment, which was the subject of the court’s opinion.

The court stated that the “central question in [the] case [was] one of contract interpretation.” The court reviewed Section 16.03 of the agreements which provided:

If Franchisee has the right to buy a successor franchise in accordance with Section 16.01 and states its desire to exercise that right . . . Franchisor and Franchisee will execute the form of a franchise agreement (which may contain provisions, including royalty fees, mutually different from those contained herein) and all ancillary agreements . . . which Franchisor then customarily uses, or most recently used, granting franchise rights for Jos. A. Bank Stores . . . Failure by Franchisee . . . to sign such agreements . . . within 30 days after delivery shall be deemed an election by Franchisee not to buy a successor franchise for the Store.

The agreement provided that it was governed by the law of Maryland. The court recited the black-letter provisions of contract interpretation, including that the “cardinal rule” was to give effect to the parties’ intentions and that, if the terms are unambiguous, the court is required to give effect to the term’s plain meaning.

In interpreting Section 16.01, JAB argued that the right “to buy a successor franchise” meant the right to one renewal because “a” means “one.” The court found such an interpretation too simplistic, noting that “a” is an indefinite article and can be used in many different ways. The court provided an example whereby an employee entitled to a lunch break is obviously not limited to one lunch break while employed. The court determined that the true issue was how Section 16.01 should be interpreted as to the rights of the defendants to buy a successor franchise. The court broke the issue down into two sub-parts: (1) what was the then current form of the franchise
agreement, and (2) regardless of which form is correct, whether JAB may alter the provision of the form.

The court first dismissed any argument by the Defendants that they were entitled to rolling renewals. The court determined that it was unambiguous that the agreements did not provide for such renewals. Whether JAB provided that right to other franchisees was in question, but irrelevant, for the court's determination because the agreement terms were unambiguous. Next, the court analyzed which form was the proper form to be used by JAB. The court determined that the phrase “current form” was ambiguous because it could mean the form most recently used or the form customarily used. The court further determined that it could not determine as a matter of law that JAB was entitled to alter material terms of a new franchise agreement because reasonable people could disagree on the agreement terms on that point as well. The court then turned to extrinsic evidence on the issue of what was a “current form.” The court noted certain correspondence by JAB officers and attorneys appearing to imply that the then-current form put no limit on renewals. But the court determined that the evidence was not sufficient to resolve the ambiguity. Because of the unresolved material issue of fact, the court denied JAB's summary judgment motion.


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

TRADEMARK INFRINGEMENT


This case is discussed under the topic heading “Injunctive Relief.”


La Bamba Licensing, LLC (the plaintiff) operated eight casual Mexican restaurants in Ohio, Michigan, Pennsylvania, Kentucky, Indiana, and Wisconsin. A popular location, located in Louisville, Kentucky, had been operating under the name La Bamba since 1997. The founder of the plaintiff filed a trademark application for the La Bamba mark in 1996. The mark was registered in 1998 and then became incontestable under Section 1065 of the Lanham Act.

La Bamba Authentic Mexican Cuisine, Inc. (the defendant) operated a one-location casual Mexican restaurant in 2015 in Lebanon, Kentucky, approximately sixty-five miles from the plaintiff's Louisville location. In May 2016, the plaintiff sent a letter to the defendant advising of the plaintiff's rights in the La Bamba mark and demanded that the defendant cease using
that name on its restaurant. The plaintiff sent another letter in June 2016. The defendant ignored both letters. The plaintiff then filed suit against the defendant in the U.S. District Court for the Western District of Kentucky, alleging trademark infringement and unfair competition under the Lanham Act and also common law unfair competition under Kentucky law. The plaintiff moved for summary judgment.

The court first noted that the analysis under the Lanham Act and Kentucky common law were identical. The court noted that proving trademark infringement requires a plaintiff to show that (1) the plaintiff held the trademark; (2) the plaintiff did not consent to the use of the mark; and (3) the defendant’s use of the mark was likely to cause confusion among relevant consumers. The court concluded that the first and second elements were not contested in the case. Thus, the only issue for the court was whether the defendant’s use of the mark was likely to cause confusion.

The court determined that the issue was a mixed question of fact and law and required analysis of the following factors: (1) the strength of the plaintiff’s mark; (2) the relatedness of the goods; (3) the similarity of the marks; (4) evidence of actual confusion; (5) the marking channels used; (6) the likely degree of purchaser care; (7) the defendant’s intent in selecting the mark; and (8) the likelihood of expansion of the product lines.

The court applied the facts to each of the eight factors. First, the court concluded that the plaintiff’s mark was arbitrary, meaning the term has some common usage in ordinary language, but the term is unrelated to restaurants. The court also considered the uncontested evidence that the mark had been used continuously in Kentucky for twenty years. The court concluded that the factor weighed in favor of the plaintiff.

Second, the court concluded that the plaintiff’s and the defendant’s services were related because both restaurants served casual Mexican-style food. The defendant argued that the parties have different markets, use different logos, and have different products. The court noted, however, that the defendant failed to provide any evidence to guide the court’s analysis on that assertion. The court therefore concluded that the parties’ services were sufficiently related to cause buyers to believe that the services are somehow connected.

Third, the court noted that the parties’ marks are not identical because the plaintiff used the mark La Bamba, while the defendant used the mark La Bamba Authentic Mexican Cuisine. The court further noted that the overall impression, rather than an individual feature, is the significant feature of the analysis. The court concluded that, despite the differences in the names, the marks were sufficiently similar to cause confusion and therefore the factor weighed in favor of the plaintiff.

Fourth, the court considered evidence provided by the plaintiff of alleged actual confusion. The evidence included affidavits from the plaintiff’s Louisville location alleging questions and comments from customers regarding the defendant’s location and alleging that customers had shown up at the
Louisville restaurant after placing orders at the defendant’s location. The court concluded that it could not definitively conclude that chronic and serious confusion had actually occurred. But the court did conclude that actual confusion had occurred, and therefore the factor weighed in favor of the plaintiff.

Fifth, the court considered the marking channels used by the parties. Both parties used Facebook promotions and newspaper advertisements. Neither party provided any evidence on marketing budgets, frequency of advertising, or sophistication of advertising. The court concluded that the use of Internet advertising does not alone constitute overlapping marketing channels as a matter of law. The court thus concluded that the factor was neutral.

Sixth, the court concluded that customers exercise an ordinary level of caution in selecting the parties’ services and that such ordinary caution was the relevant standard. For that reason, the court found the factor to weigh in favor of the plaintiff.

Seventh, the court determined that, at the summary judgment stage, it was bound to accept the defendant’s statement that it was not aware of the plaintiff’s use of the mark until the defendant received the plaintiff’s letters. The court therefore found the factor not relevant in determining likelihood of confusion.

Eighth, and finally, the court considered the plaintiff’s assertion that there was a strong possibility the plaintiff would expand its product line to new geographic locations. The court concluded that the possibility weighed in favor of the plaintiff.

The court determined on balance that no genuine dispute of material fact existed on the issue of likelihood of confusion and therefore granted the plaintiff’s summary judgment motion. The court also entered a permanent injunction enjoining the defendant from using the La Bamba mark.

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES

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

This case is discussed under the topic heading “Choice of Law.”

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


A Jane Doe plaintiff (the plaintiff) alleged that on July 19, 2015, at the Elements Massage studio in Greenbrae, California, defendant Joseph Sanchez (Sanchez) gave her a massage treatment that included inappropriate touching of a sexual nature, and the application of extreme and painful pressure to her body. The plaintiff brought suit not only against Sanchez, but also against Flying Monkeys Massage I, LLC (Flying Monkeys)—the franchisee and owner of the studio—and Elements Therapeutic Massage LLC (Elements) as the franchisor. The plaintiff alleged that Elements was vicariously liable for Sanchez's and Flying Monkeys' conduct, on theories of both actual agency and ostensible agency. Elements moved for summary judgment.

Applying California state law principles of agency, the court granted Elements’ motion. Regarding actual agency, the court held that Elements did not have sufficient control over Flying Monkeys’ franchise operations to result in an actual agency relationship. Specifically, the court determined that (a) the franchise agreement expressly stated that Elements and Flying Monkeys did not have an agency or employment relationship, and that Flying Monkeys was solely responsible for all personnel decisions; (b) Flying Monkeys owned the studio and independently controlled the studio’s day-to-day operations, including whom the studio would hire and what training the employees would receive; and (c) Elements’ operational control was limited to protecting its trade name and assets, proprietary professional methods, customer goodwill, and commercial image, and that the level of control did not include the right of general control over the studio’s daily operations and personnel and employment decisions.

Regarding ostensible agency, the court also sided with Elements. In particular, the evidence was abundant that the studio held itself out expressly as an independently operated franchise and not as an agency of Elements. In addition, the plaintiff testified that she knew that Flying Monkeys’ principal owned the studio and was responsible for hiring the studio’s employees. Therefore, even though Sanchez was dressed in a shirt displaying the Elements logo at the time of the conduct in question, and even though Elements’ trademarks were displayed in the studio and on advertising materials for the studio, the facts were insufficient, as a matter of law, to hold that the plaintiff could reasonably believe that the studio and Sanchez were agents of Elements. The court therefore dismissed the vicarious liability claims alleged against Elements.