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From the Editor-in-Chief

Daniel J. Oates

Mr. Oates

One night when I was in high school, at the apex of my stupid years,[1] I, along with a group of about twelve other guys, thought it would be a brilliant idea to play a game of tackle football in a local park, in the dark, at 2 am.[2] You know, like most typical teenaged idiots. Someone spilled the beans on the plan, and a large group of girls decided to raid the game with water balloons. Childhood chaos ensued, and, predictably, some disgruntled neighbor called the cops, who showed up with four squad cars and a K-9 unit following up on reports of a gang war.[3] When the megaphone blared out "freeze" and the squad-car floodlights lit up the field, we were all terrified we would get in trouble (i.e., grounded). But that's about all that we worried about.

What I can assure you without question is that *not one* of the teenaged idiots in the muddy field that night thought they might get shot. What cop would shoot a teenager for having a water balloon fight (even at 2 am)? And that was correct, inasmuch as we were mostly white kids in a very white town, and the very thought of getting shot by a cop never crossed anyone's

1. Ok, I know there are at least some of you that are raising an eyebrow at this description and/or shouting out loud at the page that my stupid years extend well into recent times, up to and including the present. Future Dan, from editorials past, is probably in agreement with you. Since I'm dealing with a bunch of lawyers, I will specifically define, for purposes of this editorial, the "stupid years" as high school age (fifteen to eighteen). Also, if we're going to get pedantic about it, I did say "apex," so it's not like I'm hiding the ball or anything.

2. The thought of playing tackle football now, much less in the dark, shrieks of torn ACLs, sprained ankles, broken bones, and concussions. Playing in near pitch-black conditions is just a recipe for severe injury. How I ever lived into adulthood is beyond me.

3. Yes, a gang war. At least that is what we were told. I'm sure there was some serious pearl-clutching going on in nearby homes with excited mutterings of "won't someone think of the children" thrown in.

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mind. Despite the reports of an unfolding gang war, all we got were some eye rolls and a stern "go home and go to bed" from the police.[4]

Many people of color in this country have a very different experience. They face the prospect of death by simply playing in a park during the daytime,[5] driving their cars,[6] going to church,[7] walking home from the convenience store,[8] going for a morning jog,[9] sleeping in their own bedroom,[10] or eating ice cream in their own living room.[11] These are just the examples most of us have heard about. While the world deals with a pandemic, America still has yet to deal with a much more deeply rooted problem: the persistent and pernicious effect of racism and racial inequity that pervades so many layers of our society. These are not new issues to 2020 by any stretch; but the awakening conscience of white Americans (locked in our homes with nothing to do but watch the violent suppression of peaceful protests against racial bias, inequality, and police brutality) has forced us to confront a problem that has long been known and identified by people of color.

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4. The fact that I can't even identify how old I was with any degree of accuracy is telling. The incident clearly didn't leave any mental scars or cause any psychological trauma.

5. *See*, *e.g.*, Tamir Rice. Shaila Dewan & Richard A. Oppel Jr., *In Tamir Rice Case*, *Many Errors by Cleveland Police*, *Then a Fatal One*, N.Y. Times (Jan. 22, 2015), https://www.nytimes.com/2015/01/23/us/in-tamir-rice-shooting-in-cleveland-many-errors-by-police-then-a-fatal-one.html.

6. *See*, *e.g.*, George Floyd, Walter Scott, and Philando Castile. *See* Evan Hill, Ainara Tiefenthaler, Christiaan Triebert, Drew Jordan, Haley Willis & Robin Stein, *How George Floyd Was Killed in Police Custody*, N.Y. Times (May 31, 2020); Gregory Yee, *How Walter Scott's Death Continues to Reverberate 5 Years Later for Two SC Families*, Post & Courier (Apr. 3, 2020), https://www.postandcourier.com/news/how-walter-scotts-death-continues-to-reverberate-5-years-later-for-two-sc-families/article_6a6f74dc-58cc-11ea-b9f2-9bb5868db708.html; *Philando Castile Death: Police Footage Released*, BBC News (June 21, 2017), https://www.bbc.com/news/world-us-canada-40357355.

7. *See*, *e.g.*, Clementa C. Pinckney, Cynthia Marie Graham Hurd, Susie Jackson, Ethel Lee Lance, Depayne Middleton-Doctor, Tywanza Sanders, Daniel L. Simmons Sr., Sharonda Coleman-Singleton, and Myra Thompson. *See*, *e.g.*, Susanna Kim, *Charleston Shooting Victims Identified*, ABC News (June 18, 2015), https://abcnews.go.com/US/charleston-shooting-victims-identified/story?id=31863489; Jason Horowitz, Nick Corasaniti & Ashley Southall, *Nine Killed in Shooting at Black Church in Charleston*, N.Y. Times (June 17, 2015), https://www.nytimes.com/2015/06/18/us/church-attacked-in-charleston-south-carolina.html.

8. *See*, *e.g.*, Trayvon Martin and Elijah McClain. *A Look at What Happened the Night Trayvon Martin Died*, Miami Herald, July 6, 2012; Elijah McClain case: *Death After Arrest by Colorado Police Receiving Renewed Attention*, ABC7.com (June 24, 2020), https://abc7.com/elijah-mcclain-mccain-colorado-police-death-aurora/6266195.

9. *See*, *e.g.*, Amaud Arbery. Richard Fausset, *What We Know About the Shooting Death of Ahmaud Arbery*, N.Y. Times (June 24, 2020), https://www.nytimes.com/article/ahmaud-arbery-shooting-georgia.html.

10. *See*, *e.g.*, Breonna Taylor. Richard A. Oppel, Jr. & Derrick Bryson Taylor, *Here's What You Need to Know About Breonna Taylor's Death*, N.Y. Times (Sept. 1, 2020), https://www.nytimes.com/article/breonna-taylor-police.html.

11. *See*, *e.g.*, Botham Jean. Bobby Allyn, *Amber Guyger*; *Ex-Officer Who Killed Man in His Apartment*, *Given 10 Years in Prison*, NPR News (Oct. 2, 2019), https://www.npr.org/2019/10/02/766454839/amber-guyger-ex-officer-who-killed-man-in-his-apartment-given-10-years-in-prison ("Guyger, who is white, fatally shot 26-year-old Botham Jean, an accountant from the Caribbean island of St. Lucia, who was watching television and eating a bowl of ice cream. . . .").

I remember being viscerally outraged and upset when I saw the video footage of a North Charleston police officer shooting Walter Scott in the back five times as he fled across a playfield of a park.[12] But to my everlasting shame and regret, I did nothing about it beyond being angry and upset. Like many white people who did not grow up fearing encounters with the police, I have had a bad habit of explaining away these incidents (the officer thought the victim had a weapon, the victim was resisting arrest, etc.). I have come to accept that the reality is much more grim and dystopian. I ask myself now why I have not been more outraged by these injustices, and I can only conclude that it is a result of my childhood, and my own privileged experience of being told to "go home and go to bed." I never feared that I wouldn't get to go home. In my cloistered world, the police and the grumpy, complaining neighbor may be tired of stupid kids doing stupid things, but ultimately they wanted us to live, succeed, and carry forward the next generation. I am now forced to call that entire experience into question as being tainted by the rose-colored lens of whiteness. Because that is clearly not how it works for everyone.

Ultimately, what the past few months have laid bare is that the United States, ostensibly founded on the lofty and inspiring ideals of freedom and equality, continues to discount, ignore, and dehumanize people of color. Black people are three times more likely than white people to contract COVID-19, six times more likely to be hospitalized as a result, and twice as likely to die.[13] When police initiate contact with civilians, Black and Hispanic people are more than twice as likely to experience the threat or use of physical force than white people.[14] The vast majority of those who experienced the threat of force perceived it as excessive.[15] The studies on the broad societal effect of these different metrics[16] are compelling and generally in

12. Scott was pulled over for a non-functioning rear brake light. Sarah Parvini & David Zucchino, *Did North Charleston, S.C., Police Try to Aid Walter Scott After Shooting?*, L.A. Times (Apr. 11, 2015), https://www.latimes.com/nation/la-na-south-carolina-cpr-20150411-story.html. After shooting Scott repeatedly, Officer Michael Slager handcuffed Scott, who was motionless on the ground, and provided no medical aid. *Id.* Instead, he threw his stun gun to the ground by Scott to make it appear as though he had been holding the officers' stun weapon when the officer pulled the trigger on his firearm. Yee, *supra* note 6. The initial police report on the incident claimed that officers on the scene performed CPR and rendered first aid. Parvini & Zucchino, *supra*. But the subsequently released video of the incident showed no such efforts. *Id.* Instead, it appears as though the officers callously let the man bleed to death, and planted evidence on his rapidly dying body, to cover up the shooter's crime. It is beyond sickening to think about.

13. Gus Wezerek, Opinion, *Racism's Hidden Toll*, N.Y. Times (Aug. 11, 2020), https://www.nytimes.com/interactive/2020/08/11/opinion/us-coronavirus-black-mortality.html.

14. Special Report, *Contacts Between Police and the Public*, U.S. Dep't of Justice, at 1 (Oct. 2018), https://www.bjs.gov/content/pub/pdf/cpp15.pdf.

15. *Id.* at 17. The common sense response for dealing with teenagers in their stupid years ("go home and go to bed") is largely reserved for white people.

16. The data and statistics on these issues extend to virtually every facet of our lives, from home ownership, to longevity, to incarceration, and are far beyond the meager scope of this editorial.

agreement, as are the American people, who recent polls show broadly agree that racial and ethnic discrimination is a big problem in the United States.[17]

Despite the obvious truths this data reveals, most Americans continue to believe that fairness and equality are a birthright.[18] These beliefs are central to our core identity as Americans, going back to the very founding document upon which our entire system of government is based: the Declaration of Independence. That document, which publicly announced our right (and our descendants' right) to freedom from tyranny and oppression, succinctly sums up that American ideal:

> We hold these truths to be self-evident: that all men are created equal. That they are endowed by their creator with certain unalienable rights, that among these are Life, Liberty, and the pursuit of Happiness.[19]

These words were of course written by Thomas Jefferson, a man who was not only our third President and drafter of the Declaration, but also expanded the country with the Louisiana Purchase, created of the Library of Congress, and founded of the University of Virginia. He was also a man who committed heinous and despicable acts, espousing patriotic words of liberty and freedom, while he simultaneously held people in bondage, enslaved his own children,[20] and maintained the strongly held belief that people of color are inherently inferior to white people.[21] In other words, Jefferson was not referring to all "men" when he wrote the Declaration of Independence. He certainly wasn't including women. He was referring to white men of privilege, like himself. Despite the irony of the situation, the words of the Declaration themselves have inspired generations of Americans to the higher ideal that is generally ascribed to Jefferson's words; the ideal that *everyone* is created equal and that we each have the right to live our lives and pursue our own happiness free from reprisal, recrimination, or threat of violence. And after more than two centuries, the words do not belong to Jefferson; *they belong to us*. Like the fairies in Peter Pan who survive only if children continue to believe in them,[22] the ideals of the Declaration only have meaning

17. *National: Protestors' Anger Justified Even if Actions May Not Be*, Monmouth Univ. Polling Inst. at 3 (June 2, 2020), https://www.monmouth.edu/polling-institute/documents/monmouthpoll_us_060220.pdf (finding that seventy-six percent of Americans believe that racial and ethnic discrimination is a big problem in the United States, and an additional sixteen percent say that it is problem).

18. *Eight out of 10 American Voters Believe the U.S. Was Founded on Ideals of Freedom and Equality*, Justthenews.com (Aug. 7, 2020), https://justthenews.com/politics-policy/polling/eight-out-10-american-voters-believe-us-was-founded-ideals-freedom-and.

19. The Declaration of Independence ¶ 1 (U.S. 1776).

20. *See, e.g.*, Annette Gordon-Reed, The Hemingses of Monticello: An American Family (2009).

21. *See, e.g.*, Thomas Jefferson, Notes on the State of Virginia at 148–49 (1788). I won't besmirch these pages with the actual parenthetical quote.

22. J.M. Barrie, Peter and Wendy, ch. 13: Do you believe in Fairies? (1911).

if we collectively believe that they do, and it is incumbent upon us to give them effect.

By now you are probably wondering what any of this has to do with franchising or the *Franchise Law Journal*. While it may seem insignificant, every step we take toward improving diversity and inclusiveness is a step toward a more just and equitable society. That includes the humble *Journal.* And as the preeminent academic treatise on the subject of franchising, the *Journal* is uniquely positioned to address issues of diversity and inclusion in our niche area of law. While the *Journal* and the Forum on Franchising have made diversity and inclusion a cornerstone of our mission and visions for growth,[23] based on the most recent survey of the Forum's membership in 2016, there is no question that we (like America) still have a lot of work to do.[24] The number one response by forum members in the survey was that the organization should strive to improve Forum diversity and inclusiveness.[25]

Our Forum community owes it to our diverse colleagues to stand up for these ideals and to give meaning and purpose to those self-evident truths espoused by our Declaration. At the *Journal*, that means a commitment to publishing articles on franchising topics that impact the lives of people of color. I cannot do that without your help. As the editor-in-chief, I can cheerlead, but other than these soapbox editorials shouted out into the void, I don't really contribute to the substantive discussion of law and policy. In other words, while "I'm the one with enthusiasm; you're the one with experience, which I'm looking forward to learning from."[26] So I'm counting on you to help author articles and educate our membership (including myself) on issues of racial justice and equity in franchising. Only you can move the Forum forward to help reach its goals of being a truly diverse and inclusive organization that is representative of this country and our membership.

It is not enough to sit idly by; we must all take positive and affirmative antiracist steps if we are to solve this problem.[27] If you have any interest in

23. It is one of the four goals of the Forum, as adopted in 1997, to "promote full and equal participation of minorities, women, and underrepresented groups in Forum activities." Policies & Procedures Manual, ABA Forum on Franchising 10 (2018). This is reflected in the Diversity Caucus, which, beginning in 2006 or 2007, has the mission of (1) increasing the number of diverse members in the Forum; (2) growing the representation by diverse members on the Forum's divisions and committees; (3) continuing to develop a strong base of diverse writers and speakers for the Forum; (4) creating a growing pool of diverse members ready to assume leadership positions for the Forum; and (5) raising awareness of the value of diversity in the profession. *Id.* at 42.

24. This is not to imply that the work is ever going to be finished. Like democracy itself, achieving racial equity is less of an attainable goal and more of an ongoing sacred duty.

25. *Id.* at 62.

26. Ahsoka Tano, Star Wars—The Clone Wars (Lucasfilm 2008).

27. *See, e.g.*, Ibram X. Kendi, How to Be an Antiracist 9 (2019) ("One either allows racial inequities to persevere, as a racist, or confronts racial inequities, as an antiracist."); *see also* Theodore Roosevelt, Fear God and Take Your Own Part 26–27 (1916) ("[J]ustice consists not in being neutral between right and wrong, but in finding out the right and upholding it, wherever found, against the wrong.").

writing on diversity and inclusion, racial justice, or racial equity topics relevant to franchising, or if you know someone who does, or even if you have great ideas or untapped on these topics, please don't hesitate to reach out to me or one of our team of excellent editors to discuss. At the *Journal*, we will endeavor to improve our open topics list to better reflect our mission of diversity and inclusion, and to give a voice to underrepresented communities and perspectives through our publication of content.

This is intended as a call to action. I hope you take it.

Franchise Sales Laws Need Revisions to Further Their Objectives, but Federal Preemption Is Not the Solution

*Peter C. Lagarias**

Mr. Lagarias

A recent *Franchise Law Journal* article recommends transmogrifying all state and federal franchise sales laws into a unitary federal standard which would preempt all state laws (the Preemption Article).[1] A central premise of the Preemption Article is the chorus of franchisors' complaints of expensive and duplicative state franchise registration requirements. The Preemption Article concludes by recommending preempting federal legislation, including several new, and some useful, provisions: 1) establishing a national database for all franchise disclosure documents (FDDs); 2) deputizing state attorneys to enforce a new federal disclosure law; and 3) providing a federal cause of action under the new federal disclosure statute.

But the Preemption Article provides no justification for the central proposal of eliminating state government review of FDDs before registration and sale of franchises. Nor are studies or empirical evidence provided that the current dual-regulation regime is overly burdensome and expensive. To the contrary, the uniform national disclosure standards are mandated by the Federal Trade Commission (FTC) under the FTC Franchise Rule (FTC Franchise Rule).[2] And state franchise registration laws, rather than being administered inconsistently by state franchise examiners, are unified in approach and streamlined under the auspices of the North American Securities Administrators Association (NASAA).

1. Rochelle Spandorf, *Can Federal Preemption Solve What's Wrong with Franchise Sales Laws?*, 39 Franchise L.J. 477 (2020).
2. Disclosure Requirements and Prohibitions Concerning Franchising, 16 C.F.R. § 436 *et seq*.

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The Preemption Article prioritizes the desires of franchisors to quickly get to market and sell franchises over consumer protection—namely, the checks and balances that promote accuracy and completeness. Society's goal, reflected in state franchise laws, is to ensure potential franchisees receive sufficient and accurate information to enable them to make informed investment decisions and avoid misleading franchise offerings. The best social outcome would be to increase the portion of franchises sold that succeed, not merely increase the number of franchises sold. The Preemption Article's suggested policies would eliminate core state law protections by eliminating prior review of FDDs and other safeguards provided by multiple states. Presale screening and stop orders by state franchise examiners thwart some of the worst actors before fraudulent franchise sales occur. State enforcement actions also provide needed relief and enjoin continuing violations. Without state presale review, there would be no stopping the distribution of fraudulent, deceptive, or incomplete FDDs to prospective franchise buyers.

Dual regulation in commerce is often the rule, rather than the exception, in our federal system. This is especially so in the regulation of fraud in the marketplace. And a public policy concern arises when the real goal of federal preemption is to lessen public protections with weak federal legislation supplanting stronger state laws. Changes to the franchise laws should instead address the purpose of franchise disclosure: providing essential, understandable, and truthful information to prospective franchisees. Many proposals to this end were presented to the Commission during the FTC's 2019 FTC Franchise Rule review. Some of the additions suggested in the Preemption Article could assist in that effort, including increased private enforcement via a federal cause of action, but preemption is not warranted.

A. *A Brief History of the Purpose of Franchise Sales Regulation*

1. In the Beginning, State Franchise Regulation Through Review, Registration, and Disclosure Was Followed by Federal Regulation Limited to Disclosure

The first franchise disclosure law, the California Franchise Investment Law, was enacted in 1970 following testimony from franchisees and law enforcement regarding franchise fraud. State Senator Bill Bradley explained the purpose: "There are no effective legal remedies available to combat the problem of misleading and deceptive practices engaged in by those franchisors whose activities reflect unfairly on the rest of the industry."[3] The proposed law was drafted by the California Department of Corporations and the California Attorney General using the registration and disclosure structure of California's securities laws. The statute was signed into law by then Governor Ronald Reagan as part of his 1970 consumer protection package. The

3. Statement of State Senator Clark Bradley, SB 67, California Leg. Intent Servs. (Mar. 30, 1970).

future President explained that the need for consumer protection required honest businesses to accept regulation:

> The fact is, free enterprise has prospered in our society—indeed, it has brought this nation the highest standard of living ever known to man—because, on the whole, the system has served our people honestly and fairly. Nevertheless, there are always some persons who try to misuse and exploit the system through dishonest and unethical operating methods. The laws I have proposed to the legislature have been directed at these unrepresentative few—to either bring them in line or put them out of business. At the same time, I have cautioned that we must always be scrupulously careful *not* to penalize the vast multitude of hardworking, honest, and legitimate businesses for the sins of the few.[4]

The California statute was copied, in whole or in part, by several states. A group of states adopted laws requiring presale registration of franchise offerings as well as disclosures, including Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, Virginia, and Washington.[5] A smaller group, either originally or later, eliminated registration in favor of notice filing only, including Michigan, South Dakota, and Wisconsin. Oregon and Ohio simply require disclosure without registration.[6] Florida and Mississippi have statutory anti-fraud requirements regarding the sale of franchises but do not require registration or pre-sale disclosure. That state franchise sales laws are not identical in definitional coverage, substantive regulation, or remedies, is not unusual. In our federal system, the caldron of fifty state legislative bodies, the "laboratories of democracy," often leads to better laws and protections.[7] The big picture, however, is that the states' legislative approaches are remarkably similar: most require franchise offerings, similarly defined, to be reviewed and registered and for there to be disclosure to potential franchisees before a sale. Some states only require notice filings. Almost all states have addressed statutory fraud with most prohibiting misrepresentations and material omissions in the FDD or elsewhere.

In 1971, after Congress failed to enact federal franchise disclosure legislation, the Federal Trade Commission announced the proposed rulemaking that led to the enactment of the FTC Franchise Rule in 1978. The ensuing rule provided for similar pre-sale disclosure, but did not require registration or approval of the disclosure document. The Commission's process included substantial public comments and testimony, culminating in an official Statement of Basis and Purpose for the Franchise Rule. The FTC found

4. Press Release, Office of the Governor Ronald Reagan (Sept. 24, 1970).

5. These statutes and other franchise disclosure laws are ably delineated in the following treatise: Franchise Deskbook: Selected State Laws, Commentary, and Annotations (Bethany L. Appleby, W. Michael Garner & Karen Boring Satterlee eds., 3d ed. 2019).

6. All of the state statutes are covered in the *Franchise Deskbook*, *id.*, except Ohio's. Perhaps this omission was due to the designation of the statute as the Ohio Business Opportunity Purchasers Protection Act. Ohio Rev. Code Ann. § 1334 *et seq.* Nonetheless the Ohio law allows franchisees to sue under that statute for violations of the FTC Franchise Rule, including its prohibitions of misrepresentations and certain omissions.

7. *Preemption of State Laws: Good for Big Tech, Bad for the Public*, Public Citizen (May 30, 2019), https://www.citizen.org/article/preemption-faq.

significant evidence that the sale of franchises included multiple instances of misrepresentations, especially false and deceptive earnings claims, as well as fly-by-night operators. In addition, the Commission noted the existence of a fundamental information imbalance: Professor Urban Ozanne testified that "a severe informational disparity exists as well . . . [when] the franchisor presents the information about the franchise and its sales and profits. Unlike the franchisee, he knows how much information is fact and how much puffery."[8]

The initial FTC Franchise Rule required disclosure similar to the already existing state statutes, but no federal review or registration. The lack of registration or filing thus differs from the similar regulation of stock prospectuses by the SEC. While stock prospectuses must be disclosed to investors like FDDs, federal law requires non-exempt prospectuses to be filed with the SEC.[9] In addition to registration, the SEC selectively reviews prospectuses as well as companies under the Sarbanes-Oxley Act of 2002.[10]

The SEC does not guarantee that a disclosure is complete and accurate; instead that responsibility rests with the company and its professional advisers. While the SEC review of prospectuses is not exhaustive, the SEC review is a first line of defense from fraudulent offerings. The SEC describes its reviews as follows: "In its filing reviews, the Division [of Corporate Finance of the SEC] concentrates its resources on critical disclosures that appear to conflict with Commission rules or applicable accounting standards and on disclosure that appears to be materially deficient in explanation or clarity."[11] Unlike the SEC, the FTC conducts no reviews of FDDs. Because it has no registration or review obligation, the FTC does not maintain staff trained for review of FDDs.

When a security offering is fraudulent or otherwise fails, the investor loses only their investment, sometimes denominated as risk-capital. But when a franchise is fraudulent or otherwise fails, the franchisee stands to lose much more than the initial franchise fee. The failing franchisee loses the investment in a buildout of the unit, in the equipment, and possibly in other long-term obligations, which keep growing such as commercial leases, equipment leases, and loans with accruing interest. On top of those losses, the franchisee may have been looking to the franchise business for their livelihood. The magnitude of risk for franchisees is often exponential to that of stock investors.

The FTC specifically declined to preempt consistent state regulations and specifically allowed additional state protections of franchisees:

8. FTC Statement of Basis and Purpose, Bus. Franchise Guide (CCH) ¶ 6304 (July 21, 1979).

9. 15 U.S.C. § 77j. *See generally* Securities Act of 1933, the Securities Exchange Act of 1934, and the Sarbanes-Oxley Act of 2002.

10. Sarbanes-Oxley Act of 2002.

11. SEC, Filing Review Process (Aug. 8, 2020), https://www.sec.gov/divisionscorpfin/cffilingreview.htm.

> The FTC does not intend to preempt the franchise practices laws of any state or local government except to the extent of an inconsistency with part 436. A law is not inconsistent with part 436 if it affords prospective franchisees equal or greater protection, such as a registration of disclosure documents or more extensive disclosures.[12]

This provision reflects a partial preemption of state franchise statutes: state franchise sales laws are preempted to the extent they are inconsistent with the FTC Franchise Rule.

2. The States' Pre-Sale Review and Registration of FDDs

Although not significantly analyzed in the Preemption Article, state franchise disclosure statutes conduct a first line of defense to fraudulent and defective offerings, much like the SEC. This state review, like the SEC, typically includes study of critical disclosures, legal compliance, and appropriate accounting reporting, and ensures that disclosures are complete and clear. This should not be surprising, as NASAA is comprised of state securities and franchise disclosure regulators who regularly meet and train with representatives of the SEC and FTC. Among the specific and multiple consumer protections not found under the FTC Franchise Rule, and enforced by state agencies, are the following:

> —Presale review of franchise offering circulars and required registration before franchises can be offered and sold in the state.[13]
>
> —Prior review of franchise advertisements.[14]

12. 16 C.F.R. § 436.10(b).

13. The following states conduct presale review and registration of franchise disclosure documents although with some exemptions: California, Cal. Corp. Code §§ 31110–31225 (Commissioner may issue a stop order); Hawaii, Haw. Rev. Stat. §§ 482E-3 (filing), 482E-8(a) (stop orders); Illinois, 815 Ill. Comp. Stat. 705/1 §§ 705/5, 705/10, 705/22–705/23 (Administrator may issue stop orders); Maryland, Md. Code Ann., Bus. Reg. §§ 14-214–14.215, 14-221 (Commissioner may issue a stop order); Minnesota, Minn. Stat. §§ 80C.02–80C.05 (verification of registration); New York: N.Y. Gen. Bus. L. § 683(1); North Dakota, N.D. Cent. Code § 51-19.03; Rhode Island, R.I. Gen. Laws § 19-28.1-5; Virginia, Va. Code Ann. § 13.1-560; Washington, Wash. Rev. Code §§ 19.100.020, 19.100.120 (Director may issue stop order). The following states generally require only notice filing and disclosure with no review and registration before sale of franchises: Indiana, Ind. Code § 23-2-2.5-9; Michigan, Mich. Comp. Laws § 445.1507(a); Oregon, Or. Rev. Stat. § 441-325-0020 (Oregon requires disclosure but no registration or filing); South Dakota, S.D. Codified Laws § 37-5B-5; Utah, Utah Code Ann. § 13-15-1; Wisconsin, Wis. Stat. § 553.21.

14. The following states conduct presale filing or review of advertisements for the sale of franchises: California, Cal. Corp. Code §§ 31156–31157 (Commissioner may summarily find advertisements as false or misleading and prohibit publication of the advertisement); Illinois, Ill. Admin. Code tit. 14 § 200.301 (limits on content of advertising regarding safe investments, success, and profits); Indiana, Ind. Code § 23-2-2.5-26; Maryland, Md. Code Ann., Bus. Reg. § 14-225, Md. Regs. Code § 02.02.08.09; Michigan, Mich. Comp. Laws § 445.1524 (filing may be required); Minnesota, Minn. Stat. § 80C.09 (filing required five days before use), Minn. R. §§ 2860.4100, 2860.4200; New York, N.Y. Gen. Bus. L. § 683(15); North Dakota, N.D. Cent. Code Ann. § 51-19.10; South Dakota, S.D. Codified Laws § 37-5B-23; Washington, Wash. Rev. Code §§ 19.100.100, 19.100.110.

—Franchisors with limited financial capacity may be required by most state laws to impound, defer, escrow or secure with a surety bond, initial franchise fees pending performance of the franchisor's initial training and opening assistance obligations.[15]

—Administrative enforcement.[16]

—Criminal prosecutions for violations.[17]

—Private civil lawsuits including for damages and rescission for willful violations. This self-help remedy is missing from FTC Franchise Rule, which contains no private right of action.[18]

—Jurisdiction over the franchisor by the state and for service of process by service on the state.[19]

15. The following states provide for impoundment of initial franchise fees in certain conditions. California, 10 Cal. Admin. Code § 310.113; Hawaii, Haw. Code R. 16-37-5; Illinois, 815 Ill. Comp. Stat. § 705/15, Ill. Admin. Code tit. 14 §§ 200.502–200.508; Indiana, Ind. Code § 23-2-2.5-12; Maryland, Md. Code Ann., Bus. Reg. § 14-217, Md. Regs. Code § 02.02.08.08; Washington, Wash. Rev. Code § 19.100.050; Michigan, Mich. Comp. Laws § 445.1512; Minnesota, Minn. R. 2860.1800, 2860.1900; New York, N.Y. Gen. Bus. L. § 685, N.Y. Comp. Codes R. 200.6; Virginia, Va. Admin. Code § 5-110.65, 553.605.

16. The following states provide for administrative enforcement under the statutes: California, Cal. Corp. Code § 31406; Hawaii, Haw. Rev. Stat. §§ 482E-8, 482E-10-7; Illinois, 815 Ill. Comp. Stat. §§ 705/23-705/31; Indiana, Ind. Code § 23-2-2.5-14, 23-2-2.5-35; Maryland, Md. Code Ann., Bus. Reg. §§ 14.210, 14.222; Michigan, Mich. Comp. Laws § 445.1535; Minnesota, Minn. Stat. §§ 80C.12–80C.18 (verification of registration); New York: N.Y. Gen. Bus. L. §§ 688-689; North Dakota, N.D. Cent. Code Ann. §§ 51-19.09, 51-19-13; Oregon, Or. Rev. Stat. § 650.057; Rhode Island, R.I. Gen. Laws §§ 19-28.1-18, 19-28.1-25; Virginia, Va. Code Ann. § 13.1-570; Washington, Wash. Rev. Code § 19.100.130; Wisconsin, Wis. Stat. §§ 553.55–553.57.

17. The following states provide criminal sanctions for certain violations: California, Cal. Corp. Code §§ 31404, 31410–31416; Hawaii, Haw. Rev. Stat. §§ 482E-10.5 (civil penalties), 482E-10.6 (criminal penalties); Illinois, 815 Ill. Comp. Stat. §§ 705/24–705/25; Indiana, Ind. Code §§ 23-2-2.5-36, 23-2-2.5-37; Maryland, Md. Code Ann., Bus. Reg. §14-211; Michigan, Mich. Comp. Laws §§ 445.1538, 445.1540 (fines); Minnesota, Minn. Stat. § 80C.16 (civil fines and criminal penalties); New York, N.Y. Gen. Bus. L. §§ 690, 692; North Dakota, N.D. Cent. Code Ann. § 51-19.03; Rhode Island, R.I. Gen. Law § 19-28.1-20; South Dakota: S.D. Codified Laws § 37-5B-25; Virginia, Va. Code Ann. § 13.1-569; Wisconsin, Wis. Stat. §§ 553.52, 553.57.

18. Virtually all states, unlike the FTC Franchise Rule, provide for private rights of action for franchisees for violations of the state statutes: California, Cal. Corp. Code § 31300; Hawaii, Haw. Rev. Stat. §§ 482E-9; Illinois, 815 Ill. Comp. Stat. § 705/26; Indiana, Ind. Code §§ 23-2-2.5-28, 23-2-2.7-4; Maryland, Md. Code Ann., Bus. Reg. § 14-227; Michigan, Mich. Comp. Laws §§ 445.1531–445.1532; Wisconsin: Wis. Stat.§ 553.51; Minnesota, Minn. Stat. § 80C.17; New York: N.Y. Gen. Bus. L. § 691; North Dakota, N.D. Cent. Code Ann. § 51-19.12; Oregon, Or. Rev. Stat. § 650.020; Rhode Island, R.I. Gen. Laws § 19-28.1-21; Virginia, Va. Code Ann. § 13.1-571; Washington, Wash. Rev. Code § 19.100.190.

19. Most states provide for jurisdiction in their courts by franchisors and for service of process on the franchisor at government offices: California, Cal. Corp. Code § 31420; Hawaii, Haw. Rev. Stat. §§ 482E-5(c); Illinois, 815 Ill. Comp. Stat. 705/1 § 705/35: Indiana, Ind. Code §§ 23-2-2.5-24, 23-2-2.5-38; Michigan, Mich. Comp. Laws §§ 445.1522, 445.1539; Minnesota, Minn. Stat. § 80C.020; New York, N.Y. Gen. Bus. L. § 686; North Dakota, N.D. Cent. Code Ann. § 51-19.15; Oregon, Or. Rev. Stat. § 650.070; Rhode Island, R.I. Gen. Laws § 19-28.1-28; South Dakota, S.D. Codified Laws § 37-5B-22; Virginia, Va. Code Ann. § 13.1-566, Va. Admin. Code § 5-110.7; Washington, Wash. Rev. Code § 19.100.160; Wisconsin, Wis. Stat.§ 553.73.

—Anti-waiver provisions.[20]

—Voiding of out of state of state venue clauses.[21]

State agencies regularly obtain judgments and orders against franchisors for violations of state franchise disclosure statutes and regulations.[22]

3. NAASA and State Regulators Provisions for Uniformity

Also not addressed in the Preemption Article is the dedicated and valuable work by NASAA and state franchise examiners that has provided a fundamental unifying element to all franchise sales laws. NASAA is the association of sixty-seven state, provincial, and territorial securities regulatory agencies of the United States, Canada, and Mexico. NASAA also works on franchise regulations that are most often modeled after securities laws and that exist in sixteen states.

For over thirty years, NASAA's Franchise Project Group has worked to assist franchise examiners and practitioners to comply with state franchise disclosure and registration laws. The Franchise Project Group has developed multiple policy statements and interpretive guidelines to assist franchisors and the franchise bar. NASAA and the Franchise Practice Group conduct annual trainings and webinars for franchise examiners.

While none of the state statutes and regulations is identical, NASAA has consistently led the way toward achieving uniformity. NASAA worked diligently developing the Uniform Franchise Offering Circular, which the FTC approved for use under the Franchise Rule despite the different federal disclosure format. NASAA consults with the FTC staff on franchise regulation. In comments supporting the continuation of the Franchise Rule, NASAA President Michael Pieciak stated:

20. The following states have anti-waiver provisions: California, Cal. Corp. Code § 31512; Illinois, 815 Ill. Comp. Stat. 705/1 § 705/41; Maryland, Md. Code Ann., Bus. Reg. § 14-226; Michigan, Mich. Comp. Laws § 445.1527(b); Minnesota, Minn. Stat. § 80C.21, Minn. R. 2860.4400.D; North Dakota, N.D. Cent. Code Ann. § 51-19.16(7); South Dakota, S.D. Codified Laws § 37-5B-26(8); Virginia, Va. Code Ann. § 13.1-571(c); Wisconsin, Wis. Stat.§ 553.76.

21. The following states laws void out-of-state venue clauses in franchise agreements: California, Cal. Bus. & Prof. Code § 20040.5; Illinois, 815 Ill. Comp. Stat. §§ 705/1, 705/4, Ill. Admin. Code tit. 14 § 200.608.

22. *In re* Dental Support Plus Franchise, LLC, Kent Maerki, and Norma Jean Maerki, Cal. Dep't of Bus. Oversight (Dec. 20, 2018) (citation and cease and desist order for selling franchises; making untruthful statements or willfully omitting required disclosures); *In re* USA Sub, Inc., Case No. SEU-2017-028, Dep't of Com. & Consumer Affs. (June 29, 2020) (order against franchisor for selling unregistered franchises to Hawaii residents also without disclosures. Civil penalty of $30,000 and franchisor ordered to offer rescission of franchise agreements and payment to franchisees within sixty days); Virginia, *ex rel.* State Corps. Comm'n v. N.Y. Bagel Enters., Inc., Case No. SEC-2016-00046, State Corps. Comm'n (Mar. 10, 2017) (judgment against franchisor and its principals for selling unregistered franchises, using false statements, and material omissions in the offer and sale of franchises to Virginia residents. Award of $225,000 in penalties, ordered to rescind franchises with restitution to franchisees, and pay costs to the State in excess of $20,000); *In re* Conner & Assocs., Inc., Case No. S-16-2021-19-FO01, State of Wash. Dep't of Fin. Inst. Secs. Div. (Sept. 16, 2019) (sales of unregistered franchise agreement including by misrepresentations and material omissions, cease and desist against certain defendants).

> On June 6, 2008, NASAA adopted the disclosures under the Franchise Rule as the replacement for the [Uniform Franchise Offering Circular] Guidelines. The Franchise Practice Group works closely with Commission staff and state franchise regulators regarding franchise disclosure requirements.[23]

B. *What's Wrong with the Status Quo of Franchise Sales Regulation?*

Are the problems asserted in the Preemption Article substantiated, and substantial enough, to warrant preempting current state regulation protecting prospective franchisees? Or are some of the problems advanced in the Preemption Article insubstantial, exaggerated, or simply straw men introduced to advance the interests of regulated franchisors to the detriment of prospective franchisees? The touchstone in analyzing the future of franchise sales regulation should be the intent of franchise disclosure. Bearing that in mind, some of the non-preemption proposals in the Preemption Article, such as creating a national data base of FDDs and providing real remedies for franchisees, do merit further study.

1. Multiple Franchise Definition Problems, Not So Much

The differences between the definitions of a franchise in the FTC Franchise Rule and most state franchise disclosure statutes are minimal. The definitions generally include the right to operate a business substantially associated with the franchisor's trademark, a marketing plan by the franchisor, and a franchise fee paid by the franchisee.[24] The sole exceptions are the few statutes that include a different definition of a *community of interest*, such as in the Minnesota Franchise Act.[25] The Preemption Article cites no cases that found an accidental franchise under state law that was not a franchise under the FTC Franchise Rule.

The problem of the scope of statutory definitions and gray areas on the edges is inherent in any regulatory scheme. Regulated parties will contest the limits of the definitions as to whether there are one or more regulatory definitions. And whatever definitions of a franchise exist, both accidental franchisors and prospective licensors who want to avoid regulation as a franchisor will have incentive to contest the application of the definitions. Some putative franchisors may also seek to skirt the definitions and disclosures. But this evasion is not a function of dual regulation; it is inherent to the intersection of regulation and commerce. The presence of definitional litigation does not warrant the removal of the protections provided by state regulations.

23. Letter from Michael Pieciak, NASAA Pres., Comments on Franchise Rule Regulatory Review, to April Tabor, FTC Acting Sec., 2 (May 13, 2019), https://www.nasaa.org/wp-content/uploads/2019/05/NASAA-Comment-Letter-FTC-Franchise-Rule.pdf.

24. 16 C.F.R. § 436.1(h).

25. Minn. Stat. § 80C.01(4)(a)(1)(ii). The oft-cited Wisconsin Fair Dealership Law (Wis. Stat. § 135.01 *et. seq*.) includes a community of interest element in its definition of *dealership*, but is not a franchise statute. *See* Bruce Napell, *State Definitions of Franchise Relationship Laws Not Uniform*, 26 Franchise L.J. 3, 12 (2006).

Finally, a nationwide non-partisan group, the Uniform Law Commission (ULC), exists to assist with state law uniformity. This group of lawyers, judges, and legislators appointed by state governments "provides states with non-partisan, well-conceived and well-drafted legislation that brings clarity and stability to critical areas of state statutory law."[26] In the mid-1980s, a proposed Uniform Franchise Act achieved little more than disagreements between franchisor and franchisee attorneys as to the need for legislation at all much less coverage of the legislation.[27]

2. Regulatory Process Problems, Not So Much

The central problem with dual regulation asserted in the Preemption Article, and elsewhere, is that it is duplicative and a waste of franchisor resources. The Preemption Article characterizes state agencies as "uncoordinated," "redundant," a "patchwork," and even a "noose strangling the golden goose." State regulators are accused of wielding "absolute authority." But the support for these positions is remarkably sparse. Instead of empirical evidence or data, the Preemption Article cites opinions of two franchisor lawyers.[28] And the final opinion that state regulation of franchising is destroying franchising is belied by contrary published data. According to the International Franchise Association (IFA), the 750,000 franchises in the United States account for over forty percent of all retail sales in the country.[29] Despite the COVID-19 pandemic hitting in the middle of this year's franchise registration cycle, the state of California received a total of 1,126 franchise registration and renewal applications in the spring of 2020.[30] Ironically, when the IFA was newly formed, it initially supported franchise regulation to help cleanse the franchise marketplace of fraudsters and fly-by-night operators.[31]

If franchising has been growing steadily since the 1970s despite state regulation, one of the reasons is the efficacy of NASAA's promulgation of the original Uniform Franchise Offering Circular Guidelines and the more recent 2008 Franchise Registration and Disclosure Guidelines, which are

26. Uniform Law Comm'n, Overview, https://www.uniformlaws.org/aboutulc/overview (last visited Sept. 24, 2020).

27. Rupert M. Barkoff & Timothy Fine, *The Proposed Uniform Franchise Act: Questions and Answers*, 5 Franchise L.J. 4 (Spring 1986).

28. The opinions came from two respected members of the franchise bar, the late Rupert Barkoff and Philip Zeidman. Rupert M. Barkoff, *Franchise Sales Regulation Reform: Taking the Noose off the Golden Goose*, 3 Entrepreneurial Bus. L.J. 233, 240 (2009); Rupert M. Barkoff, *Upcoming Review of the Franchise Disclosure Rule: Here We Go Again*, Law.com (Nov. 19, 2018), https://www.law.com/newyorklawjournal/2018/11/19/upcoming-review-of-the-franchise-disclosure-rule-here-we-go-again/?slreturn=20200824132539; Sharon Collins Casey, *Franchisors and the FTC: State Regulation and Federal Preemption*, 3 Harv. J.L & Pub. Pol'y 155, 160–65 (1980).

29. *See, e.g.*, PriceWaterhouseCoopers LLP, The Economic Impact of Franchised Businesses, Vol. IV (2016).

30. Interview of Theresa Leets, Attorney, Cal. Dep't of Bus. Oversight (July 2, 2020).

31. IFA, *The International Franchise Association—Celebrating Fifty Years of Dedicated Service to Franchising*, Franchising World 2 (Jan. 2020).

accepted by the FTC and all franchise registration and notice filing states. Uniform disclosure helps alleviate redundancy and a lack of coordination.[32]

Regarding the problem of patchwork laws, NASAA addressed concerns over differing state cover pages, by a new uniform state cover page.[33] This document also eliminates redundancy and a lack of coordination. Regarding the related claimed problems of lack of coordination and redundancy, NASAA has recently commenced a program allowing electronic filing of franchise registrations in multiple states simultaneously.[34] The Electronic Filing Depository (EFD) largely copies the program for state securities filing. Although in its infancy, the program allows for a single filing for electronic registration of an FDD in multiple states, with the FDD automatically forwarded to listed states in the filing, together with electronic payment for all listed state application fees. The program is brand new, and not all states have entered the program for franchise registrations due to the presence of electronic filing platforms already present in several states.

NASAA's very existence belies the Preemption Article's assertions about an uncoordinated patchwork: NASAA has led the way in studying and educating the FTC and the public about ongoing, new, and difficult issues regarding franchise regulation, registration, and disclosure. Although the FTC provided innumerable advisory letters and opinions in the 1980s, NASAA has been the enduring resource for the franchising industry and the franchise bar. Here are some of NASAA's additional output to assist practitioners:

—Disclosing Financial Performance Representations in the Time of COVID-19[35]

—NASAA Financial Performance Representation Commentary[36]

—NASAA Franchise Multi-Unit Commentary (adopted September 16, 2014)[37]

—NASAA Commentary on 2008 Franchise Regulation and Disclosure Guidelines[38]

—NASAA Franchise Disclosure Handbook[39]

32. 16 C.F.R. § 436.10(b); *see also* NASAA Franchise State Cover Sheets Instructions (effective Jan. 1, 2020), https://www.masaa.org/industry=resources/franchise-resources.

33. NASAA Franchise State Cover Sheets Instructions, *supra* note 32.

34. NASAA, Electronic Filing Depository, www.efdnasaa.org (last visited Sept. 24, 2020); *see also* NASAA, Electronic Filing Depository Functionality Expanded (May 27, 2020), https://www.nasaa.org/48078/nasaas-electronic-filing-depository-functionality-expanded/#:~:text=WASHINGTON%2C%20DC%2C%20March%2012%2C,UITs)%20with%20state%20securities%20regulators.

35. Disclosing Financial Performance Representations in the Time of Covid-19 (June 2020), https://www.masaa.org/industry-resources/franchise-resources.

36. NASAA, Financial Performance Representation Commentary (May, 8, 2017), https://www.masaa.org/industry-resources/franchise-resources.

37. NASAA, Franchise Multi-Unit Commentary (adopted Sept. 16, 2014), https://www.masaa.org/industry-resources/franchise-resources.

38. NASAA Commentary on 2008 Franchise Regulation and Disclosure Guidelines (adopted Apr. 27, 2009), https://www.masaa.org/industry-resources/franchise-resources.

39. NASAA, Franchise Disclosure Handbook (June 2020), https://www.masaa.org/industry-resources/franchise-resources.

Further, NASAA annually provides training, and often webinars, to state franchise examiners to enhance their knowledge and provide for uniformity. And NASAA franchise examiners regularly confer between meetings on all manner of topics seeking uniformity in regulation and enforcement.

The remaining challenge to franchise registration is the claim of "absolute authority" over franchise registrations. While this assertion is discussed in some length, not one example of a worthy FDD that was not eventually registered is presented. Instead the real issue may be that franchisors and their attorneys do not want to be told no. But the rules are present to be followed, and many registrations are lodged with missing disclosures, missing exhibits, or worse, with inconsistent or unsubstantiated data. Moreover, many states have exemptions from registration for large franchisors, which the statutes presume to be experienced and to employ competent counsel. Even experienced legal counsel have to follow the rules. And so too should regulators. At the end of the day, systems are in place for franchisors to challenge all actions by state examiners and administrators. Stop orders can be challenged by a variety of means, including administrative hearings and court proceedings.

If, at the end of the day, the complaints about dual regulation are not supported by data, then what is the real intent of the Preemption Article? Rather than stopping dual-state regulation, the Preemption Article appears to be an attempt to stop presale review and approval of disclosure documents. This is a substantive proposal for weakening the protections of franchisees, masquerading as the mere avoidance of duplicative regulation. The FTC does not look at anything before it hits the marketplace. It does not review or vet franchise disclosure documents. Franchisors' advertising is not presented to the Commission staff for study and possible action. Franchisors' balance sheets are not examined to determine the necessity of impounding initial franchise fees or requiring surety bonds. Rather than creating regulatory uniformity, the Preemption Article seeks substantive deregulation by eliminating any and all presale review. Without mandatory regulatory review, there will be no chance that contradictory, incomplete, or fraudulent franchise offerings will be weeded out before being offered and sold. Questionable earnings claims will not be prohibited. The horse will be out of the barn, and damage done to franchisees who have invested. The current regulatory regime does not stop every scam, but it catches some and deters others. Requiring no prior review empowers fraudfeasors and bad actors; the very persons that the statutes seeks to regulate and stop.

3. Lack of Statutory Remedies for Aggrieved Franchisees; Yes, This Is a Problem for Half of All Franchisees

The Preemption Article asserts that most of the United States is a "registration free zone" and that "[t]here is something unjust with a status quo where all franchisees in the same network may experience the same wrongdoing yet some are left remediless."[40] The Preemption Article correctly notes that not all franchisees have rights for violations of franchise statutory

40. Spandorf, *supra* note 1, at 491–92.

disclosure and anti-fraud rules and that this is a serious problem. The scope of the problem may be overstated, while a minority of states have state franchise statutes several of the larger states by population, including California, New York, and Illinois, have those statutes. Yet in most states there are no franchise disclosure laws or statutory remedies. In case after case, courts have concluded there is no private right of action under the FTC Act or its trade regulation rules like the FTC Franchise Rule.[41] Defrauded franchisees are left to cobble together claims under common law fraud or Little FTC Acts. But such claims may not exist or succeed. And state Little FTC Acts may be limited to consumer transactions or provide limited remedies. Common-law fraud claims are, in many states, subject to being thwarted by the omnipresent disclaimers franchisors' use to negate justified reliance.[42] Thus the proposal in the Preemption Article for a federal private right of action for violations of the FTC Franchise Rule is long overdue.

The Preemption Article also includes a proposal for all state prosecutors to be deputized to enforce a preempting federal disclosure law. But there are concerns with this novel proposal. First, no comparable antecedents are cited. Currently, several state governments have franchise-law expertise from reviewing FDDs for registration. These states have experienced franchise-registration examiners and legal counsel. Many have decades of experience in franchising, having reviewed hundreds of franchise disclosure documents. Even novice examiners receive training and develop a depth of specialized knowledge and experience. If the state registration laws are eliminated, this resource will be unavailable to state attorneys general who would be prosecuting such actions.

4. National Database of Franchise Disclosure Documents: A Helpful Proposal

The Preemption Article also proposes creation of a national database of all FDDs. This proposal neither relates to, nor justifies, preemption of state law protections. But a national database would be an incremental improvement. Currently, three states have publicly accessible databases of franchisor filings: California, Minnesota, and Wisconsin. But many large franchisors are exempt from registration, and, therefore, their FDDs are not included in the databases. Given franchise industry estimates that there are between 4,000 to 5,000 franchisors in the United States, it is clear that many FDDs are not available to the public. The NASAA multi-state filing platform may eventually become a national database of franchisors filing for registration.

41. Holloway v. Bristol-Myers Corp., 485 F.2d 986 (D.C. Cir. 1973); Morales v. Walker Motor Sales, Inc., 162 F. Supp. 2d 786 (S.D. Ohio 2000); Days Inn of America Franchising, Inc. v. Windham, 699 F. Supp. 1581 (N.D. Ga. 1988); Freedman v. Meldy's, Inc., 587 F. Supp. 658 (E.D. Pa. 1984).

42. Courad, LLC v. Kidville Franchise Co., 109 F. Supp. 3d 615 (S.D.N.Y. 2015).

Currently, however, the NASAA system is simply a platform allowing a franchisor to upload an FDD once for registration in multiple states.

A national database could increase competition in franchising. If the FDDs for five major pizza franchisors were online, prospective franchisees could compare the initial investment costs, the royalty rates, and any financial performance representations. Franchisors not providing financial performance representations could be ignored, and the most competitive franchisor would likely be selected by the prospects. This option comports with the theory of competitive free-market economies: the marketplace functions best when sellers and buyers are fully informed about everything in the marketplace. Only then will sellers offer, and buyers choose, the best products at the best price. On a practical level, with full and transparent disclosure and a national database, prospective franchisees would be unlikely to purchase franchise businesses that are unprofitable or merely break even, often with the franchisees working long hours with no pay to themselves.

C. *Why Federal Preemption of State Franchise Regulation Is Unlikely*

1. The Scope of Federal Preemption

Federal preemption flows from the United States Constitution's Supremacy Clause: "This Constitution and the Laws of the United States . . . shall be the supreme law of the land."[43] The category "laws of the United States" extends to the duly enacted regulations of federal agencies.[44] Nonetheless, the federal government has enumerated, rather than unlimited, powers. The express federal power that commonly supports preemption is the Commerce Clause, which gives Congress the power "to regulate Commerce . . . among the States."[45] And case after case has expansively recognized the power of Congress to regulate commerce and, expressly or by implication, preempt conflicting state regulation.[46] Moreover, modern jurisprudence has found that the federal commerce authority extends to intrastate conduct that affects interstate commerce.[47] As a result, few would doubt, and the Preemption Article agrees, that Congress could enact federal laws regulating the sale of franchises nationwide under the Commerce Clause and preempt state franchise sales laws.

In asserting its preemptive authority, Congress can act in varying degrees. Most drastically, Congress can expressly prohibit state regulation of a subject

43. U.S. Const. art. VI. cl. 2.

44. Sperry v. Florida, 373 U.S. 379 (1963) (noting federal statute authorizing the Patent Office to regulate practice of patent agents allowed lawyer residing in Florida to continue to practice patent law under Patent Office regulations despite the Florida Supreme Court finding the lawyer committed the unlicensed practice of law in California).

45. U.S. Const., art. I. § 8, cl. 3.

46. *E.g.*, New York v. United States, 505 U.S. 144 (1992); Hodel v. Va. Surface Min. and Reclamation Ass'n, Inc., 452 U.S. 264 (1981).

47. *E.g.*, United States v. Sw. Underwriters, 322 U.S. 533 (1944); United States v. Darby, 312 U.S. 100 (1941).

matter. An example is the Federal Cigarette Labeling and Advertising Act, which, when enacted in 1966, required all cigarette packages and advertising to state: "CAUTION: CIGARETTE SMOKING MAY BE HAZARDOUS TO YOUR HEALTH." The statute then expressly preempted state law by stating: "No statement relating to smoking and health, other than the statement required by this Act, shall be required on any cigarette package."[48] Alternatively, Congress can positively prohibit conflicting state laws, but expressly allow state regulation that does not conflict, including additional state regulation supplementing the federal law. Still other preemption cases involve confusing or inconsistent express Congressional preemption provisions.

When Congress fails to address preemption in a federal statute or regulation, courts are nonetheless often called upon to resolve assertions of federal preemption. With an outright conflict, such as when a state law mandates conduct proscribed by federal law, the result will be federal preemption. On other occasions, courts will find a congressional intent to occupy an entire field of legislation and preempt state laws. In *Northern States Power Co. v. Minnesota*, the Eighth Circuit found that Congress occupied the field of radioactive discharges from nuclear power plants and struck down a Minnesota law imposing more stringent limitations on radioactive discharges from a Minnesota plant.[49]

The FTC Franchise Rule, although adopted by an administrative agency, currently follows the pattern of prohibiting inconsistent state laws but expressly allowing non-conflicting additional or supplementary state regulation.[50] In *Mon-Shore Management, Inc. v. Family Media, Inc.*,[51] the U.S. District Court for the Southern District of New York confirmed that the FTC Franchise Rule did not preempt more stringent state law franchise disclosure protections.

If there are political and public policy choices regarding Congress's decisions to preempt state laws, and to what extent, at least one elephant remains in the room. The Tenth Amendment provides that "the powers not delegated to the United States by the Constitution, nor prohibited by it to the States are reserved to the States, respectively, or to the people."[52]

48. Express preemption statutory language may still lead to uncertainties. The cigarette industry sought to use the above federal preemption to shield itself from common law fraud and breach of warranty claims of a diseased and dying smoker in *Cipollone v. Liggett Group, Inc.*, 505 U.S. 504 (1992). The Supreme Court narrowly construed the preemption language to allow state law claims to proceed. *See also* Altria Group, Inc. v. Good, 555 U.S. 70 (2008).

49. N. States Powers Co. v. Minn., 320 F. Supp. 172 (D. Minn. 1970); Gade v. Nat'l Solid Waste Mgmt. Ass'n, 505 U.S. 88, 98 (1992).

50. 16 C.F.R. § 436 n.2 (1996); 6 C.F.R. § 436.10(b).

51. Mon-Shore Mgmt., Inc. v. Fam. Media, Inc., 584 F. Supp. 186, 190 n.1 (S.D.N.Y. 1984) (quoting the FTC's statement of non-preemption in the Statement of Basis and purpose); *see also* Spring Fresh Corp., v. Dep't of Secs., 829 P.2d 1001 (Okla. App. 1992).

52. U.S. Const. amend. X.

2. Traditional State Police Power Regulation of Fraudulent Business Practices and Preemption

The states regularly enact legislation under their reserved and plenary police powers. Health and safety laws lead the list. When New York enacted a requirement for mandatory typhoid fever inoculation, the United States Supreme Court upheld the law against a constitutional challenge.[53] Perhaps the second most common area in which states exercise their police power is statutes prohibiting fraud in the marketplace. Virtually every state prohibits unfair and deceptive practices under "Little FTC Acts" and unfair and deceptive practices statutes.[54] Such state regulation extends into many fields of commerce such as Blue Sky laws regulating the sales of securities, insurance laws, false advertising laws, and consumer protection statutes.

In deference to the Tenth Amendment, the U.S. Supreme Court has repeatedly declared a presumption against preemption, especially over legislation traditionally covered by state legislation.[55] In *Medtronic v. Lohr*, the U.S. Supreme Court held that the Medical Device Amendments of 1976 did not preempt Florida common law allowing the injured plaintiff to maintain an action for negligent design of her pacemaker.[56]

> First, because the States are independent sovereigns in our federal system, we have long presumed that Congress does not cavalierly pre-empt state-law causes of action. In all pre-emption cases, and particularly in those in which Congress has "legislated . . . in a field which the States have traditionally occupied," we "start with the assumption that the historic police powers of the States were not to be superseded by the Federal Act unless that was the clear and manifest purpose of Congress." Although dissenting Justices have argued that this assumption should apply only to the question whether Congress intended any pre-emption at all, as opposed to questions concerning the *scope* of its intended invalidation of state law, we used a "presumption against the pre-emption of state police power regulations" to support a narrow interpretation of such an express command in *Cipollone*. That approach is consistent with both federalism concerns and the historic primacy of state regulation of matters of health and safety.[57]

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53. Jacobsen v. Commonwealth of Mass., 197 U.S. 11 (1905).

54. Many of the state unfair and deceptive practices mirror the FTC Act and hence are called "Little FTC Acts." Some state statutes differ in their coverage of unfair and deceptive acts and practices. Some states cover only consumer transactions while others also include business practices including disclosure and other misconduct by franchisors. *See, e.g.*, Bethany L. Appleby, Robert S. Burstein & John M. Doroghazi, *Cause of Action Alchemy: Little FTC Act Claims Based on Alleged Disclosure Violations*, 36 Franchise L.J. 429 (2010); Altresha Q. Burchett-Williams, Robert M. Einhorn & Paula J. Morency, *Claims Under the "Little FTC Acts" The High Stakes of Risk and Reward*, Am. Bar Ass'n 33rd Annual Forum on Franchising, W-6 (2010); John G. Parker & Angela M. Fifelski, *Claims Under Little FTC Acts*, Am. Bar Ass'n 28th Annual Forum on Franchising, W-4 (2005); Arthur L. Pressman, Ellen R. Lokker & Eric H. Karp, *The Use of State Little FTC Acts in* Franchise *Relationship Litigation*, Int'l Franchise Ass'n, 31st Annual Legal Symposium (1998).

55. Medtronic, Inc. v. Lohr, 518 U.S. 470 (1996); *see also* Rice v. Santa Fe Elevator Corp., 331 U.S. 218 (1947).

56. *Medtronic, Inc.*, 518 U.S. at 485.

57. *Id.* (citations omitted).

Congress nonetheless has enacted federal laws that preempt state law designed to protect the public usually when industry contends that they would otherwise be unduly impaired. Approval of drugs and medications that are marketed nationwide was deemed to require uniformity. In *Geier v. American Honda Motor Co.*, a passenger in a Honda was severely injured despite wearing a shoulder harness that met the National Traffic and Highway Commission's safety standards.[58] She contended that the car was unreasonably dangerous because it could have been manufactured with air bags available at the time. Honda successfully asserted federal preemption of state law claims, because the federal statute "reflects a desire to subject the industry to a single, uniform set of federal safety standards."[59]

Ultimately, this uniformity is a policy decision for Congress: does federal legislation set a minimum level of protection that states may exceed, or a uniform national standard that states may not alter? In the political caldron of the legislative process, many federal statutes wind up setting a floor and allowing states to provide more protection for their citizens. Minimum wages follow this path: federal law sets a floor, but states may adopt higher minimum wages. And Congress seldom thwarts the ability of states to protect their citizens from fraud and chicanery in commercial practices. Thus, the case for preemption will likely have to be significantly stronger than that made in the Preemption Article in order to convince Congress to pass a preemptive national franchise investment law.

3. The Use of Federal Preemption by Regulated Industries to Remove or Weaken State Regulations and Protections

Perhaps the biggest concern with preemption is the use of federal preemption by industry to weaken or remove states' protections for their citizens. As noted above, federal preemption can negate not only state legislation but also state common-law remedies. The public-policy concern was succinctly described in a recent article in the *American Prospect*:

> Federal preemption is a bad thing when it prevents states from protecting their citizens more effectively than federal agencies that sometimes fail to fulfill their statutory responsibilities. Regulatory failure is clearly a problem when federal agencies are run by political appointees who are ideologically opposed to the agencies' missions. But even under leadership of non-ideological technocrats, agencies can become captured by regulated interests.[60]

The Preemption Article suggests franchising should adopt the proposed federal privacy law and preempt state laws in favor of a single federal standard. Since the enactment of the California Consumer Privacy Act, effective in 2020, several big technology companies have been pushing for a weaker

58. Geier v. Am. Honda Motor Co., 529 U.S. 861 (2000).
59. *Id.* at 871.
60. Thomas O. McGarity, *Trumping State Regulators and Juries*, Am. Spectator at 16 (Apr. 14, 2017).

federal statute preempting state laws. *Public Citizen* compiled examples of existing state statutes that could be preempted by a federal privacy law:

> —The California Consumer Protection Act (protects personal data);
>
> —The Illinois Biometric Information Privacy Act (safeguards biometric data);
>
> —The Vermont Data Broker Act (protects consumers from fraudulent data use);
>
> —The Massachusetts Data Security Law (establishes strong security and data breach notification standards);
>
> —Alaska's and Nevada's Genetic Privacy laws (safeguard genetic data);
>
> —Dozens of state laws that specifically protect the privacy of schoolchildren and prevent the commercial use of their educational information; and
>
> —Laws that protect consumers caught up in data breaches, which have been enacted in all fifty states, the District of Columbia, Guam, Puerto Rico and the U.S. Virgin Islands.[61]

The Preemption Article proposes federal preemption with a few benefits for franchisees, but that could substantially hollow out real state regulation of franchise sales. Those state consumer protections designed to protect the public from the bad actors in the marketplace—including franchisors who make false and unsubstantiated financial performance representations and other frauds, or who misstate their experience and the value or quality of their systems, and are undercapitalized—would be rendered unenforceable.

D. *Conclusion: An Alternate Path Forward*

Future changes to franchise laws will likely start with the Commission's review of franchisor and franchisee comments regarding the 2019 FTC Franchise Rule review. Most of the franchisor comments followed the lead of the IFA that, from a franchisor perspective, the FTC Franchise Rule should continue as is, but should let the IFA know if any changes are considered. Other than the author of the Preemption Article, other comments did not raise the issue of federal preemption of state registration and disclosure laws. Franchisees and their counsel recommended strengthening the rule by multiple proposed changes to the FTC Franchise Rule.[62] The franchisee comments did not propose that the FTC adopt a private right of action under the FTC Franchise Rule, due to the multiple decisions that the FTC lacks such authority that will instead require congressional action.

> The franchisee advocates proposed strengthening the FTC Franchise Rule in multiple ways. Some proposed changes to individual disclosures. Others recommended eliminating franchisor disclaimers, noting that the FTC Franchise Rule was intended to provide information to prospective franchisees, not to disclaim

61. *Preemption of State Laws*, *supra* note 7, at 2.

62. Peter Lagarias & Jonathan Solish, *How Should the FTC Franchise Rule Be Restructured, If at All?*, Am. Bar Ass'n 42nd Annual Forum on Franchising, W-9 (Oct. 2019).

liability for franchisors. Perhaps the most fundamental changes emanated from comments regarding the difficulty of reading and comprehending FDDs, often exceeding three hundred pages in length with franchise agreements exceeding fifty single-spaced pages. Several cited not only their own experiences but also academic articles on the difficulty of laymen, even attorneys, understanding FDDs.[63] Rather than a mishmash of ideas, practical ideas were advocated for improvement of FDDs on readability and comprehension.

Here are some of those proposed changes:

1. The addition of a summary statement of key information in the front of the FDD with toggles to the full disclosure on each topic.[64]
2. Use of ever-advancing technology to allow prospects to link between table of content subjects and the full disclosure and then return to the table of contents. In addition, toggling may allow the user to link directly to the actual text of the standard franchise agreement on the same subject.[65]
3. Use of a single standard registry with uniform searching capabilities available not only to franchise examiners but also to prospective franchisees and their legal counsel. Such a uniform database would allow prospects to compare start-up costs and Item 19 financial disclosures of, for example, five different pizza franchisors. Such comparison shopping is impractical today and if available at all through expensive consulting and reports.[66]

A remaining core problem with FDDs today is that they are unreadable and incomprehensible. Even with comprehensible disclosures, imbalances remain that favor repetitive preparation and use of FDDs. This has allowed franchisors to refine how to disguise problems. Disclaimers added to franchise agreements and FDDs often immunize franchisors from liability for misstatements or even fraud. Settlement of lawsuits and arbitration claims by franchisors invariably require that settling franchisees agree to nondisclosure and non-disparagement provisions. From that moment onward the best and clearest source of the true results of being a franchisee are forever silenced.

Far from being hamstrung by registration and disclosure requirements, franchising has in fact flourished under the current dual regulatory system. While franchises are sold with aplomb, the result for many franchisees is not so beneficial. Disclosures are carefully crafted to avoid serious negative issues with particular franchisors. And the franchise agreements, among the most complex agreements in the known world, are not fathomable, and even if understood are not negotiable. For many the result is a perfect storm of

63. *See, e.g.*, Uri Benoliel & Xu (Vivian) Zheng, *Are Disclosures Readable? An Empirical Test*, 70 Ala. L. Rev. 237 (2018).

64. *See* Lagarias & Solish, *supra* note 62, at 25 (citing Eric N. Karp & Ari N. Stern, *A Proposal for a Mandatory Summary Disclosure Document*, 35 Franchise L.J. 541 (2016)).

65. *Id.*, at 25–26.

66. *Id.*

acquiring an unprofitable business with enormous and ongoing costs for which the franchisee has little or no rights and remedies. There is a need for stronger, not weaker, disclosure laws and, not mentioned in the Preemption Article, for franchise relationship laws providing basic rights and remedies for all franchisees. No one should lose all of their rights and assets simply because they signed a franchise agreement at a persuasive franchise salesperson's beckoning.

Franchise Advertising in the Digital Age: Regulators Need to Contemporaneously Address Advancing Advertising Technologies or Step Aside

*Mark J. Burzych**

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The states of California, Maryland, Minnesota, New York, North Dakota, Rhode Island, and Washington all regulate the "advertisement" of franchise sales.[1] Though well intentioned, these regulations are dated and clumsy when applied to regulate advertising in the digital age. Today's franchise marketing may involve "traditional" advertising, such as advertisement in franchise trade publications or in local or regional business publications; but more often, franchisors are utilizing the technologies of the twenty-first century, such as "Google Ads," "Facebook Ads," "re-marketing," or "geo-fencing" or "geo-targeting." As applied to digital advertising, the current state of franchise advertising regulations is archaic and antiquated . . . and frankly inapplicable in most situations. This article will examine the existing state advertising regulations and identify where they fall short in addressing today's digital advertising methods. It will also discuss some of the most frequently used digital advertising methods.

I. State Franchise Advertising Regulations

A. *California*

In California, an *advertisement* is defined as "any written or printed communication or any communication by means of recorded telephone messages or spoken on radio, television, or similar communications media, published

1. California Franchise Investment Law, Cal. Corp. Code § 31003; Indiana Franchise Act, Ind. Code § 23-2-2.5-1; Maryland Franchise Registration and Disclosure Law, Md. Code Ann., Bus. Reg. § 14-201; Minnesota Franchise Act, Minn. Stat. Ann. § 80C.01; New York Franchise Sales Act, N.Y. Gen. Bus. Law § 681; North Dakota Franchise Investment Law, N.D. Cent. Code § 51-19-02; Rhode Island Franchise Investment Act, R.I. Gen. Laws § 19-28.1-3; South Dakota Franchise Investment Act, S.D. Codified Laws § 37-5A5; Washington Franchise Investment Protection Act, Wash. Rev. Code § 19.100.010; Wash. Admin. Code § 460-80-520 (including communications on the Internet and at trade shows).

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in connection with an offer or sale of a franchise."[2] California prohibits a franchisor from publishing any "advertisement offering a franchise subject to the registration requirements of this law unless a true copy of the advertisement has been filed in the office of the commissioner at least three business days prior to the first publication."[3]

California has some exemptions to franchise advertising registration. The national advertising exemption includes the circulation in California of "any bona fide newspaper or other publication of general, regular, and paid circulation which has had more than two-thirds of its circulation outside of this state during the past 12 months" or radio or television program originating outside of California but received in the state.[4] A second exemption in California defines an advertisement as not including a circular or other communication that is published after a franchise registration is in effect and contains only the statements permitted by 10 C.C.R. § 310.156.2. The advertisement may include the name of the franchisor, a brief description of the type of franchise being offered, a brief description of the type of business to be conducted by the franchisee, the total dollar investment for the franchisee, the city and/or state in which the franchises are being offered, and the name and address of the sender of the communication.[5] Finally, California has adopted its own Internet Advertisement Exemption.[6]

> Any communication made in connection with an offer or sale of a franchise posted on a website on the Internet ("Internet advertisement") is exempt from the requirements of the Corporations Code Section 31156 for filing advertisements with the Commissioner provided that the franchisor complies with the following:
>
> (1) The franchisor files with the Commissioner a written notice, executed by an officer or general partner of the franchisor having direct responsibility for the conduct of the franchisor's activities, and verified pursuant to Section 2015.5 of the Code of Civil Procedure, that includes:
>
>> (A) The Uniform Resource Locator ("URL") address or similar address or device identifying the location of any Internet advertisement;
>>
>> (B) A statement that the franchisor, or anyone acting with the franchisor's knowledge, agrees to comply with the California Franchise Investment Law, and Rules thereunder, when posting any Internet advertisement on a website; and
>>
>> (C) The franchisor's name, address, telephone number, and contact person.

2. California Franchise Investment Law, Cal. Corp. Code § 31003.
3. *Id.* § 31156.
4. *Id.* § 31013(c).
5. Cal. Code Regs. tit. 10, § 310.156.2(a). Such an advertisement must contain the following statement in no less than 10-point font: "THESE FRANCHISES HAVE BEEN REGISTERED UNDER THE FRANCHISE INVESTMENT LAW OF THE STATE OF CALIFORNIA. SUCH REGISTRATION DOES NOT CONSTITUTE APPROVAL, RECOMMENDATION OR ENDORSEMENT BY THE COMMISSIONER OF BUSINESS OVERSIGHT NOR A FINDING BY THE COMMISSIONER THAT THE INFORMATON PROVIDED HEREIN IS TRUE, COMPLETE AND NOT MISLEADING."
6. Cal. Code Regs. tit. 10, § 310.156.3.

(2) The Internet advertisement is not directed to any person in the State of California by or on behalf of the franchisor or anyone acting with the franchisor's knowledge. For the purposes of this section, "directed to any person in the State of California," means directed to a specifically named person, or group of persons, and not to the public generally, and includes, but is not limited to, nonpassive forms of communication such as e-mail, instant messages, or other similar modes of communication; and

(3) A preface, exhibit or appendix of the franchisor's offering circular includes the URL address of the franchisor's website, and the following statement, in clear readable type, of not less than 12-point size:

> OUR WEBSITE HAS NOT BEEN REVIEWED OR APPROVED BY THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT. ANY COMPLAINTS CONCERNING THE CONTENT OF THIS WEBSITE MAY BE DIRECTED TO THE CALIFORNIA DEPARTMENT OF BUSINESS OVERSIGHT at www.dbo.ca.gov.[7]

B. *Maryland*

Maryland defines *advertisement* as "any means of communication that is published in connection with an offer to sell or sale of a franchise, and either is written or printed, made by means of a recorded telephone message, or spoken on radio, television, or similar communications media."[8] Franchisors may not publish any advertisement offering to sell a franchise that is subject to registration in Maryland, unless the franchisor submits a copy of the advertisement to the Maryland Securities Commissioner five days before the advertisement is published.[9]

Online offers, or any offers made through a similar electronic delivery system, may be exempt from registration in Maryland.[10] To be exempt, the offer must indicate that the franchise is not being offered to residents of Maryland, and is not otherwise directed to any person in Maryland by or on behalf of the franchisor or anyone acting with the franchisor's knowledge.[11] Further, the advertising franchisor may not *sell* franchises in Maryland until the offering has been registered and declared effective and the franchisor has complied with other applicable provisions of Maryland's Franchise Law.[12]

C. *Minnesota*

Minnesota defines *advertisement* as "any written or printed communication or any communication by recorded telephone message, radio, television, picture or similar means published in connection with a sale of, or offer to sell, any franchise."[13] Franchisors may not

7. *Id.*
8. Md. Code Ann., Bus. Reg. § 14-201.
9. *Id.* at § 14-225; Md. Code Regs. 02.02.08.09.
10. Md. Code Regs. 02.02.08.18.
11. *Id.*
12. *Id.*
13. Minn. Stat. § 80C.01.

> publish or cause to be published . . . any advertisement offering a franchise subject to the registration requirements [of the state] . . . unless a true copy of the advertisement has been filed in the office of the commissioner at least five business days prior to the first publication . . . unless such advertisement has been exempted by rule of the commissioner [of commerce].[14]

If the Commissioner of Commerce does not provide written notice disallowing the advertisement within three days of filing a copy with the Department of Commerce, the advertisement may run.[15]

Although Minnesota has provided its Department of Commerce with the authority to promulgate exemptions to its advertising rules, it has promulgated no rules identifying any exemptions to the advertising registration requirement.[16] Presently, franchisors must comply with Minnesota's advertising registration requirements before doing any advertising for the sale of franchises in the state, regardless of the form or medium of the advertisement.

D. *New York*

New York defines *advertisement* as "any written or printed communication, or any communication by means of recorded telephone messages or spoken on radio, television, or similar communications media, published in connection with an offer or sale of a franchise."[17] Before offering to sell or selling a franchise in New York, franchisors must file an "offering prospectus."[18] Franchisors may not publish any advertisement for the sale of its franchises before the New York Department of Law has accepted and approved its offering prospectus.[19] Additionally, all New York advertisements for franchises must include a disclosure that "no offer of such franchise is made except by [the] offering prospectus."[20] New York's Franchise Law requires franchisors to file with the Department of Law any pamphlet, circular, form letter, advertisement, sales literature, or advertising communication prior to its distribution to prospective franchisees.

Advertisements that are connected to a broader, national advertising campaign do not have to await approval of the offering prospectus before being published or circulated. New York provides that an offer is not being made in the state when:

> (1) a publisher circulates or there is circulated on his behalf in this state a bona fide newspaper or other publication of general, regular and paid circulation

14. *Id.* § 80C.09.
15. Minn. R. 2860.4200.
16. Minn. Stat. § 80C.09.
17. N.Y. Gen. Bus. Law § 681.
18. *Id.* § 683.
19. *Id.*
20. *Id.* § 683(11). All advertisements must also contain "a statement that the filing of an application for registration of an offering prospectus or the acceptance and filing thereof by the department of law as required by this section does not constitute approval of the offering or the sale of such franchise by the department of law or the attorney general of this state." *Id.* § 683(12).

> which has had more than two-thirds of its circulation outside this state during the past twelve months, or a radio or television program originating outside this state is received in this state.[21]

In addition, advertisements of certain mediums that are part of advertising campaigns wherein two-thirds of advertising takes place outside of New York are exempt from its advertising restrictions and requirements.

Finally, New York exempts certain Internet advertisement from its filing requirements.[22] Communications about a franchise offering that a franchisor posts on the Internet do not have to be filed with the New York Department of Law if (1) the franchisor discloses the URL address, or similar address or device, identifying the online location of the advertisement; and (2) the advertisement is not directed to any person in the State of New York.[23] However, the exemption from filing with the state does not exempt the online advertisement from being the subject of antifraud liability under New York's Franchise Law.

E. *North Dakota*

North Dakota defines *advertisement* as "any written or printed communication by means of recorded telephone messages or spoken on radio, television, or similar communications media published in connection with an offer or sale of a franchise."[24] A true copy of all advertisements for the sale of a franchise that is subject to the state's registration requirements must be filed with the office of the Securities Commissioner at least five days before the advertisement's initial publication.[25] The Securities Commissioner may deny publication of an advertisement if he or she finds that the advertisement is misleading.

The North Dakota Securities Commissioner issued an Order Regarding Franchise Advertising on the Internet.[26] In the Order, the Securities Commissioner exempts Internet advertisements from advertising registration requirements if (1) the franchisor discloses to the Securities Commissioner the URL address or similar address or device identifying the location of the Internet advertising (a) on the cover page of a franchise offering circular included with the application for registration that is effective in North Dakota; (b) on the cover page of the offering circular included with an application for exemption from franchise registration; or (c) on the notice filed with the Securities Commissioner; and (2) the Internet advertisement is not directed to any person in North Dakota by or on behalf of the franchisor or anyone acting with the franchisor's knowledge.[27]

21. *Id.* § 683(12)(c).
22. N.Y. Comp. Codes R. & Regs. tit. 13, § 200.12
23. *Id.*
24. N.D. Cent. Code § 51-19-02(1).
25. *Id.* § 51-19-10.
26. Order *re* Exemption of Certain Offers of Franchises Made on the Internet, ND Sec. Comm'r (Nov. 29, 2000).
27. *Id.*

North Dakota provides an exception for national advertising campaigns. North Dakota does not require filing of advertisements that are part of a broader advertising campaign, wherein the publication or circulation of the advertisement in North Dakota represents less than two-thirds of the advertisement's total circulation in the past twelve months.[28] The state only extends this exemption to advertisements in the form of a bona fide newspaper or other publication of general, regular, and paid circulation, or a radio or television program originating outside of North Dakota.[29]

F. *Rhode Island*

Rhode Island defines *advertisement* as "a communication published in connection with an offer or sale of a franchise."[30] Unique among states that regulate franchise advertisements, Rhode Island does not require franchisors to file copies of their advertisements with the state prior to their publication. Instead, the state requires franchisors to maintain the advertising materials for five years.[31] This maintenance requirement is part of a broader mandate that franchisors maintain "a complete and accurate set of books and records of the offers and sales of franchises" for five years.[32] Rhode Island does not exempt any form or medium of advertisement from its maintenance requirement.

G. *Washington*

Washington defines *advertisement* as "any written or printed communication or any communication by means of recorded telephone messages or spoken on radio, television, or similar communication media published in connection with an offer or sale of a franchise."[33] Communications on the Internet and at trade shows are also expressly included in the definition of advertisement.[34] Franchisors must file a true copy of an advertisement with the Office of the Director of Financial Institutions at least seven days before the advertisement's initial publication. The Director of Financial Institutions may then deny publication of the franchisor's advertisement if he or she finds that the advertisement is misleading.

Similar to California's or New York's Internet advertisement exemption, Washington provides an exemption to its general filing requirement for Internet advertisements. Rather than adhere to the general seven-day filing rule, franchisors must only provide the URL address to the online location of the advertisement to the Director of Financial Institutions. Franchisors may provide the URL address either (1) on the cover of the franchise disclosure document that the franchisor includes with its application for

28. N.D. Cent. Code § 51-19-02(14).
29. *Id.*
30. R.I. Gen. Laws § 19-28.1-3(2).
31. *Id.* § 19-28.1-12.
32. *Id.* § 19-28.1-13.
33. Wash Rev. Code § 19.100.010.
34. Wash. Admin. Code § 460-80-520.

registration, or (2) on a notice filed with the state within five business days following the advertisement's publication. Importantly, franchisors may only take advantage of this exemption if the Internet advertising "is not directed to any person in the state of Washington by, or on behalf of, the franchisor or anyone acting with the franchisor's knowledge."[35]

Finally, an Internet offer for the sale a franchise that is not registered with the state, or is not exempt from registration, does not have to be registered if the advertisement meets the following criteria:

1. The internet offer indicates, directly or indirectly, that the franchises are not being offered to residents of Washington;
2. The internet offer is not otherwise specifically directed to any person in Washington; and
3. No franchises are sold in Washington until the offering is registered and declared effective, and the Washington FDD has been delivered to the offeree before the sale.[36]

As technology has advanced, the various state regulations relating to advertising have not evolved at the same pace. As described in further detail below, popular advertising technology such as Google Ads, retargeting, remarketing, and geo-targeting, or geo-fencing does not squarely fit in the current regulatory scheme.

II. NASAA Internet Advertisement Exemption

In 1998, the North American Securities Administrators Association (NASAA), the association of state franchise regulators, issued the *Statement of Policy Regarding Offers of Franchises on the Internet*. The NASAA Statement makes it clear that franchise sales advertising on a franchisor's website may constitute an "offer" that may trigger state registration requirements. The NASAA Statement suggests a form of exemption for unregistered Internet offers, so long as (1) the website indicates that the franchise is not being offered to residents of the state; (2) the offer is not otherwise directed into the state by or on behalf of the franchisor; and (3) no franchise sales take place until the franchisor has complied with the state's registration and disclosure requirements.[37]

California, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, and Washington have adopted laws, regulations, or administrative orders that exempt offers on the Internet that comply with the NASAA Statement.[38] Generally, these state laws,

35. *Id.* § 460-80-530.
36. *Id.* § 460-80-540.
37. Statement of Policy Regarding Offers of Franchises on the Internet, N. Am. Secs. Admins. Ass'n (May 3, 1998).
38. Cal. Code Regs. tit. 10, § 310.100.3; Ill. Admin. Code tit. 14 § 200.306; Order *re* Exemption for Internet Sales, Ind. Sec. Comm'r, Admin. Order No. 97-0378 (Dec. 24, 1997); Order *re* Offers of Franchises Made on the Internet, Minn. Dep't Com. (Dec. 4, 2002); Md. Code

regulations, and orders exempt Internet advertising of franchise sales that meet the requirements of the NASAA Statement.

In Indiana, the Securities Commissioner issued an Administrative Order in 1997 that exempts Internet offers for franchises from registration if the offer indicates, directly or indirectly, that such franchises will not be sold to persons in Indiana; an offer is not otherwise specifically directed to any person in Indiana by, or on behalf of, the franchisor; and no sales of such franchises are made in Indiana as a result of the offer.[39] In addition, California, Minnesota, and New York have established additional criteria to meet the exemption. As stated earlier, in California, franchisors must complete and sign the annual notice governing franchise sales information on the franchisor's website and the franchisor's disclosure document must contain an exhibit (usually found in the state specific addendum for California) that must include the URL address of the franchisor's website and the following statement in at least twelve-point font: "OUR WEBSITE HAS NOT BEEN REVIEWED OR APPROVED BY THE CALIFORNIA DEPARTMENT OF CORPORATIONS, ANY COMPLAINTS CONCERNING THE CONTENT OF THIS WEBSITE MAY BE DIRECTED TO THE CALIFORNIA DEPARTMENT OF CORPORATIONS AT www.corp.ca.gov."[40] In Minnesota, New York, and Washington, the franchisor must disclose on the cover page of the franchise disclosure document the URL address identifying the location of the franchise sales advertisement on the franchisor's website.[41]

III. Types of Digital Advertising

Although scores or hundreds of different types of digital advertising are available to franchisors to advertise the sale of franchises, this article will focus on a limited universe of Google Ads, re-marketing, Facebook Ads, and geo-fencing or geo-targeting.

Regs. 02.02.02.18; N.Y. Comp. Codes R. & Regs. tit. 13 § 200.12; Order *re* Exemption of Certain Offers of Franchises Made on the Internet, N.D. Sec. Comm'r (Nov. 29, 2000); 230 R.I. Code R. § 19-28.1-6.10; Order *re* Internet Offers and Sales, S.D. Div. of Sec. (Oct. 16, 2000); Wash. Admin. Code § 460-80-540.

39. Order *re* Exemption for Internet Sales, Ind. Sec. Comm'r, Admin. Order No. 97-0378 (Dec. 24, 1997).

40. Cal. Code Regs. tit. 10, § 310.156.3.

41. Order *re* Offers of Franchises Made on the Internet, Minn. Dep't Com. (Dec. 4, 2002); N.Y. Comp. Codes Regs. tit. 13 § 200.12; Wash. Admin. Code § 460-80-530. This may require that, in addition to the FTC Franchise Rule requirement that the primary Internet home page address be disclosed, additional URL addresses may be necessary to disclose the specific franchise sales advertising pages of the website.

A. *Google Ads*

Google offers Google Ads (formerly Google AdWords) as a marketing service.[42] Google Ads appear at the top of Google's search engine results page (SERP). Google Ads are not to be confused with Display Ads, also provided by Google, which appear on webpages in the Google Display Network (GPN).[43]

Google Ads are displayed to Internet users based on a combination of keywords, bidding, and the advertiser's "Quality Score."[44] When advertisers sign up for Google Ads, they choose a list of keywords that are relevant to their products or services and that the advertisers believe that Internet users will be most likely to search when looking for their products. Once advertisers identify keywords, they decide how much they are willing to pay each time a person clicks on their Google Ad.[45] Next, Google determines an advertiser's Quality Score each time an individual query (a specific search by an Internet user) triggers keywords being used by multiple advertisers. An advertiser's Quality Score is based on the following factors:

- The relevance of the advertiser's ad to the particular search query
- The relevance of the Google keywords to the advertiser's "ad group"[46]
- The relevance of the advertiser's ad to its "landing page"[47]
- The historical click-through rate of the ad and its ad group[48]

Whenever a query triggers keywords that multiple advertisers have bid on, an auction takes place. Advertisers with the highest Quality Score and bid amount will win the auction, and their advertisement will appear on the SERP, to the exclusion of others who lost the auction.

For example, a hamburger franchisor could purchase Google Ads relating to any search query for "hamburger franchises." If a consumer searches for "hamburger franchises" on Google, the hamburger franchisor ad is displayed at the top of the search results. If the consumer clicks on that search result, the consumer could be directed to the hamburger franchisor website related to franchise sales.

42. *Google Ads: What Are Google Ads & How Do They Work?*, WordStream, https://www.wordstream.com/google-ads (last visited Dec. 6, 2019).

43. GPN is made up of a collection of third-party websites that have partnered with Google and serve Google Ads. Retargeting advertisements are delivered through GPN. *Id.*

44. *What Is Google AdWords? How the Google Ads Auction Works*, WordStream, https://www.wordstream.com/articles/what-is-google-adwords (last visited Dec. 6, 2019).

45. *Id.* This is referred to as cost-per-click (CPC).

46. An "ad group" is an advertiser's portfolio of keywords, text ads (what the ad will say when it runs), and landing pages (where the Internet user will be taken after they click on the ad). Advertisers will have multiple ad groups, which can vary in content based on the advertiser's goals. *Ad Groups: How to Crete More Effective Ad Groups for PPC*, WordStream, https://www.wordstream.com/ad-groups (last visited Dec. 6, 2019).

47. *Id.*

48. Clickthrough rate refers to the frequency that Internet users click on a particular Google Ad when it appears on their browser.

Google Ads offers a marketing strategy that attempts to collect data related to any consumer that might be interested in purchasing a franchise in the franchisor's industry. Since the consumer is directed to the franchisor's website, so long as the franchisor's website complies with the applicable NASAA Internet exemption guidelines discussed above and the California-specific Internet Advertising exemption, there is no additional franchise advertising regulatory approval needed for a franchisor to use Google Ads in its advertising strategy for franchise sales.

B. *Retargeting or Remarketing*

Retargeting or remarketing provides a new and efficient method for converting online consumers. Industry actors define retargeting as "the tactic of serving targeted ads to people who have already visited or taken action on a website."[49] When a person visits a website, a retargeting platform will place a cookie in the visitor's Internet browser. This cookie records which pages the person visited on the initial website and relays the information to whichever retargeting platform the website is using.[50] Once the information is relayed, the retargeting platform will begin delivering advertisements to the visitor based on their previous activity on the initial website.

Retargeting is a popular marketing method among businesses with an online presence because of its efficiency. Retargeting only markets to Internet users who have previously displayed interest in the products or services offered on the website.[51] Retargeting platforms can only place cookies on users' browsers who have sought out the website on their own. Moreover, the user will be served with advertisements relating to the specific pages that the user actually visited while on the initial website. For example, if a person leaves the website of a retail seller of athletic equipment after clicking on a pair of shoes, the cookie placed in that person's browser will notify the website's retargeting platform exactly which pair of shoes the visitor was contemplating purchasing. After leaving the site, the visitor will likely find an advertisement for that specific pair of shoes on the side of their Internet browser.

In the franchise sales context, a person may visit the franchisor's franchise Internet site, clearly indicating that the consumer may be interested in purchasing a franchise. So long as the franchisor's franchise sales web page complies with the NASAA Internet advertising exemption, the initial inquiry by the consumer to the franchisor's franchise sales webpage is not an advertisement that requires registration in any of the franchise advertising states. If the franchisor uses this re-targeting technology to re-engage the consumer

49. *Remarketing*, Dynamic Yield, https://www.dynamicyield.com/glossary/remarketing/#:~:targetText=Remarketing%20(also%20known%20as%20retargeting,cookie%20in%20the%20user's%20browser (last visited Sept. 21, 2020).

50. Dan Hecht, *A Beginner's Guide to Retargeting Ads*, HubSpot, https://blog.hubspot.com/marketing/retargeting-campaigns-beginner-guide (last updated Aug. 9, 2017).

51. *A Brief Introduction to Retargeting*, ReTargeter, https://retargeter.com/blog/a-brief-introduction/ (last visited Dec. 6, 2019).

who visited the website, and so long as the franchisor's re-targeting campaign only attempts to redirect the consumer back to the franchisor's compliant franchise sales webpage, the franchisor is engaging in no new advertising that would trigger additional state regulatory involvement. However, if the franchisor's re-targeting campaign uses an advertisement that is not is not a re-direction link back to the franchisor's franchise sales webpage (that already complies with the Internet advertising regulations), but rather another advertisement for the sale of the franchise, the franchise advertising regulation of the various states may apply. Though it could be argued that as long as the new advertisement was not directed disproportionately to one or more states (i.e., more than two-thirds of the circulation directed outside of the relevant state) the new advertisement is part of a national advertising campaign exempt from the registration requirements of California, Maryland, New York, and Washington,[52] regulators may argue that these new advertisements are "directed to a person" in the state. It is probably difficult to argue that this new advertisement is not "directed to a person" in California, Maryland, New York, or Washington. The franchisor in this case should either only re-target a customer using the link back to the franchisor's compliant franchise sales webpage or register the new advertisement in the applicable states in which the franchisor's re-targeting campaign is directed.

C. *Facebook Ads*

Another option for companies seeking efficient methods of marketing their products or services online is Facebook Ads.[53] Facebook Ads can be created by businesses on Facebook and target Facebook audiences based on user activity, demographic and profile information, device-use information, and even activity off Facebook.[54] Ads can also target Facebook users based on their interests, things they have liked, which Facebook groups they are part of, and their geographic location. For example, advertisers can narrow their target audience to people living in California between the ages of thirty and fifty and who liked a competitive hamburger franchise system. Based on the targeting criteria, Facebook will provide an estimated number of people the ad will reach.[55] The Ads will appear directly on a newsfeed of a Facebook user who falls within the target audience criteria.

52. California Franchise Investment Law, Cal. Corp. Code § 31013; Cal. Code Regs. tit. 10, § 310.013; Maryland Franchise Registration and Disclosure Law, Md. Code Ann., Bus. Reg. §14-203; New York Franchise Sales Act, N.Y. Gen. Bus. Law § 681; Washington Franchise Investment Protection Act, Wash. Rev. Code § 19.100.020.

53. Fred Perotta, *A Deep Dive into Facebook Advertising*, NeilPatel, https://neilpatel.com/blog/deep-dive-facebookadvertising/#:~:targetText=Facebook%20ads%20are%20targeted%20to,%2C%20demographic%2C%20and%20profile%20information.&targetText=After%20creating%20an%20ad%2C%20you,the%20sidebar%20on%20 Facebook.com. (last visited Dec. 6, 2019).

54. *Id.*

55. Christina Newberry, *How to Advertise on Facebook in 2020: The Definitive Facebook Ads Guide*, Hootsuite (Oct. 2, 2019), https://blog.hootsuite.com/how-to-advertise-on-facebook/#howto.

In addition to manually customizing the audience the advertiser wants to reach, advertising may use Facebook's Advanced Automatic Matching (AAM) service.[56] AAM will link Facebook user information with information that the user has inputted on the advertiser's website by using a pixel, akin to a cookie. For example, if a Facebook user has created an account with Dick's, and has therefore given Dick's their email address, which is the same email address associated with the user's Facebook account, AAM will track this activity and display a Dick's advertisement on that user's newsfeed. AAM therefore provides a service very similar to retargeting services, discussed above.

A hamburger franchisor can use Facebook to target any person who liked a competitor hamburger franchise in any geographic location in the nation. Although that may not be the best franchisee prospect and may be a better marketing expenditure to drive traffic to the local franchisee in certain areas, the hamburger franchisor could use this technology to market/advertise the sale of franchises. The hamburger franchisor may argue that the franchise advertising using this type of Facebook ad is nothing different than a national advertising campaign, using the same advertising piece to market the sale of franchises throughout the nation, albeit to a narrower group of consumers (i.e., those consumers that liked a Facebook group of the hamburger franchisor's competitor). This type of advertising is functionally no different than advertising in a print edition of a hamburger industry specific periodical, or a franchise industry periodical, both of which would clearly be considered a "national advertisement" under the regulations of California, New York, or North Dakota. And, so long as the advertisement complies with the Internet exemptions of the states of Maryland and Washington,[57] the Facebook ad is exempt from these states' advertisement regulations.

But Facebook has much more powerful technological capabilities, most of which may implicate the advertising regulations of some states. For example, if the hamburger franchisor wanted to sell franchises in California, Maryland, and Washington, the franchisor can use Facebook to target these geographic locations with other search tools to specifically target potential franchisees in these markets. At this point, it is difficult to argue that these targeted advertisements are not offered to residents of the state, or not directed to a person in the state. These targeted advertisement campaigns are also not part of a more widespread advertising campaign that could be argued to be a "national advertising campaign." With regards to these much more technologically targeted franchise sales advertising campaigns, the advertisement would require registration in at least the states of California, Maryland, Minnesota, New York, North Dakota, and Washington.

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56. Gary Henderson, *Take Advantage of Facebook Advanced Automatic Matching*, Digital Marketing.org (Dec. 11, 2018), https://www.digitalmarketing.org/blog/facebook-advanced-automatic-matching?ref=DigitalMarketing.org.

57. The ad specifically states that the franchise is not being offered to residents: the ad is not directed to any person in the state; and any franchise sale is completed only pursuant to a validly registered offering circular. *See* sources cited *supra* notes 11 and 36.

D. *Geo-targeting and Geo-fencing*

Advertisers can maximize their return on investment (ROI) and click conversions on online ads through geo-targeting and geo-fencing. Geo-targeting is simply customizing an ad campaign to reach audiences (through their computers or mobile devices) who are physically located in a particular geographic area. Both Google Ads and Facebook Ads offer advertisers the option to limit a particular campaign to a geographic area, such as the United States or Michigan. If advertisers want to get even more geographically specific with their ad audiences, they can pursue a geo-fencing strategy.

Geo-fencing allows advertisers to create a virtual box around a geographic location, wherein their ads will appear only on computers or mobile devices that are physically located in the box.[58] Using GPS or Internet users' IP addresses, advertisers can reach out only to specific users who enter a geographic area relevant to the advertiser's business. For example, a retail establishment in a shopping mall may draw a several-block radius around the mall to specifically target Internet users who may either be out in the vicinity of the mall, or are already shopping inside. Alternatively, a local pizzeria (say one of two in town) can draw a geo-fence around not only its own location, but also around the location of its competitor, specifically targeting people in the vicinity of its competitor with advertisements showing its comparatively lower prices or current promotional deals.

Many companies take advantage of geo-fencing when customers download their mobile app and opt-in to the app's "location services."[59] By allowing GPS to track where the device is located, advertisers can send push notifications, text messages, or PPC (pay-per-click) ads to the device.[60] However, geo-fencing is available to companies that do not have a mobile app to track customers' movements, and any business with access to Google or Facebook can set up a geo-fencing marketing campaign.[61]

Advertisers can set up geo-fencing campaigns through either Google or Facebook relatively easily.[62] Google Ads users can manually enter a specific location to target their ad campaigns, rather than selecting an entire state or country. Alternatively, advertisers may choose to target a radius of miles around a specific location, allowing the advertisers to maximize the specificity of their targeted audience.

Facebook users have an identical option. When customizing their Facebook ad campaign, advertisers can target their ads to a specified location, such as a particular state or country. If the advertiser wants to be even more

58. Seth Winterer, *What Is Geofencing Marketing*, Digital Logic, https://www.digitallogic.co/blog/geofencing-geotargeting-advertising-online-marketing (last visited Jan. 24, 2020).

59. Lauryn Preston, *How Does Geofencing Work?*, Digital Logic, https://www.digitallogic.co/blog/how-does-geofencing-work (last visited Jan. 24, 2020).

60. *Id.*

61. *Id.*

62. Ryan Stemkoski, *How to Geofence Advertising with Google*, *Facebook*, *Instagram and Snapchat*, Zipline Interactive, https://ziplineinteractive.com/blog/how-to-geofence-advertising-with-google-facebook-instagram-and-snapchat (last visited Jan. 24, 2020).

specific, Facebook provides an interactive map that allows the advertiser to drop a "pin" on a central location and determine a radius of miles surrounding the pin where the ad campaign will be targeted. Although the minimum radius an advertiser can draw is one mile, advertisers can be even more specific by excluding certain geographic areas captured by the radius.

In the franchise sales context, a franchisor may geo-fence a franchise sales conference and push a franchise sales advertisement to all mobile phones in attendance. So long as the franchise sales conference is not within one of the states that regulates franchise sales advertising, no advertising registration will be necessary. However, if the franchise sales conference is within a state that regulates franchise sales advertising, registration of the push advertising is necessary.

IV. Conclusion

The franchise sales advertising regulations were created in response to "traditional" advertising strategies such as print, radio, television, or direct mail. The Internet advertising exemptions contemplate that a franchisor will advertise the sale of its franchises only on its own website. Digital advertising has changed and continues to evolve. The franchise sales advertising regulations have not. States interested in regulating franchise sales advertising should carefully consider what types of digital advertising should be registered. Setting advertising parameters with Google or Facebook that advertises the sale of franchises to a certain demographic should not cause a regulator any concern, so long as the advertisement is identical and it is not targeted such that more than two-thirds of the advertisements are outside of the targeted state. However, once the advertisement becomes targeted to only prospects in a certain state (such as California, Maryland, or Washington, for example), then registration of that digital advertisement should be required. Using the current regulations to attempt to regulate conduct that could not be imagined at the time the advertising regulations were promulgated is unacceptable. The states' inaction leaves the franchise industry to guess what technologically fits within the aged definitions. Since advertising is rarely done by way of print newspaper ads, it is time for the regulatory agencies to update their franchise sales advertising regulations to address the current technologies.

The Anatomy of Lost-Profits Claims in Franchise Cases

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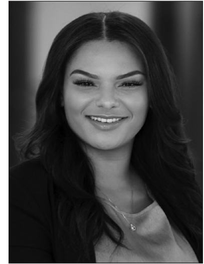
Ms. Lockridge

I. Introduction

Claims seeking the recovery of lost profits are becoming increasingly more common in franchise litigation, particularly after franchise termination. Because both the franchisor and the franchisee enter into the relationship with the expectation of profit, a termination frustrates both sides' expectations and the economic rationale for entering the relationship in the first place. Although historically franchisees were more likely to assert these claims in reaction to terminations, more recently franchisors have also pursued such claims when franchisees leave the relationship before the end of the contract term. This article provides a brief history of the law governing claims for lost profits, outlines selected issues facing litigants under the current law, and concludes by offering some opinions about best practices for litigants relating to lost profits, particularly in the franchise context.

II. Overview of the Development of Lost-Profits Claims

In the early to mid-nineteenth century, American courts were reluctant to award monetary damages in general, especially lost profit. The reluctance to award lost profits stemmed from the inherent uncertainties in the

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underlying business venture and the desire to apply an objective formula to every damage calculation.[1]

Then, in 1845, the New York High Court announced that lost profits were available in breach of contract cases.[2] In *Masterton v. Brooklyn*, the court rejected an award of lost profits, but not because of a general rule prohibiting their recovery, but instead because the parties did not contemplate them at the time of contract formation.[3] The Chief Justice noted that the rule against the recovery of lost profits did not apply when the damages sought were "the direct and immediate fruits of the contract . . . between the parties."[4]

Throughout the next decade, other courts began to follow *Masterton* and allow plaintiffs to recover lost profits as direct damages in contract cases.[5] For example, in 1854, the English Court of Exchequer decided the famous case of *Hadley v. Baxendale*.[6] In *Hadley*, the court held that consequential damages were recoverable only if, at the time the parties formed the contract, the breaching party had reason to foresee that consequential damages would be the probable result of the breach.[7]

Just a few years later, in *Griffin v. Colver*, the New York Court of Appeals set the tone for the more modern rule of lost profits damages, stating:

> It is a well-established rule of the common law that the damages to be recovered for a breach of contract must be shown with certainty, and not left to speculation or conjecture; and it is under this rule that profits are excluded from the estimate of damages in such cases, and not because there is anything in their nature which should per se prevent their allowance. Profits which would certainly have been realized but for the defendant's default are recoverable; those which are speculative or contingent are not.[8]

Griffin thus concluded that lost profits are recoverable in contract cases, but only if the aggrieved party proved them with certainty. *Griffin* quickly became the "leading American case on recovery of lost profits."[9]

Since *Griffin*, it has been relatively clear that lost profits are available where the parties' contract clearly anticipated them and the party seeking them could prove the amount with relative certainty. Lost-profit damages

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1. Robert M. Lloyd & Nicholas J. Chase, *Recovery of Damages for Lost Profits: The Historical Development*, 18 U. Pa. J. Bus. L. 315 (2016).
2. Masterton v. Brooklyn, 7 Hill 61 (N.Y. 1845).
3. *Id.*
4. *Id.* at 69.
5. *See, e.g.*, Chi. & Rock Island R.R. Co. v. Ward, 16 Ill. 522, 530–31 (1855) (finding that farmer could recover lost profits where railroad breached covenant to maintain fence); Bridges v. Stickney, 38 Me. 361, 368 (1854) (allowing recovery of direct damages but not consequential damages); Simmons v. Brown, 5 R.I. 299, 302–03 (1858) (relying on *Masterton* to allow a mill owner to recover lost profits where defendant's damn reduced water flow at the mill); Hoy v. Gronoble, 34 Pa. 9, 10–11 (1859) (enabling sharecropper to recover profits lost when landowner breached oral contract); Hinckley v. Beckwith, 13 Wis. 31, 35 (1860) (holding that the lost profits of sawmill were recoverable).
6. Hadley v. Baxendale, 156 Eng. Rep. 145 (Ex. Ch. 1854).
7. *Id.* at 151.
8. Griffin v. Colver, 16 N.Y. 489, 491 (1858).
9. Lloyd & Chase, *supra* note 1.

are now available in a variety of civil contexts—tort actions (both personal and business), breach of contract actions, antitrust suits, and claims for trademark and patent infringement.[10] Nonetheless, courts continue to face the often difficult questions of how to assess whether the parties contemplated lost-profit damages, whether a party actually suffered them, and if so, how to measure those lost profits.[11] The remainder of this article will focus on the following common issues confronting franchise litigants when determining if lost profits damages are available, and if so, in what amount:

> (1) how a franchisee can prove lost profits, including the types and amounts of evidence necessary, and how a franchisor can challenge the factual basis of a claim for lost profits;
>
> (2) how new franchised businesses can prove lost profits without an available history of past profits;
>
> (3) the role of experts; and
>
> (4) whether a franchisor can contractually disclaim lost profit damages.

III. Quality and Quantum of Proof Required to Establish Lost Profit Damages

Perhaps the most important consideration in any lost-profits case is how much and what type of evidence a party needs to prove the alleged lost profits. To understand the necessary quantum of evidence, it is helpful first to understand the definition of *lost-profits damages*. Typically, *lost-profits damages* refer to the loss of net profits, rather than gross profits or revenue.[12] "Lost profits are damages for the loss of net income to a business and, broadly speaking, reflect income from lost business activity, less expenses that would have been attributable to that activity."[13] However, courts may award gross profits when operating expenses are fixed.[14]

After calculating net lost profits, the plaintiff (typically, but not always, the franchisee) must show

> (1) that the conduct upon which the claim is based caused the lost profit damages; (2) that the parties contemplated the possibility of lost profit damages or that the lost profit damages were a foreseeable consequence of the conduct; and (3) that the lost profit damages are capable of proof with reasonable certainty.[15]

These three elements of the claim are commonly known as proximate cause, foreseeability, and reasonable certainty.[16]

10. Erwin v. Mendenhall, 433 P.3d 1090, 1095 (Alaska 2018).

11. Todd R. Smyth, *Recovery of Anticipated Lost Profits of New Business: Post-1965 cases*, 55 A.L.R.4th 507 (1987).

12. Hunter Bldgs. & Mfg., LP v. MBI Glob., LLC, 436 S.W.3d 9, 18 (Tex. App. 2014).

13. *Id.*; Ginn v. Stonecreek Dental Care, 30 N.E.3d 1034, 1043 (Ohio Ct. App. 2015).

14. 22 Am. Jur. 2d *Damages* § 57 (2019).

15. Jonathan Dunitz & Nancy Fannon, The Comprehensive Guide to Economic Damages (5th ed, 2018); Bona Fide Conglomerate, Inc. v. SourceAmerica, 2017 U.S. Dist. LEXIS 116329, at *13 (S.D. Cal. July 24, 2017).

16. Dunitz & Fannon, *supra* note 15.

A. *Causation*

Except where the defendant does not dispute liability, this first element of a claim for lost profits (proximate cause) typically requires an in-depth analysis of both the applicable law and the facts. The parties will likely dispute both what actually happened and the effect of the defendant's alleged actions. To resolve these conflicts, the showing of causation requires "comparison between the breach and non-breach worlds."[17] Specifically, the plaintiff must show, by a preponderance of the evidence, that the plaintiff's alleged loss was the proximate result of the breach, the so-called "but-for test" (i.e., but for the breaching conduct, the plaintiff would have earned profit). A "proximate" cause is a cause that (1) produces a result in a natural and continuous sequence and (2) without which the result would not have occurred.[18]

For example, in *National Controls Corp. v. National Semiconductor Corp.*,[19] the Third Circuit considered in detail the type and quantum of evidence needed to demonstrate proximate causation for purposes of lost-profits damages. The Third Circuit described the required proof as follows:

> The damages sought must be "a proximate consequence of the breach, not merely remote or possible . . . . The element of causation defines the range of socially and economically desirable recovery and requires not only 'but-for' causation in fact but also that the conduct be a substantial factor in bringing about the harm." Where the losses cannot be allocated between those caused by the defendant's breach and those not, an entire claim may be rejected. [Plaintiff] thus had to prove that any lost profits were proximately caused by [defendant's] breach, and not through some other cause. In essence, the proximate causation requirement demands that the plaintiff prove that the defendant's breach was a substantial factor in causing some harm.[20]

Notably, although causation is a required element in lost-profit cases, some courts only require the plaintiff to prove that the defendant was a cause of the lost-profit damages, rather than the sole cause. In *HSS Enterprises, LLC v. Amco Ins. Co.*, for example, the court stated that, in terms of proving causation for lost profit damages, Washington law does not mandate a "direct result" test or require that certain of defendants' acts of bad faith caused a certain specific amount of monetary damages.[21] Such an approach, the court concluded, would not comport with the long-held view that a defendant should not profit from the difficulty in proving exact damages, particularly if his breach contributes to that difficulty.[22] The court held that, to survive summary judgment, the insured must simply establish a genuine

17. Nycal Offshore Dev. Corp. v. United States, 743 F.3d 837, 843 (Fed. Cir. 2014) (citations omitted).

18. Racicky v. Farmland Indus., Inc., 328 F.3d 389, 396 (8th Cir. 2003).

19. Nat'l Controls Corp. v. Nat'l Semiconductor Corp., 833 F.2d 491, 496 (3d Cir. 1987).

20. *Id.* at 496.

21. HSS Enters., LLC v. Amco Ins. Co., 2008 WL 1787127, at *13 (W.D. Wash. Apr. 16, 2008).

22. *Id.*; Milgard Tempering, Inc. v. Selas Corp., 902 F.2d 703, 710 (9th Cir. 1990); Butcher v. Garrett-Enumclaw Co., 20 Wash. App. 361, 374, 581 P.2d 1352, 1361 (1978).

issue of material fact concerning whether the insurer's conduct was one of the causes of its lost profits.[23]

A common causation issue that arises in the franchise context is whether a franchisor can claim future lost royalties after it has terminated a franchisee for failing to timely pay royalties. In 1996, the California Court of Appeal first confronted this issue in *Postal Instant Press, Inc. v. Sealy*.[24] In *Sealy*, franchisor Postal Instant Press, Inc. (PIP) entered into a twenty-year franchise agreement with the Sealys whereby PIP would provide its trademark and certain services to the Sealys in exchange for royalty and advertising fees.[25] When the Sealys failed to make timely royalty and advertising payments, PIP terminated the franchise agreement and sued the Sealys for unpaid past royalties and future royalties remaining under the franchise agreement.[26] After a bench trial, the trial court awarded damages for lost royalties, including lost future royalties.[27] The Court of Appeal reversed the judgment, finding that the Sealys' breach in failing to pay *past* royalties was not a "proximate" or "natural and direct" cause of PIP's loss of future royalties.[28] Instead, it was the franchisor's own decision to terminate the franchise agreement that deprived it of lost future royalties.[29]

While some courts have followed *Sealy* and have taken a similar pro-franchisee approach to the issue of future lost royalties,[30] other courts have taken a pro-franchisor approach. In *Legacy Academy, Inc. v. JLK, Inc.*, for example, Legacy Academy, a franchisor of childcare centers, sued one of its franchisees, JLK, Inc., alleging breach of contract.[31] Similar to *Sealy*, the franchisee defaulted, which allowed the franchisor to terminate the agreement.[32] However, unlike *Sealy*, the Georgia Court of Appeal held that the franchisor was entitled to lost future royalties because the franchisor would have received the royalties had the franchisee not defaulted and therefore prompted the termination.[33] Thus, that the franchisor terminated the contract was not a *per se* bar on recovering future royalties.[34]

23. *HSS Enterprises*, 2008 WL 1787127, at *13; *see, e.g.*, Alpine Indus., Inc. v. Gohl, 30 Wash. App. 750, 755 (1981) ("If the plaintiff proves that the defendant's fault was a cause of lost profits, the plaintiff is not required to prove the entire loss was due to the defendant's fault.").

24. Postal Instant Press, Inc. v. Sealy, 43 Cal. App. 4th 1704, 1706 (1996).

25. *Id.* at 1706–07.

26. *Id.* at 1707–08.

27. *Id.* at 1708.

28. *Id.* at 1713.

29. *Id.* at 1711. The Court went on to note that even if the Sealys' breach caused PIP to lose future royalties, the award was inappropriate because it would result in damages that were unreasonable, oppressive, and unconscionable. *Id.* at 1713–17.

30. *See, e.g.*, Burger King Corp. v. Hinton, Inc., 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002); Kissinger, Inc. v. Singh, 304 F. Supp. 2d 944, 950–51 (W.D. Mich. 2003); I Can't Believe It's Yogurt v. Gunn, 1997 WL 599391 (D. Colo. Apr. 15, 1997).

31. Legacy Acad., Inc. v. JLK, Inc., 765 S.E.2d 472, 473 (Ga. Ct. App. 2014).

32. *Id.* at 476.

33. *Id.* However, the court went on to find that the franchisor failed to prove lost future royalties with reasonable certainty. *Id.* at 478.

34. *See, e.g.*, Leisure Sys., Inc. v. Roundup, 2013 WL 12178132, at *5 (S.D. Ohio Jan. 23, 2013); Radisson Hotels Int'l, Inc. v. Majestic Towers, Inc., 488 F. Supp. 2d 953, 963 (C.D. Cal.

In sum, based on differences in the causation standard across jurisdictions, it is important to understand the controlling law in the jurisdiction when determining whether sufficient causation exists to establish lost-profits damages.[35]

B. *Foreseeability*

The second element of a lost-profits claim is foreseeability, which is essentially a determination if the parties contemplated such damages or should have reasonably foreseen that they would arise.[36] In the franchise context, the parties' relationship is typically governed by a contract, usually with a specific term. The language in the franchise contract usually determines whether lost profits were foreseeable.

1. The Parties' Contemplation

Determining whether contracting parties contemplated lost-profits damages typically involves two questions. First, does the contract allow lost profits at all? In a well-drafted contract, this first issue may be determinative, and the contract may expressly exclude any possibility of lost profits (see discussion in Section V regarding disclaimers of lost profits). Where a contract is not clear, however, this issue can be problematic.

Absent controlling contractual terms, lost profits are legally foreseeable if, at the time of contracting, (1) the loss was natural and inevitable upon the breach so that the defaulting party may be presumed from all the circumstances to have foreseen it; or (2) if the breach resulted in lost profits because of a special circumstance, a circumstance that must have been known to the defaulting party at the time of the contracting.[37] Importantly, the rule requires only a reasonable reason to foresee, not actual foresight.[38]

To meet this standard, courts require significant contractual evidence of the reasonable contemplation of lost profits.[39] Nonetheless, that does not mean the contract must expressly state that lost profits are available. In *Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, for example, the Fourth Circuit found that the district court erred in rejecting a claim for lost profits based solely on whether the terms of the franchise and trademark agreement

2007); Progressive Child Care Sys., Inc. v. Kids 'R' Kids Int'l, Inc., 2008 WL 4831339, at *5 (Tex. Civ. App. Nov. 6, 2008).

35. HSS Enters., LLC v. Amco Ins. Co., 2008 WL 1787127, at *13 (W.D. Wash. Apr. 16, 2008).

36. *Id.*

37. Precision Pine & Timber, Inc. v. United States, 63 Fed. Cl. 122, 130 (2004); Restatement (Second) of Contracts § 351(2).

38. *Precision Pine & Timber*, 63 Fed. Cl. at 130; *see* Am. Sav. Bank, F.A. v. United States, 98 Fed. Cl. 291, 298 (2011) ("[W]hat is required is merely that the injury actually suffered must be one of a kind that the defendant had reason to foresee and of an amount that is not beyond the bounds of reasonable prediction.") (citation omitted); Franconia Assocs. v. United States, 61 Fed. Cl. 718, 751 (2004) (plaintiff need not show that a particular type of breach is foreseeable, but must prove that both the general magnitude and type of damages were foreseeable).

39. Ashland Mgmt. Inc. v. Janien, 82 N.Y.2d 395, 405 (1993).

explicitly provided for such prospective damages.[40] The court held that "[d]emanding such express evidence of contemplation requires more than proof that lost profits were 'reasonably supposed to have been' within the parties contemplation, and instead requires absolute certainty that the parties considered such terms by including them in their written agreement."[41] Reversing, the Fourth Circuit instead held that although the absence of an express lost-profits provision in the contract is one factor that the court may consider in determining whether the parties reasonably contemplated future damages, it is not the *only* evidence relevant to the determination.[42] In fact, the court found that several relevant factors supported that the parties contemplated future lost profits—including the contract's fifteen-year term and the grant of an exclusive territorial right.[43] The court also found that the entire purpose of the contract was to establish a binding agreement whereby the defendant paid the plaintiff royalties and advertising-fund contributions in exchange for being permitted to operate under its names and marks.[44]

Indeed, courts may even reject the need to perform an express "foreseeability" analysis at all if the parties' contract is amenable to interpreting lost profits as a "direct" damage, rather than merely a consequential one. For example, in a somewhat uncommon twist, a franchisor was able to obtain lost profits from the franchisee in *Stern Oil Co. v. Brown* without proving the damages were "foreseeable" to the franchisee.[45] In that case, the franchisee (Brown) stopped purchasing ExxonMobil-branded motor fuel from the franchisor (Stern Oil) only a year and a half in to a ten-year franchise relationship.[46] Stern Oil sued and sought lost profits damages, and the South Dakota Supreme Court ultimately determined that, because the lost profits damages flowed directly from the motor fuel supply agreements that created the franchise relationship, Stern Oil did not have an obligation to demonstrate foreseeability.[47] The court instead determined that the damages were direct because, by their very nature, they were foreseeable.[48] Specifically, it was foreseeable to Brown that Stern Oil expected to earn a profit from the fuel supplied.[49] The agreement required Brown to use good faith and best efforts to maximize sales and required him to purchase a specified amount of fuel.[50] Because the court ruled that the damages were direct, it held that "direct damages for breach of contract do not have an element of

40. Meineke Car Care Ctrs., Inc. v. RLB Holdings, LLC, 423 F. App'x 274, 287 (4th Cir. 2011).
41. *Id.*
42. *Id.*
43. *Id.*
44. *Id.* at 288.
45. Stern Oil Co. v. Brown, 908 N.W.2d 144, 153 (S.D. 2018).
46. *Id.*
47. *Id.*
48. *Id.*
49. *Id.*
50. *Id.*

foreseeability because they are, by their very nature, foreseeable by the parties at the time of contracting."

2. The Loss Period

If the plaintiff is able to demonstrate that lost profits are actually available under the contract, it will typically then have to establish the applicable duration for which lost profits are recoverable. Parties often refer to this period for calculating lost profits as the "damage period" or the "loss period."

Calculating the loss period is typically fact-specific. Contract terms, statutory requirements, prior custom and practice, and industry standards can, and typically will, influence the extent of the loss period.[51] The loss period may be relatively short and in the past, or may be ongoing into the future, particularly when a franchisee continues to operate its business while pursuing litigation.[52]

For many franchise-based lost-profits cases under a breach of contract theory, the loss begins at the date of the breach and ends when the injured party is returned to the position it would have been in "but for" the alleged breach of the defendant.[53] However, not every lost-profits matter is a straightforward breach-of-contract matter where beginning and ending dates are apparent.[54] When dates are not definite to determine a loss period, experts often calculate losses, including future losses, by examining the facts in combination with the market and economic environment.[55]

In sum, there is no one way to determine a loss period for lost profits ahead of time.[56] Courts have provided little overall guidance on loss periods, other than indicating that the plaintiff must support its alleged loss period with sufficient evidence, and the loss period cannot be arbitrary.[57] Of course, the calculation will always depend on the type of case, the facts of the

51. 35 U.S.C. § 284 (notes of decision); 15 U.S.C. § 15.

52. Norman A. Kur, Economic Damages in Commercial Litigation (Oct. 2016), https://www.hhcpa.com/wp-content/uploads/2016/10/Economic-Damages-in-Commercial-Litigation_Kur.pdf (last visited Sept. 24, 2019).

53. ABA Section of Antitrust Law, Proving Antitrust Damages: Legal and Economic Issues at 36 (1996).

54. *Id.*

55. Nancy Fannon & Jonathan Dunitz, The Comprehensive Guide to Lost Profits and Other Commercial Damages 500 (3d ed. 2014) ("Projecting lost revenues can be straightforward if the disrupted revenue stream occurs immediately following the bad act and the firm recovers relatively quickly. More complex cases can arise if the effect is delayed or the recovery is slow, intermittent, or nonexistent. . . . The projection of the revenue stream is likely to be the most controversial part of any damages estimate in a business case because it requires so many assumptions on the part of both experts with respect to the other players in the market and customer demand.").

56. LeMond Cycling, Inc. v. PTI Holding, Inc., 2005 U.S. Dist. LEXIS 742, at *16 (D. Minn. Jan. 14, 2005) (finding that lost profits depend on the circumstances of each case).

57. In *IC Mfg & Assocs. v. Bare Bd. Grp., Inc.*, 602 B.R. 780, 796 (Bankr. M.D. Fla. 2018), the court found that an arbitrary loss period that can be extended at the expert's whim is not a reasonable yardstick for adequately determining lost profits. In *Transverse, LLC v. Iowa Wireless Services, LLC*, 617 F. App'x 272, 278 (5th Cir. 2015), the court found that lost profit damages may not be based on evidence that is "speculative, uncertain, contingent, or hypothetical."

case, and applicable law.[58] A few of the more "certain" rules are that the loss period will typically start no earlier than the date of the damaging event, but the duration of the loss period can vary substantially.[59] In cases involving a breach of contract, the loss period is generally measured through the date on which the business returns to normal customary levels or the end of the term of the contract.[60] The longer the foreseeable period, the greater the risk that the damage claims will not meet the certainty and foreseeability tests and, consequently, that the courts will be reluctant to award those damages.[61]

3. Two Common Franchise Foreseeability Disputes: Renewals and Terminations

Foreseeability disputes in franchise cases most often arise in disputes concerning franchise agreement renewal or termination. In the case of a franchisee suing a franchisor, the franchisee can typically only seek lost profits during the term of the parties' contract. However, where a contract contains an option for renewal, the franchisee will often seek to project losses for a future period that includes the renewal.[62] Conversely, the franchisor likely will seek to limit losses to the initial term of the contract, under the theory that no future lost profits should arise following the date on which the agreement would have expired.[63]

For example, in *Comerica v. Smith (*In re *Magna Cum Latte*, *Inc.)*, a case arising from the purchase of three coffee franchises, the parties disputed whether the franchisee was entitled to lost profits for the ten-year franchise renewal period.[64] The court held that the franchisee was not entitled to lost

58. There is no set minimum or maximum loss period and there is no established way for determining a loss period via case or state law. Damages experts provide evidence to a judge to establish a loss period and the judge decides whether that evidence is sufficient to support that damages were incurred over that particular period. In *USM Corp. v. Marson Fastener Corp.*, 467 N.E.2d 1271, 1285 (Mass. 1984), the court found a damage period spanning fifteen years to be sufficiently supported by evidence of the defendant's profits from use of the trade secret that was at issue. In *Kenford Co. v. Erie County*, 108 A.D.2d 132, 489 N.Y.S.2d 939 (N.Y. App. Div. 1985), the Fourth Department of the New York Appellate Division held that although no rule in New York automatically precludes a new business from recovering lost profits, plaintiff's evidence contained too many variables and was too uncertain to support an award of lost profits. In *Lexington Insurance Co. v. Newbern Fabricating, Inc.*, 2016 U.S. Dist. LEXIS 171004, at *16–17 (N.D. Okla. Nov. 15, 2016), the court found that a loss period of nine months provided by the plaintiff's expert witness was reasonable but that such expert must establish a foundational basis for his opinion at trial. The Federal Circuit has implied that at least a two-year period of lost profits is acceptable if the lost profits are proved with the requisite evidence and precision. Dahl v. United States, 695 F.2d 1373, 1382 (Fed. Cir. 1982). And finally, in *Packgen v. Berry Plastics Corp.*, 847 F.3d 80, 87 (1st Cir. 2017), the court found evidence of conversations with the company president, expert analysis, and no competitors entering into the market sufficient to support a ten-year loss period.

59. 1 Patrick A. Gaughan & Michael L. Brookshire, *Economic Framework for the Lost Profits Estimation Process*, Commercial Damages: Remedies in Business Litig. § 22.04 (2019).

60. *Id.*; Matt Connors & Robert P.K. Mooney, Business Valuation Applications to Economic Damages for Lost Profits, Utah Bus. J. at 25–26 (Jan./Feb. 2011).

61. Gaughan & Brookshire, *supra* note 59.

62. *Id.*

63. *Id.*

64. Comerica v. Smith, 2008 Bankr. LEXIS 3736, at *40 (Bankr. S.D. Tex. May 9, 2008).

profits for the ten-year renewal period because the franchisor's obligation to renew the franchise agreement was contingent upon conditions not satisfied by the franchise. Moreover, the court found that even if the franchisee had not failed to satisfy the conditions for renewal, it would not be entitled to lost profits for the renewal period because a plaintiff must establish with "reasonable certainty both the occurrence and extent of alleged lost profits," and the franchisee offered insufficient evidence that it would be able to extend the store's operations for an additional ten years.[65] The franchisee's inability to negotiate its own lease and find a replacement location, rent, royalty, and product payment defaults, and inability to comply with the ADA's building requirements, all diminished the franchisee's likelihood of a successful renewal.[66] Based on those factors, the court determined that the franchisee did not meet its burden with respect to lost profits for the ten-year renewal period.[67]

Another important element of future lost profits claims in the renewal context turns on the actual history of the parties and the franchise system. Courts appear to be more likely to award future lost profits for renewal periods when the plaintiff shows a history of renewals and extensions.[68]

Another issue arises where a contract contains a termination notice provision. In such instances, most courts hold that the non-breaching party's damages are limited to the notice period in the contract.[69] The courts have held that neither party could reasonably anticipate that damages would result from a breach that could exceed the notice period.[70] However, a contract

65. *Id.* at 43–44.
66. *Id.*
67. *Id.*
68. Mariner Capital Advisors, The Basics of Lost Profits Calculations, http://marinercapitaladvisors.com/resources/the-basics-of-lost-profits-calculations (last visited Sept. 24, 2019).
69. *See*, *e.g.*, Reliable Tire Distrib., Inc. v. Kelly Springfield Tire Co., 607 F. Supp. 361, 369 (E.D. Pa. 1985) (concluding that plaintiff was only entitled to lost profits through the time that a manufacturing contract would have otherwise terminated pursuant to a ninety-day notice provision); Mach. Maint. & Equip. Co. v. Cooper Indus., Inc., 634 F. Supp. 367, 371 (E.D. Mo. 1986) (finding plaintiff's lost-profit damages were limited to the ninety–day termination period for a machinery distribution agreement); Martin v. U-Haul Co., 204 Cal. App. 3d 396 (1988) (finding damages should be limited to the damages attributable to the thirty days following the breach because the contract contained a thirty-day notice provision); Hentze v. Unverfehrt, 237 Ill. App. 3d 606 (1992) (finding lost profit damages for termination of an animal health store's dealership should be limited to a sixty-day period because either party could terminate the dealership at will with sixty days' notice); Trimed, Inc. v. Sherwood Med. Co., 977 F.2d 885, 893 (4th Cir. 1992) (concluding that lost profits would be limited to those incurred during the six months following the breach of a product-supply contract's termination provision requiring six months' notice); Smalley Transp. Co. v. Bay Dray, Inc., 612 So.2d 1182, 1186–91 (Ala. 1992) (holding the trial court should have awarded damages for ten days instead of seven years because the notice-of-cancellation period provided in a transportation-agency contract was ten days). *But see* Keystone Floor Prods. Co. v. Beattie Mfg. Co., 432 F. Supp. 869, 879–80 (E.D. Pa. 1977) (noting the notice period does not set the parameters for provable damages), Mercury Marine Div. of Brunswick Corp. v. Boat Town U.S.A., Inc., 444 So. 2d 88, 89 (Fla. Dist. Ct. App. 1984) (lost profit damages were not limited to the notice period).
70. *Martin*, 204 Cal. App. 3d 396.

that is terminable upon "reasonable notice" is not as clear. The court will have to determine, based on the circumstances, what is reasonable.[71]

C. *Reasonable Certainty*

The third element the plaintiff must prove is that lost profit damages are "reasonably certain and not speculative."[72] Generally, the certainty of damages is sufficient if the evidence enables the court to make a fair and reasonable approximation of damages.[73] Almost every jurisdiction has adopted "reasonable certainty" as the standard of proof for lost profits.[74] But whether lost profits are "reasonably certain" is a fact-intensive determination.[75] The basis of lost profits should be "objective facts, figures, or data from which the amount of lost profits can be ascertained."[76]

Courts generally recognize two ways to prove lost profits: the so-called "before and after" comparison and the "yardstick" approach. The "before and after" approach compares the profitability of the plaintiff before the breach to the post-breach profitability, or lack thereof, of the plaintiff to arrive at lost profits.[77] The yardstick approach is used when the "before and after" method is not available and uses some other entity or benchmark (industry standard) to set profitability.[78] Under either framework, courts examine whether the evidence of lost profits is supported by verifiable and relevant data.

For example, In *UST Corp. v. General Road Trucking Corp.*, the court found that "one of the best ways of establishing reasonably certain future lost profits . . . is to use the operational history of the enterprise for which future lost profits are being sought, or a representative portion thereof, as a basis for predicting lost profits" (the "before and after" test).[79] The court determined that lost-profit damages were not proved with reasonable certainty where the joint venture had only been in business for approximately three months when the breach of contract occurred and the plaintiff's damage expert's projections of future lost profits were based on only one week of available operating data.[80] Further, the court found that the damage expert relied on unsupported and speculative assumptions.[81]

In franchise cases, reasonable certainty can sometimes be established even when the franchised business does not have a substantial operational history. In *Pauline's Chicken Villa, Inc. v. KFC Corp.*, 701 S.W.2d 399, 401 (Ky.

71. *See* Sierra Wine & Liquor Co. v. Heublein, Inc., 626 F.2d 129, 130 (9th Cir. 1980) (finding six months reasonable).
72. Rubin Res., Inc. v. Morris, 237 W. Va. 370, 379 (2016); Stern Oil Co. v. Brown, 908 N.W.2d 144, 151 (S.D. 2018)
73. Precision Pine & Timber, Inc. v. United States, 63 Fed. Cl. 122, 131 (2004).
74. Robert L. Dunn, Recovery of Damages for Lost Profits § 1.6 (6th ed. 2005).
75. Holt Atherton Indus., Inc. v. Heine, 835 S.W.2d 80, 84 (Tex. 1992).
76. *Id.*
77. Lehrman v. Gulf Oil Corp., 500 F.2d 659, 667 (5th Cir. 1974).
78. *Id.*
79. UST Corp. v. Gen. Rd. Trucking Corp., 783 A.2d 931, 942 (R.I. 2001).
80. *Id.*
81. *Id.*

1985), the court noted that certain characteristics of franchise outlets eliminate significant amounts of uncertainty that might exist in other contexts. The court held that when the franchisor is a national or regional franchisor with uniform advertising and quality control, and when there is available data on earnings and expenses and on failure and success ratios from similar locations, the franchisee can usually show lost profits with "reasonable certainty."[82] The court further noted that if, in addition, the franchisee is experienced in the particular business or has a past record of success in that industry (the yardstick approach), the case for awarding lost profits becomes even stronger.[83]

D. *Case Analysis:* Maaco Franchisor SPV, LLC v. Cruce

In *Maaco Franchisor SPV, LLC v. Cruce*, a federal district court recently applied the three-prong test and determined that the plaintiff franchisor was entitled to future lost-profit damages.[84] The parties entered into franchise agreements in 2013 and 2014 for the franchisees to run Maaco automotive maintenance and repair centers for fifteen-year terms.[85] Under the franchise agreements, the franchisees were required to continue the operation of the centers and pay certain royalties and advertising contributions for the term of the agreements.[86] In April 2017, the franchisees ceased operations with no intention of reopening.[87] The franchisor sued, alleging breach of the franchise agreements, and sought damages, including lost future royalties and lost future advertising contributions.[88] The franchisees failed to respond, so the franchisor filed a motion for default judgment.[89]

Applying North Carolina law, the court found that the franchisor had demonstrated that the closure of the centers before the end of the term of the franchise agreements proximately caused it to suffer damages because the closure stopped the potential for generating any revenue.[90] Further, the franchisor provided sufficient evidence, in the form of historical data concerning the franchisees' centers before closure (the "before and after" test), to establish the amount of its lost profits with reasonable certainty.[91] The court also found that the franchisor was entitled to future damages because it was reasonable for the parties to contemplate lost profits given the duration of the agreements with rights to renew.[92] Finally, the court found that

82. Pauline's Chicken Villa, Inc. v. KFC Corp., 701 S.W.2d 399, 401 (Ky. 1985).
83. *Id.* at 401–02.
84. Maaco Franchisor SPV, LLC v. Cruce, 2019 WL 5295702, at *7 (W.D.N.C. Oct. 18, 2019).
85. *Id.* at *1–2.
86. *Id.* at *2.
87. *Id.*
88. *Id.* at *3.
89. *Id.* at *1.
90. *Id.* at *5.
91. *Id.*
92. *Id.* at *6.

limiting damages to three years was a reasonable period because that is the average time that it takes to replace a franchisee's operations.[93]

Cruce offers valuable lessons regarding the sort of evidence that a franchise party can use to establish lost profits based on a potential renewal period, including the value of historical operating data and the relevance of a reasonable "replacement period" to determine the loss period. Of course, future plaintiffs should take *Cruce* with a grain of salt, because it is unclear how successful Maaco would have been if the franchisees had responded to the complaint and defended the litigation with experts and legal arguments aimed at contradicting the franchisor's evidence of foreseeability and reasonableness of lost profits.

IV. The Role of the Expert

Expert-opinion evidence is central to establishing the amount of lost-profits damages in franchise cases. Generally, an expert will determine what amount of profits that the plaintiff would have earned, but for the actions of the defendant.

Under Federal Rule 702 and analogous state law, an expert's opinion testimony regarding lost profits must be the "product of reliable principles and methods."[94] Most often, the financial expert is a certified public accountant (CPA). The American Institute of Certified Public Accountants (AICPA) governs CPAs. The AICPA issues standards and practice aids for CPAs relating to damages, and specifically the calculation of lost profit damages. Litigation engagements performed by a CPA that include an estimation of value are subject to the following AICPA standards: (1) Practice Aid 06-4, "Calculating Lost Profits," which discusses the "reasonably foreseeable" and "reasonable certainty," elements; and, (2) Forensic and Valuation Services Practice Aid, "Discount Rates Risk, and Uncertainty in Economic Damages Calculations." [95] Courts typically recognize that testimony based on AICPA standards, if those standards are properly applied, is "the product of reliable principles and methods."[96]

Two common AICPA-approved methods exist to prove lost profits: (1) the "before and after" method; and (2) the "yardstick test."[97] The "yardstick test" is generally used when a business has not operated long enough to compile an earnings record that can be used to extrapolate lost future profits.[98] It compares the profits of businesses that are closely comparable to

93. *Id.*
94. Fed. R. Civ. P. 702.
95. Connors & Mooney, *supra* note 60, at 25–26.
96. *See* Leon v. Kelly, 2009 WL 1300936, at *13, 20 (D.N.M. Jan. 12, 2009) (admitting lost profit opinion testimony that utilized the guidance in the AICPA practice aid on calculating lost profits).
97. Devon Med., Inc. v. Ryvmed Med., Inc., 60 So. 3d 1125, 1128 (Fla. Dist. Ct. App. 2011).
98. G.M. Brod & Co., Inc. v. U.S. Home Corp., 759 F.2d 1526, 1538 (11th Cir.1985).

the plaintiff.[99] By necessity, the "yardstick" approach is commonly used when calculating lost profits damages sustained by a new business.[100]

The "before and after" method is used for an established business, and it compares the plaintiff's profitability before the defendant's wrongful conduct with the plaintiff's profitability after the wrongful conduct.[101] Because it is based upon actual data specific to the plaintiff, the "before and after" method is the more preferred method for proving lost profits.[102] In using the "before and after" method, it is important that the expert takes into consideration and, where appropriate, adjusts for factors that were likely unrelated to the defendant's actions because it will seldom be the case that the defendant's conduct was the only reason that the plaintiff's results varied between the two periods being compared.[103] Some courts have required that a party presenting a "before and after" analysis identify potential confounding factors and show that they did not affect the business. For example, in *Isaksen v. Vermont Castings, Inc.*, Judge Posner dismissed a "before and after" theory analysis that failed to account for factors other than the defendant's conduct.[104] Judge Posner stated:

> Although [the plaintiff] may well have suffered losses during the period of [the defendant's] unlawful activity, he made no effort to establish how much of the loss was due to that activity as distinct from unrelated business factors. . . . All [the plaintiff] did to prove damages was to compare his average profits for several years before and several years during the period of unlawful activity. *Post hoc ergo prompter hoc* is not a valid methodology of damages calculation, especially when it is apparent that other causal factors are at work.[105]

Similarly, in *Saks Fifth Ave., Inc. v. James, Ltd.*, the court rejected a claim for lost-profit damages where the claimant using the "before and after" method, failed to rule out other causes of its loss of customers.[106] Here, James, a high-end men's clothing retailer, asserted claims against Saks Fifth Avenue and one of James' former employees after the employee left James to work at a Saks Fifth Avenue store located in the same mall.[107] James' calculation of damages focused solely on a but-for model to determine what James' profits would have been had the employee remained employed, but the court found that, under that analysis, James' damages were the same regardless of whether the employee left to work at Saks or simply retired.[108] The court concluded that James' claims, in neglecting to prove that damages

99. *Id.*

100. *See infra* Section V.

101. *In re* ICMfg & Assocs., Inc., 602 B.R. 780, 795 (Bankr. M.D. Fla. 2018).

102. *Id.*

103. Robert M. Lloyd, *Proving Damages for Lost Profits: The Before-and-After Method*, Coll. Law Fac. Scholarship (2014), http://trace.tennessee.edu/cgi/viewcontent.cgi?article=1074&context=utk_lawpubl.

104. Isaksen v. Vt. Castings, Inc., 825 F.2d 1158, 1164–65 (7th Cir. 1987).

105. *Id.* at 1165.

106. Saks Fifth Ave., Inc. v. James, Ltd., 630 S.E.2d 304, 312 (Va. 2006).

107. *Id.* at 307.

108. *Id.*

corresponded to the defendants' wrongful conduct, that James failed to show proximate cause and thus did not carry the necessary burden of proof as to lost-profit damages.[109]

Lost profits also typically have historical and future loss components. For both components, it is important for the expert to calculate past and future losses in terms of their present value. One commonly used method for doing so is the discounted cash flow model. The expert discounts cash flow to the date of loss and then calculates prejudgment interest to a future date, commonly the date of the award.[110] To perform this calculation, the expert obviously needs to establish a discount rate. The discount rate usually makes a large difference in the amount that the court awards as damages, and, therefore, it can be an area of contention between the parties.

Regardless of what method the expert uses, it important that the expert make his or her calculations based on as much information as possible. The expert should use both internal information from the business and external data consistent with generally accepted approaches. Internal information includes profit-and-loss statements, cash-flow reports, income tax returns, and business plans. External data includes market constraints, competitors comparable to the plaintiff, the impact of technology, capacity, and market share constraints. "While an expert need not consider every possible factor to render a 'reliable' opinion, the expert still must consider enough factors to make his or her opinion sufficiently reliable in the eyes of the court."[111]

For example, in *Education Logistics, Inc. v. Laidlaw Transit, Inc*, the plaintiff alleged that the defendant breached their agreement by not using its best efforts to promote its bus-routing software.[112] The plaintiff claimed that, as a result of the breach, it lost profits.[113] The defendant challenged the plaintiff's expert's calculation, arguing that the expert relied on unsupported assumptions and failed to consider other plausible causes of a purposed decline in revenue growth from the software.[114] The court agreed, finding that, among other things, the plaintiff's expert did not consider any other factors, other than the defendant's alleged misconduct, that might have caused the decline in sales.[115] As evidenced in *Education Logistics, Inc.*, one way to attack a lost-profits calculation is to argue that the expert ignored relevant factors, such as the condition of the overall economy.

The defendant—often the franchisor—can challenge the plaintiff's quality or quantum of proof by filing a pre-trial motion to exclude the expert's testimony. Federal courts and most state courts follow the *Daubert* standard. In *Daubert* and *Kuhmo Tire Co.*, the Supreme Court expanded the federal

109. *Id.*

110. Connors & Mooney, *supra* note 60 at 25, 27.

111. MicroStrategy Inc. v. Bus. Objects, S.A., 429 F.3d 1344, 1355 (Fed. Cir. 2005).

112. Educ. Logistics, Inc. v. Laidlaw Transit, Inc., 2012 WL 761950, at *1 (D. Mont. Mar. 8, 2012).

113. *Id.* at *5.

114. *Id.*

115. *Id.* at *7.

courts' obligation to act as a gatekeeper and exclude speculative, unreliable expert testimony.[116] As the Supreme Court stated in *Daubert*, the starting point for the court's analysis of a motion to exclude expert testimony is Rule 702 of the Federal Rules of Evidence:

> If scientific, technical, or other specialized knowledge will assist the trier of fact to understand the evidence or to determine a fact in issue, a witness qualified as an expert by knowledge, skill, experience, training, or education, may testify thereto in the form of an opinion or otherwise, if (1) the testimony is based upon sufficient facts or data, (2) the testimony is the product of reliable principles and methods, and (3) the witness has applied the principles and methods reliably to the facts of the case.[117]

Courts have excluded expert witnesses for multiple reasons, including insufficient expertise, unsound methodology, and unfounded assumptions.[118] For example, in *Chemipal Ltd. v. Slim-Fast Nutritional Foods International, Inc.*, the court excluded an expert because he did not understand the methodology on which he relied.[119] In *Fail-Safe, LLC v. A.O. Smith Corp.*, the court found the expert's methodology was "utterly unreliable" where he "cherry picked" evidence about market share for pool pump motors.[120] In *Capital Metropolitan Transportation Authority/Central of Tennessee Railway & Navigation Co. v. Central of Tennessee Railway & Navigation Co.*, the court excluded expert testimony because the expert's lost-profit calculations were premised upon unfounded assumptions.[121] Countless other examples exist, all of which demonstrate that proving "reasonable certainty" is a difficult endeavor that often requires significant brainpower and expense. The party that allows its expert to consider and explain all of the possible relevant information will likely be much more successful than the party that tries to ignore the potential problems with its calculations.

V. New Businesses and Lost Profits—the New Business Rule

As noted earlier, measuring lost profits can be particularly tricky in cases where the plaintiff is a relatively new business venture without historical data regarding its profitability.[122] Many courts have traditionally refused to award lost-profits damages in this context, often because such profits are too remote, contingent, and speculative to meet the legal standard of reasonable certainty.[123]

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116. Kumho Tire Co., Ltd. v. Carmichael, 526 U.S. 137 (1999); Daubert v. Merrell Dow Pharms., Inc., 509 U.S. 579 (1993).

117. Fed. R. Civ. P. 702; *Daubert*, 509 U.S. 579.

118. Stewart I. Edelstein, Daubert *and Lost-Profits Testimony When Lost Profits Are an Issue, Both Parties' Experts Will Face the Judicial 'Gatekeeper.' Study the Case Law to Understand Who Will Be Admitted and Who Will Be Stranded Outside*, Trial, Sept. 2005, at 31.

119. Chemipal Ltd. v. Slim-Fast Nutritional Foods Int'l, Inc., 350 F. Supp. 2d 582, 592 (D. Del. 2004).

120. Fail-Safe, LLC v. A.O. Smith Corp., 744 F. Supp. 2d 870, 891 (E.D. Wis. 2010).

121. Capital Metro. Transp. Auth./Cent. of Tenn. Ry. & Navigation Co. v. Cent. of Tennessee Ry. & Navigation Co., 114 S.W.3d 573, 582 (Tex. App. 2003).

122. *Id.*

123. *Id.*

Under this "new business rule," courts considered claims for lost profits of a newly established business inherently speculative and, therefore, unrecoverable.[124] In other words, if a business does not have a history of profitable operations, lost-profit damages have been generally unavailable.[125]

In recent years, however, many courts have moved away from or even abandoned this general rule and instead have considered the quality of the evidence presented to determine whether the plaintiff has demonstrated a supported basis for a reasonable estimate of its damages.[126] The majority of jurisdictions have now rejected the new business rule as a *per se* rule of exclusion of all lost-profits damages when the lost profits can be proven with reasonable certainty, regardless of whether the claimant is a new business.[127] Instead, the majority of jurisdictions follow a rule whereby a new business can recover damages for lost profits when they are proven with reasonable certainty. In those situations, the age of the business is only one relevant factor in assessing the certainty of the proof.[128] Many courts have also started to characterize this issue as a factual, not legal, issue.[129] These shifts appear to

124. Jim Kern, *4 Common Misperceptions About Lost Profits Claims*, Gross Mendelsohn, https://www.gma-cpa.com/blog/4-common-misperceptions-about-lost-profits-claims (last visited Sept. 24, 2019); Dunn, *supra* note 74; Hickman v. Coshocton Real Est. Co., 58 Ohio App. 38 (1936) (absent a history of past profits, future profits seemed too "uncertain and speculative," particularly in the progress-oriented atmosphere of the late 1800s when rules defining damages were first developed).

125. Victor P. Goldberg, *The New Business Rule and Compensation for Lost Profits*, CLS Blue Sky Blog (Mar. 28, 2019), http://clsbluesky.law.columbia.edu/2019/03/28/the-new-business-rule-and-compensation-for-lost-profits; Cal. Press Mfg. Co. v. Stafford Packing Co., 192 Cal. 479, 485 (1923) ("Where . . . damages by way of profits are sought for . . . interruption or prevention [of a new business or enterprise] the rule is that they will be denied, for the reason that such business is an adventure as distinguished from an established business, and its profits are speculative and remote, existing only in anticipation. The rule is one of necessity. Damages must be certain of ascertainment. If one engages in a new industry, there are no provable data of past business from which the fact can be legally deduced that anticipated profits would have been realized.").

126. Kern, *supra* note 124; Carmen D. Caruso & Bruce S. Schaeffer, *Damages for Lost Future Profits in Franchise Disputes—Overcoming the New Business Rule and Establishing Reasonable Certainty*, 36 Franchise L.J. 1, 6 (2016); *see also* W.W. Gay Mech. Contractor, Inc. v. Wharfside Two, Ltd., 545 So. 2d 1348 (Fla. 1989); AGF, Inc. v. Great Lakes Heat Treating Co., 555 N.E.2d 634 (Ohio 1990); Iron Steamer, Ltd. v. Trinity Rest., Inc., 110 N.C. App. 843 (1993); Given v. Field, 484 S.E.2d 647 (W.Va. 1997); Beverly Hills Concepts v. Schatz & Schatz, 247 Conn. 48 (1998); Neb. Nutrients, Inc. v. Shepherd, 261 Neb. 723 (2001); Kids' Universe v. In2Labs, 95 Cal. App. 4th 870 (2002); BMK Corp. v. Clayton Corp., 226 S.W.3d 179 (Mo. Ct. App. 2007) (rejecting the new business rule as an absolute); Va. Code Ann. § 8.01-221.1 ("Damages for lost profits of a new or unestablished business may be recoverable upon proper proof. A party shall not be deemed to have failed to prove lost profits because the new or unestablished business has no history of profits. Such damages for a new or unestablished business shall not be recoverable in wrongful death or personal injury actions other than actions for defamation.").

127. Goldberg, *supra* note 125.

128. Schonfeld v. Hilliard, 218 F.3d 164 (2d Cir. 2000); Hog Slat, Inc. v. Ebert, 104 F. Supp. 2d 1112 (N.D. Iowa 2000); KW Plastics v. U.S. Can Co., 131 F. Supp. 2d 1265 (M.D. Ala. 2001).

129. Bernadette J. Bollas, *New Business Rule and the Denial of Lost Profits*, 48 Ohio State L.J. 855 (1987); Everett Gee Warner & Mark Adam Nelson, *Recovering Lost Profits for an Unestablished Business Under Georgia Law: The New Business Rule Bows to MECCA*, 39 Mercer L. Rev. 977 (1988).

be a result of changing attitudes towards jurors and a focus on the inherent injustice to new businesses under the new business rule.[130]

Courts have recognized that a successful franchise model may supply sufficient evidence to achieve reasonable certainty with respect to lost-profits claims in cases that might previously have been subject to the new business rule.[131] For example, the U.S. District Court for the Northern District of Illinois stated that "[c]ourts are willing to entertain lost profit calculations based upon historical data from franchise operations, even when those calculations also included the business owner's assumptions, and sometimes, when the business had not yet begun operation."[132] Indeed, a leading treatise on damages law has argued that a franchise in a proven brand is not a new business, at all:

> The supposed rule that lost profit damages of an unestablished business were not recoverable would seem to be least justifiable when the business to be established is a location for a national franchise. Each store is cast from the same mold. The locations are rigidly controlled by the national franchisor. Projections are readily available based on extensive experience in other stores from which sales and profits can be derived with a high degree of certainty. These projections are the basis for the franchisor's selection of the new location and the franchisee's investment in it. If the figures are good enough for the parties to invest their money, it would seem that they should be good enough for the court.[133]

This argument is premised on "the theory that one franchise unit is a 'yardstick' for anticipating results at a new unit to be opened in the same system."[134] Applying this theory, the Kentucky Supreme Court allowed a KFC franchisee to recover lost profits for units that were never built after finding consumer acceptance of the brand, national advertising, uniform quality control, earnings and expense figures on nearby, comparable locations, and an available history concerning success and failure ratios as persuasive in showing potential profits.[135]

Similarly, in *Super Valu Stores, Inc. v. Peterson*, the Alabama Supreme Court reversed a summary judgment for a defendant based on the new business rule. There, the court determined that a nationwide franchise system provided sufficient data to support the recovery of lost profits and expressly held that it would be inequitable to deny the franchisee lost profits where the franchisee produced "the best evidence available," which was a reasonable basis for estimating the claimed losses.[136]

130. *Id.*

131. Caruso & Schaeffer, *supra* note 126, at 7.

132. FMS, Inc. v. Volvo Constr. Equip. N. Am., Inc., 2007 U.S. Dist. LEXIS 19517, at *31 (N.D. Ill. Mar. 20, 2007).

133. Dunn, *supra* note 74, § 4.7 (citing Smith Dev. Corp. v. Bilow Enters., 308 A.2d 477, 483 (R.I. 1973)) (allowing a McDonald's franchisee who was blocked from opening his unit to recover lost profits).

134. Caruso & Schaeffer, *supra* note 126, at 7.

135. Pauline's Chicken Villa, Inc. v. KFC Corp., 701 S.W.2d 399, 401–02 (Ky. 1985).

136. Super Valu Stores, Inc. v. Peterson, 506 So. 2d 317, 330 (Ala. 1987) (cited with approval by the Seventh Circuit in Mid-Am. Tablewares v. Mogi Trading Co., 100 F.3d 1353, 1365 (7th Cir. 1996)).

Importantly, however, while successful franchise systems may afford a franchisee the opportunity to rely on the success of the overall brand to avoid application of the new business rule,[137] unsuccessful franchise systems may not. For example, in *Otis v. Doctor's Associates, Inc.*, the U.S. District Court for the Northern District of Illinois rejected a lost-profits claim based on an unbuilt franchised restaurant.[138] The court described the unbuilt units as potentially being a part of a "failed fast food franchise known as Cajun Joe's Chicken."[139] When determining whether a new or unbuilt franchisee is considered a new business under the new business rule, "[t]he critical dispositive factor appears to be . . . whether the performance of the brand, as a whole, provides sufficient data to overcome new business concerns. The brand as a whole, not the particular units that were never built, is the alleged new business being evaluated."[140] Based upon the court's evaluation of the Cajun Joe's brand, it declined to permit the franchisee to collect lost future profits because the brand was a brand new fast-food franchise without a history of losses or profits and, thus, subject to the new business rule. The court further found that, even if the new business rule had not precluded the plaintiff's theory of lost profits, the plaintiff failed to offer sufficient evidence to establish the reasonable degree of certainty necessary to obtain future lost profits.

Many states have taken a middle-ground approach. States taking the middle-ground approach to lost-profit damages often follow the new business rule but do not determine it as absolute. These states will apply the new business rule where the case involves a new business but will not automatically bar the new business from recovering lost-profit damages. New businesses in middle-ground states are given a chance to present evidence to prove their lost profits.[141] Other middle-ground states have not wholly abrogated the new business rule, but have either limited its effect through implementation of various exceptions to the rule or have used creatively used ways to avoid using it.[142]

137. Smith Dev. Corp. v. Bilow Enters., 112 R.I. 203, 214 (1973) (holding that a McDonald's marketing research manager testifying to the uniformity of procedures utilized at all McDonald's restaurants, its training and national advertising programs, the efforts made to maintain standards and quality and that the number of restaurants almost doubled by the time of trial and none of them failed was sufficient to establish reasonable certainty as to lost profits); *Pauline's Chicken Villa*, 701 S.W.2d at 401 (finding a franchise is sufficiently similar to other franchise outlets to negate nearly all uncertainty of lost profits).

138. Otis v. Doctor's Assocs., Inc., 1998 U.S. Dist. LEXIS 15414 (N.D. Ill. Sept. 10, 1998).

139. *Id.* at *1.

140. Caruso & Schaeffer, *supra* note 126, at 8.

141. Harsha v. State Sav. Bank, 346 N.W.2d 791, 797, 798 (Iowa 1984) (finding that the new business rule is not absolute and that if "factual data are presented which furnish a basis for compilation of probable loss of profits, evidence of future profits should be admitted and its weight, if any, should be left to the jury"); *No Ka Oi Corp. v. Nat'l 60 Minute Tune*, 71 Wash. App. 844, 849 (1993) (allowing recovery where "a reasonable estimation of damages can be made based on an analysis of the profits of identical or similar businesses operating under substantially the same market conditions").

142. Malatesta v. Leichter, 186 Ill. App. 3d 602 (1989) (applying an exception where the new business was prevented from acquiring the operations from an existing business); Milex Prods.,

Although there is not a uniform decision among courts regarding abandoning or maintaining the new business rule, there most certainly is a common trend in courts moving away from applying the new business rule, whether that is in the form of carving out exceptions or wholly abandoning the rule. With the trend moving in this direction, new businesses may have a chance at successful lost-profits claims as long as they have sufficient evidence to prove lost profits. This even holds true for new locations of established franchise chains. Franchisees have been successful in lost-profits claims for unbuilt or unopened locations of successful franchise chains.

Expert testimony may also avoid applications of the new business rule.[143] In all circumstances, the plaintiff must present sufficient evidence to demonstrate with reasonable certainty that it would have made a profit.[144] "Damages may be established with reasonable certainty through economic and financial data, market surveys and analyses, business records and experience of similar businesses, experience of the business owner, and through expert testimony."[145] When faced with quantifying lost profits for new businesses with little or no history of earnings prior to the breach, quantification of lost profits becomes more of a challenge. Fortunately, the widespread application of the "reasonable certainty" standard allows several methods of quantifying damages without the requirement of complete and absolute certainty as to amount.[146]

In sum, the new business rule traditionally made it very difficult, and many times impossible, for new businesses to be awarded lost-profit damages. But many courts have moved away from a strict reading of the rule, thereby permitting, new businesses, including new franchisees, to be awarded lost-profit damages if their evidence is sufficient to meet the "reasonable certainty" standard.

Inc. v. Alra Labs., Inc., 237 Ill. App. 3d 177 (1992) (applying exceptions to the rule where the new business planned to sell a product that is indistinct from an existing product); Lockheed Info. Mgmt. Sys. Co. v. Maximus, Inc., 259 Va. 92, 109–10 (2000) (finding that because the claimant was engaged in the relevant industry in other jurisdictions, its thwarted entry into the Virginia market did not constitute a new business); Jamsports & Entm't, LLC v. Paradama Prods., Inc., 336 F. Supp. 2d 824 (N.D. Ill. 2004) (applying exceptions where the new business lost profits were actually quantifiable); Amco Ukrservice v. Am. Meter Co., 312 F. Supp. 2d 681, 694 (E.D. Pa. 2004) (citing Delahanty v. First Pa. Bank, NA, 464 A.2d 1243 (Pa. 1983)) (recognizing an exception for "a new business that can show a 'significant interest' in its product or service"); RSB Lab. Serv., Inc. v. BSI, Corp., 847 A.2d 599, 613 (N.J. App. Div. 2004) (holding that, for purposes of the new business rule, a center that drew blood to be tested by third-party laboratories was not establishing a new business in attempting to in-source blood-testing services to a newly formed related entity); Holland Loader Co. LLC v. FLSmidth A/S, 769 F. App'x 40, 43 (2d Cir. 2019) (stating that it "is not a per se rule forbidding the award of lost profits damages to new businesses, but rather an evidentiary rule that creates a higher 'level of proof needed to achieve reasonable certainty as to the amount of damages'").

143. Kern, *supra* note 124.

144. *Id.*

145. *Id.*

146. Antrim Pharm. LLC v. Bio-Pharm, Inc., 310 F. Supp. 3d 934, 945 (N.D. Ill. 2018) (finding that expert testimony was sufficient to overcome the new business rule in a motion for summary judgment).

VI. Disclaiming Lost-Profits Damages

Because lost-profits awards are so often difficult to calculate or even estimate ahead of time, and because such awards can potentially be very large, many parties, including franchisors, seek to limit them prospectively in their contracts. Such lost-profits-damages disclaimers can serve as an important tool to allocate risk.

Contractual lost-profits-damages disclaimers are generally enforceable.[147] When constructing a lost-profits disclaimer, it is important to understand that lost profits can be considered as either direct or consequential damages. Consequential damages represent loss or injury that does not flow directly and immediately from the wrongful act of a party, but are the consequence or result of such act.[148] Lost profits are consequential damages when, because of the breach, the non-breaching party suffers loss of profits on collateral business arrangements.[149] Direct damages (or general damages) are those that are caused directly by the wrongful conduct.[150]

For example, in *Stern Oil v. Brown*, the Supreme Court of South Dakota found that a fuel distributor's alleged lost profits arising from the convenience store operator's failure to pay for fuel under the parties' fuel agreement were direct damages.[151] The court explained that the agreements granted defendant the right to use ExxonMobil proprietary marketing material and sell ExxonMobil-branded fuel, and defendant acknowledged that Stern Oil had a relationship with ExxonMobil which allowed it to purchase ExxonMobil fuel and sell it to Brown.[152] Importantly, all Stern Oil's profits arose from the sale of fuel by Stern Oil to Brown.[153] Conversely, in *Atlantech Inc. v. American Panel Corp.*, the Court of Appeals for the First Circuit found lost sales of LCD displays to third parties arising from a breach of the parties' agreement were consequential damages because they were not "necessarily inherent in the contract."[154] Thus, when determining whether lost profits are direct or consequential, the necessary question is whether the damages flow from the contract itself, or from a separate agreement with a nonparty.

The characterization of lost profits as either direct or consequential may be dispositive based on the language of the contractual disclaimer. For example, in *Westlake Financial Group, Inc. v. CDH-Delnor Health System*, the Court considered the following disclaimer:

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147. *See*, *e.g.*, Quicksilver Res., Inc. v. Eagle Drilling, LLC, 2009 WL 1312598, at *7 (S.D. Tex. May 9, 2009); Fish Net, Inc. v. ProfitCenter Software, Inc., 2013 WL 5635992, at *10–11 (E.D. Pa. Oct. 15, 2013).

148. Hartford Acc. & Indem. Co. v. Case Found. Co., 10 Ill. App. 3d 115, 124 (1973).

149. Unilever United States, Inc. v. Johnson Controls, Inc., 2017 WL 622209, at *4 (N.D. Ill. Feb. 15, 2017) (applying New York law).

150. Westlake Fin. Grp., Inc. v. CDH-Delnor Health Sys., 25 N.E.3d 1166, 1174 (Ill. Ct. App. 2015).

151. Stern Oil Co. v. Brown, 908 N.W.2d 144, 153 (S.D. 2018).

152. *Id.*

153. *Id.*

154. Atlantech Inc. v. Am. Panel Corp., 743 F.3d 287, 294 (1st Cir. 2014).

> *Limitation of Liability*. Except with respect to the indemnification and confidentiality obligations contained in this Agreement or any Exhibit hereunder, without limitation to the foregoing, under no circumstances shall either party be liable to the other party for any *indirect*, *incidental*, *consequential*, *special*, *punitive or exemplary damages*, even if either party has been advised of the possibility of such damages, arising from this Agreement, *such as*, *but not limited to*, *loss of revenue or anticipated profits or lost business*.[155]

This case considered whether the disclaimer prevented an award of *any* lost profits, or just incidental or consequential lost profits.[156] The Court ultimately agreed with the plaintiff and found that the plain reading of the clause disclaimed only indirect, consequential damages from lost profits, but not direct lost profits.[157] Similarly, in *Penncro Associates, Inc. v. Sprint Spectrum, LP*, the court found that a provision excluding consequential damages "includ[ing], but . . . not limited to, lost profits" only limited consequential lost-profit damages.[158] Lost profits as a whole were not singled out as a distinct type of damage and, therefore, not precluded from recovery in their entirety.[159]

Conversely, in *Quicksilver Resources, Inc. v. Eagle Drilling, LLC*, the provision stated that the "parties [have] agreed that special, indirect or consequential damages shall be deemed to include, *without limitation*, . . . loss of profit or revenue; . . . [and] cost of loss of use of property, equipment, materials and services, including without limitation those provided by contractors and subcontractors of every tier or by third parties."[160] The court held that this provision manifested a clear intent by the parties to modify the legal meaning and breadth of the term *consequential damages*.[161] The court found that the wording in *Penncro* implied that other unlisted damages could also be considered consequential damages and, as a result, where the provision at issue stated that the listed damages were to be considered special, indirect, or consequential, "without limitation," only those specifically enumerated damages categories were barred from recovery.[162]

In *Biotronik A.G. v. Conor Medsystems Ireland, Ltd.*, the provision excluding consequential damages precluded only consequential lost profits, not direct lost profits because it neither specifically precluded recovery for lost profits, nor did it explicitly define *lost profits* as consequential damages.[163] The issue, then, was whether the lost profits were consequential damages.[164] The plaintiff, the manufacturer and distributor of medical devices, had an agreement

155. Westlake Fin. Grp., Inc. v. CDH-Delnor Health Sys., 25 N.E.3d 1166, 1174 (Ill. Ct. App. 2015).
156. *Id.* at 1175.
157. *Id.* at 1177.
158. Penncro Assocs., Inc. v. Sprint Spectrum, LP, 499 F.3d 1151, 1155 (10th Cir. 2007).
159. *Id.* at 1157–58.
160. Quicksilver Res., Inc. v. Eagle Drilling, LLC, 2009 WL 1312598, at *5 (S.D. Tex. May 9, 2009).
161. *Id.* at *7.
162. *Id.*
163. Biotronik A.G. v. Conor Medsystems Ireland, Ltd., 22 N.Y.3d 799, 805 (2014).
164. *Id.*

with Conor Medsystems Ireland, Ltd., the developer and manufacturer of CoStar, a drug-eluting coronary stent, whereby the plaintiff was the exclusive distributor of CoStar for a defined territory.[165] The defendant ultimately recalled CoStar, and the plaintiff sued the defendant for breach of the agreement,[166] seeking, *inter alia*, lost profits related to the resale of the stents.[167] The court analyzed other cases and found that "the distinction at the heart of these cases is whether the lost profits flowed directly from the contract itself or were, instead, the result of a separate agreement with a nonparty."[168] The court ruled that the agreement clearly contemplated that the plaintiff would resell the stents.[169] Thus, plaintiff was entitled to recover because lost profits resulting from a breach constituted general damages.[170]

Lost-profit disclaimers can be a valuable tool for franchisors. But it is important to consider the specific language of the disclaimer in regard to whether the franchisor is limiting only consequential lost-profit damages. One way to do this analysis is to define specifically the categories of excluded damages. Because lost profits may reflect either general or consequential damages, contracting parties should specifically define lost profits as one or the other, and the parties should consider analogously defining *anticipated savings* and other damages normally thought to be consequential in nature.

VII. Lessons Learned

In most jurisdictions, the recovery of well-grounded lost profits damages is available, especially for so-called direct damages (i.e., those flowing directly from the breach of contract). Absent contractual disclaimers, lost profits (either direct or consequential), are available if they were a foreseeable consequence of the conduct. Although doctrinal limitations still apply in some jurisdictions to claims for new enterprises, these limitations are fading. A prudent franchisor should anticipate such claims when drafting franchise agreements and assessing litigation and risk.

For a franchisee, proving lost profits will likely depend on having detailed and sufficient past financial information. Franchisees must be prepared to explain any trends in their financials or outlying financial information. Many times, a plaintiff's inability to produce financial information impairs the ability to prove its damages. The plaintiff's experts should be diligent in applying lost-profits calculations, consistent with AICPA standards, to prevent a successful *Daubert* attack on the methodology. Plaintiffs will also need to be ready to prove causation—that but-for the defendant's wrongful conduct, they would have earned a profit. In the situation where the plaintiff is the

165. *Id.* at 804.
166. *Id.*
167. *Id.*
168. *Id.* at 806.
169. *Id.* at 808.
170. *Id.*

franchisor, depending on the jurisdiction, the franchisor may not be able to prove causation for future profits if it terminated the franchise agreement.

For the franchisor defending such claims, it is helpful to obtain all information and documents relating to the plaintiff's finances for a broad time period and potential future revenue. This may include requesting documents from third parties, such as banks, accountants, and/or auditors. The franchisor should consider a pre-trial *Daubert* motion to exclude evidence of lost profits. One way for a franchisor to attack lost profits is to show that the lost profits were not proximately caused by the alleged wrongful conduct. In other words, because of some external impediment, the franchisee would not have made a profit irrespective of the breach.

For both parties, it is important to hire an expert. Plaintiffs need an expert to help them meet the standards for proving lost profits, and defendants should have an expert to rebut the plaintiff's expert. Most often, the defense expert will merely present flaws in the plaintiff's expert's testimony, rather than offering a calculation of his own. The defense expert will help lay the groundwork for filing a pretrial motion to exclude the plaintiff's expert.

Contactless Currency During COVID-19: How the Pandemic's Business Disruptions Will Change Franchise System Payment Standards

*Paul Brunkhorst**

Mr. Brunkhorst

As the COVID-19 pandemic rages on, the economic toll of this global crisis continues to take shape with upward and downward spikes in activity, proving that the country's financial forecast remains very much in flux. As has been hashed out in seemingly countless articles since the pandemic firmly established itself by March 2020, small businesses—those without the resources of their bigger chain rivals—have suffered greatly with revenues falling and closures and layoffs continuing.[1] The future is anyone's guess. Many big picture economic questions linger, such as: Is this the end of physical malls and large department stores?[2] Will only chain restaurants survive?[3] What will experience-based businesses—birthday party venues, bowling alleys, and amusement parks—do to cope with the wariness that consumers have towards engaging in activities that

1. *See*, *e.g.*, Ben Brody, Alan Levin, Mary Schlangenstein & Roxana Tiron, *Bailout Pleas Renewed for Restaurants, Airlines as Cash Runs out*, Wash. Post (July 15, 2020), https://www.washingtonpost.com/business/on-small-business/bailout-pleas-renewed-for-restaurants-airlines-as-cash-runs-out/2020/07/15/2fe8226c-c6b0-11ea-a825-8722004e4150_story.html; Lauren Thomas, *The Coronavirus Pandemic Will Likely Leave a Lasting Legacy on Retail: Fewer Department Stores*, CNBC (Apr. 19, 2020), https://www.cnbc.com/2020/04/19/a-lasting-legacy-of-the-coronavirus-pandemic-fewer-department-stores.html.

2. Sapna Maheshwari, *With Department Stores Disappearing, Malls Could Be Next*, N.Y. Times (July 5, 2020), https://www.nytimes.com/2020/07/05/business/coronavirus-malls-department-stores-bankruptcy.html ("The standard American mall—with its vast parking lots, escalators and air conditioning, and an atmosphere heavy on perfume samples and the scent of Mrs. Fields cookies—was built around department stores. But the pandemic has been devastating for the retail industry and many of those stores are disappearing at a rapid clip.").

3. James Kwak, *The End of Small Business: Giant Corporations May Be the Only Survivors in the Post-Pandemic Economy*, Wash. Post (July 9, 2020), https://www.washingtonpost.com/outlook/2020/07/09/after-covid-19-giant-corporations-chains-may-be-only-ones-left/?arc404=true ("[T]he coronavirus will radically reshape Main Streets across the country, accelerating changes long in the making—chain stores will replace mom-and-pop businesses, some storefronts will remain vacant, and cash that once went into local hands will be redirected to Amazon and Walmart.").

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require proximity and contact? Will the travel industry ever fully recover?[4] Unlike previous recessions, most recently in 2007–2008, the nature of this economic recession (brought about by a deadly virus that makes social interaction difficult, if not dangerous) the usual consumer response—go out, spend—is often the exact opposite of the responsible thing to do. People cannot go out and spend when social distancing and quarantine measures remain the best way to flatten the curve and keep infections and deaths as low as possible until, and if, a vaccine ever comes to market.[5] The efforts by some to liken this recession to 2007–2008 are probably well-meaning, but they are seriously lacking in their failure to consider how different, and much more serious, this crisis is when compared with the Great Recession.[6]

This article will address how franchise systems—focusing primarily on the restaurant and food industry, but inclusive of any that sell products—might adjust to post-pandemic life, its social distancing realities, and other business disruptions as a result of COVID-19. Many businesses may begin to more widely embrace delivery services, contactless payment methods, and mobile ordering: changes that are both convenient and necessary. This examination will be broken into three parts: first, this article will discuss contactless payment methods, mobile ordering, and the infrastructure that makes them a reality; second, the data security risks of contactless payment methods and the latest security breaches; finally, the article will close with an examination of how future franchise agreements will change in light of the increase in contactless payments, including what franchisors might put into these future agreements in response to the risks and benefits associated with contactless payment methods.

I. The Electronic Economy: Understanding Contactless Payments and Mobile Apps

Just as it took what already existed in 2007—the smartphone—and made it accessible and "cool" to use by introducing the iPhone, Apple Computer, Inc. can probably also be credited with making mobile payments ubiquitous

4. Major airlines, such as Delta, are recognizing the dire threat to their industry that the COVID-19 pandemic presents. *See generally* Delta Coronavirus Travel Requirements, Delta, https://www.delta.com/us/en/travel-update-center/flying-what-you-need-to-know/coronavirus-regional-restrictions (last visited Aug. 10, 2020).

5. *See* Jacqueline Howard & John Bonifield, *Moderna Coronavirus Vaccine Shows 'Promising' Safety and Immune Response Results in Published Phase 1 Study, but More Research Is Needed*, CNN (July 15, 2020), https://www.cnn.com/2020/07/14/health/moderna-coronavirus-vaccine-phase-1-study/index.html.

6. For example, before this year, the record for weekly seasonally adjusted unemployment benefits claims was 695,000, from 1982. In March of this year, that record was shattered when 3.28 million people filed for benefits in the week that ended March 21. Jim Zarroli & Avie Schneider, *3.3 Million File Unemployment Claims, Shattering Records*, NPR (Mar. 26, 2020), https://www.npr.org/2020/03/26/821580191/unemployment-claims-expected-to-shatter-records. From personal experience, it is extremely difficult to, as has been discussed in various firm panels, go out and "get work" when work is being conducted from home and the informal office interactions that often led to work are impossible.

and easy to use. Apple introduced its Apple Pay mobile payment system in 2014, and it ushered in the era of widely accepted and widely used mobile payments.[7] With the introduction of Apple Pay, Apple provided a means by which the billions of iPhones that it had sold up until that point could be used in two important ways: (1) for contactless payment at stores; and (2) for easy mobile app ordering of food and other products. Apple has heavily advertised the capabilities of its mobile payment system, and news organizations heralded it at its introduction as ushering in a new age of payment and perhaps signaling the end of cash payments forever.[8] Indeed, in the wake of the adoption of mobile payments since Apple Pay's introduction, companies have more fully embraced mobile payments and contactless methods, especially in the wake of the pandemic. For example, Starbucks touts its app by saying:

> As Starbucks responds to the impacts of coronavirus (COVID-19), the company is welcoming customers back to stores with modified store operations and pausing on seating in cafes to help create social distance. Service offerings vary by store, including drive-thru, grab-and-go café service, and order-ahead entryway pickup. Delivery continues to be another option through Starbucks Delivers in markets across the United States and Canada through the Uber Eats App. *The Starbucks app is accessible, and the easiest place to find a store, check hours, order ahead and have contactless payment.*[9]

But what are the nuts and bolts of these systems—how do mobile apps get developed, and what makes contactless payment work? This section will proceed in two parts. First, the technical aspects of these technologies will be explored. Second, an argument will be made that the ubiquity of this technology and the increasing ease-of-use associated with it will allow for use beyond companies like Starbucks and Apple and into the realm of smaller businesses—namely, franchisees—who, in an effort to avoid the percentage that they must pay to third-party apps, will begin developing their own mobile ordering apps.

A. *The Technical Aspects of Mobile and Contactless Payments*

In the United States, the method by which consumers pay via credit card had changed very little until a few years ago when the credit card industry made the switch from payment using the familiar magnetic strip on the back of the card to an embedded computer chip in the card, which was read

7. Greg Bensinger & Robin Sidel, *Can Apple Solve Riddle of Mobile Payments with Apple Pay Service?*, Wall St. J. (Sept. 9, 2014), https://www.wsj.com/articles/apple-introduces-payment-service-called-apple-pay-1410286677.

8. *See* Nilay Patel, *Apple Pay Hands-on: Is This the Future of Payments?*, Verge (Sept. 9, 2014), https://www.theverge.com/2014/9/9/6128371/apple-pay-hands-on ("I just spent some quick time using Apple Pay . . . and it's remarkably smooth.").

9. Heidi Peiper, *A How-To Guide for Digital Ordering at Starbucks*, Starbucks (May 20, 2020), https://stories.starbucks.com/stories/2020/a-how-to-guide-for-digital-ordering-at-starbucks (emphasis added).

by the credit card terminal and made transactions more secure.[10] Now, the industry has transitioned to a more convenient, and faster, method of credit card payment: cards with what are called "Near Field Communication," or "NFC," chips.[11] These cards can communicate with a credit card terminal and authenticate a purchase as long as the embedded card is a few inches from the terminal's reader; there is no need to insert the card, and the entire process is quick.[12] This NFC technology is the same technology that makes mobile payment from a smartphone possible.[13] When you load a credit card into your phone for use with Apple Pay or other contactless payment providers, you are essentially making a contactless payment.

The ease by which consumers can make contactless payments or tap to pay transactions has made them a popular choice for mobile app developers, who allow for mobile wallets, such as Apple Pay, to be integrated into their apps so consumers can easily pay. For example, shortly after it introduced Apple Pay in 2014, "Apple . . . announced a slew of partners for Apple Pay, including Subway, McDonalds, Disney, Walgreens, Macy's, Sephora, and of course, Apple's 258 retail stores. Partners like Groupon, Uber, and Pandora have also integrated Apple Pay to allow customers to pay from their apps without having to enter any payment information."[14] But now it is not just the biggest players—Uber, Groupon, Pandora, etc.—who use mobile apps that allow for payment using a stored card. Many smaller companies, namely restaurants, have opted into using mobile apps, usually third-party food ordering apps such as Uber Eats and DoorDash, in order to deliver their food and maintain a customer base.[15] However, using these third-party apps has a downside: the apps often take a percentage of the payment. For example, the fees that such third-party apps charge their restaurant clients were discussed in a recent article in the *Washington Post*, which noted a somewhat shocking example of the amount of money these apps take from restaurants:

> Diners and restaurant owners from across the country have become more aware of the issue during the [COVID-19] crisis. Giuseppe Badalamenti, owner of Chicago Pizza Boss and a restaurant consultant, posted a receipt from another

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10. Bob Musinski, *How Do Contactless Credit Cards and Payments Work?*, U.S. News & World Rep. (June 13, 2019), https://creditcards.usnews.com/articles/how-do-contactless-credit-cards-and-payments-work ("EMV chip cards, which became widespread only a few years ago in the U.S., have dramatically cut down on the amount of counterfeit credit card fraud.").

11. *Id.*

12. *Id.*

13. *Id.* ("Contactless credit cards and mobile wallets use the same near-field communication technology to interact with the EMV point-of-sale terminal.").

14. Adrianne Jeffries, *Apple Pay Allows You to Pay at the Counter with Your iPhone 6*, Verge (Sept. 9, 2014), https://www.theverge.com/2014/9/9/6084211/apple-pay-iphone-6-nfc-mobile-payment.

15. *See* Heather Kelly, *To Save Their Neighborhood Small Businesses, People Are Rebelling Against Delivery Apps*, Wash. Post (May 13, 2020), https://www.washingtonpost.com/technology/2020/05/13/small-business-third-party-apps ("These apps have proved hugely useful to many restaurants suddenly unable to host diners and switching to delivery models, as well as laid-off workers desperate for work. For companies, the apps make it easier to reach a wide audience and conduct online sales despite the pandemic, and put a staff of delivery workers at their fingertips instantly.").

> restaurant he was working with that showed seemingly exorbitant fees from Chicago-based Grubhub. What started as a $1,042.63 in food sales was reduced to $376.54 after Grubhub fees for delivery, commission, processing, and promotions.[16]

What these high fees mean for small businesses like restaurants is this: as more and more restaurant and franchise operators begin to push back on the high fees collected by third-party delivery apps, the more that these operations will see value in trying to develop and be responsible for their own apps. These third-party fees also complicate the franchisor-franchisee relationship, which typically requires the franchisee to pay royalties on gross sales to its franchisor. Franchisees have argued that these third-party apps (and associated fees) are necessary for them to survive, but they reduce the gross sales on which they must remit royalties. Franchisors, however, have argued that these fees are no different than other expenses such as credit card fees, and therefore the royalty calculation is unaffected.

B. *Digital Development: Small Business Owners Will Begin to Go Their Own Way*

The cut of the profit that third-party mobile ordering apps like Grubhub take from small business owners has started the push towards these small businesses taking matters into their own hands and creating their own apps. The COVID-19 pandemic has only expedited this transition. For example, the New *York Times* reported recently on the transition to contactless payment, and the fact that cash is no longer as convenient as it once was—especially as people fear its germ-spreading potential.[17] As the article notes, "Cash was already being edged out in many countries as urban consumers paid increasingly with apps and cards for even the smallest purchases. But the coronavirus is accelerating a shift toward a cashless future, raising new calculations for merchants and enriching the digital payments industry."[18] And, as Visa itself has noted:

> While the full impact of COVID-19 on tap to pay adoption across the world is yet to be fully seen, early indications highlight a shift in consumer spend toward every day, essential segments where contactless usage is high such as grocery and pharmacy. In the U.S., this is leading to increasing awareness and usage among consumers who are looking to limit interaction during checkout time. *Tap to pay transactions in everyday segments in the U.S. including grocery and pharmacy has grown more than 100% year over year.* 31 million Americans tapped a Visa contactless card or digital wallet in March 2020, up from 25 million in November, with overall contactless usage in the U.S. growing 150% since March 2019. The U.S. now has the most contactless cards of any market globally . . . .[19]

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16. *Id.*
17. Liz Alderman, *Our Cash-Free Future Is Getting Closer*, N.Y. Times (July 6, 2020), https://www.nytimes.com/2020/07/06/business/cashless-transactions.html.
18. *Id.*
19. *Merchants and Consumers Turn to Tap to Pay as Part of New Daily Routines*, Visa (Apr. 30, 2020), https://usa.visa.com/visa-everywhere/blog/bdp/2020/04/30/merchants-and-consumers-1588276426783.html (emphasis added).

Industry publications have also commented on the mobile payment trends in light of the COVID-19 pandemic.[20] These trends follow from the fact that physical money itself has literally become scarce during the pandemic, with some banks even providing incentives for people to bring in coins to help local businesses that need them.[21]

Although these articles recognize that the pandemic has hastened the shift to contactless and mobile payments, they do not account for the fact that the pandemic, coupled with the increasing third-party app fees, has created the perfect opportunity for smaller companies to begin venturing out on their own and creating company-specific apps with their own payment systems. What this means is that small businesses—attempting to stay financially viable during the pandemic when people are hesitant to shop indoors—are going to begin creating their own apps, which will allow them to manage orders and payments without having to pay a third-party company. In the franchise realm, franchisees will begin pushing for these types of apps, and franchisors will be pressured to develop them, or let the franchise owners work on the apps themselves. With these changes, there will be an increase in apps and all that comes with them: more and more companies and franchises will offer customer accounts, rewards programs, and loyalty benefits.[22] For example, McDonald's offers mobile ordering through its app, which detects when the customer is close to a restaurant and suggests the nearest location for pickup.[23] Outside of the food industry, companies are coping in similar ways; for example, Molly Maid, a residential cleaning service, is offering virtual scheduling and estimation.[24]

QR-code-based ordering systems have also been gaining steam amidst the pandemic. These systems allow customers to scan a QR code with their

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20. *See* Jessica Shelcusky, *How the Pandemic Solidified Contactless Payment*, Fast Casual (May 4, 2020), https://www.fastcasual.com/blogs/how-the-pandemic-solidfied-contactless-payment/ ("Here in the U.S., mobile payments are on the rise with 47% of consumers expected to be using mobile payment and digital wallets this year. Approximately half of American stores—about five million locations—accepted Apple Pay in 2018, while about four million locations took Google Pay. The number of stores accepting Apple Pay was up 50% from the year before, and up considerably from the 3% that accepted Apple Pay just five years ago.").

21. Alaa Elassar, *A Bank is Paying People to Bring in Their Spare Change to Help Local Businesses Amid the Coin Shortage*, CNN (July 22, 2020), https://www.cnn.com/2020/07/19/us/coin-shortage-banks-paying-trnd/index.html ("The coin shortage is one of the many consequences of the partial closure of the economy, which halted the flow of coins. As banks and businesses shuttered or changed the way they operate, there are now fewer coins reaching the public. Some national retailers—including Wawa and CVS—are asking customers to pay with exact change or offering programs through which customers can donate their change to charity.").

22. Such perks are very common in mobile payment apps. *See id.* ("When tightly integrated with a loyalty program, mobile payments help restaurants and retailers capture information about consumer buying habits and, consequently, develop closer digital relationships with customers. In fact, mobile payments and loyalty go hand-in-hand.").

23. McDonald's Mobile Order & Pay, https://www.mcdonalds.com/us/en-us/mobile-order-and-pay.html (last visited Aug. 10, 2020).

24. Molly Maid, *Molly Maid Pivots Amidst COVID-19 Concerns and Introduces New Contactless Services*, Franchising.com (June 30, 2020), https://www.franchising.com/news/20200701_molly_maidreg_pivots_amidst_covid19_concerns_and_i.html.

phone in order to see a menu[25] or pull up drink buttons on their phones that mimic the physical self-serve beverage stations and allow the customer to "pour" his or her own drink.[26] The developers behind the mobile app Glyde, which allows customers to look at menus on their phones and order from them as well, have lofty ambitions that demonstrate the increasing significance of these technologies and this mobile ordering and mobile payment model. According to Glyde, the app is its "vision to automate the ordering and payment process within various food establishments. In time, we want to make our app the only one you use to order food no matter where you go."[27]

This model seems like a viable way for franchisees to survive during and after the pandemic, as fears over close interactions continue. With mobile apps and mobile payments, consumers will be able to buy and interact with their favorite brands and stores while maintaining distance and limiting their exposure to the coronavirus; and they will enjoy the perks of earning points and other loyalty incentives. However, new added responsibilities will come with franchisees and other small business owners maintaining their own apps, and these responsibilities will change the way franchise agreements are structured. The next two sections of this article highlight those responsibilities, and the risks that accompany them, and discuss the coming changes to franchise agreements as a result in the future uptick in mobile payment demand.

II. The Data Security Risks of Mobile Apps and Contactless Payment Systems

In March 2020, Marriott International experienced a significant data breach of one of its internal systems, a system that kept track of guest data and that had information on guest loyalty accounts.[28] As the company noted in its release acknowledging the breach: "Hotels operated and franchised under Marriott's brands use an application to help provide services to guests

25. *See FAQ: What Is Glyde?* Glyde, https://glyde.app/faq.html (last visited Aug. 10, 2020).

26. Micah Robinson, *How Drive-Thru Restaurants Can Thrive in the Age of Social Distancing*, QSR (July 2020), https://www.qsrmagazine.com/outside-insights/how-drive-thru-restaurants-can-thrive-age-social-distancing, ("One cherished feature of quick-serves—the self-service beverage dispenser—is quickly evolving to the no-touch paradigm as well. Leading soft-drink manufacturers have enabled QR-based technology on their flagship dispensers in order to allow customers to order their favorite drinks on-demand without physically interacting with the equipment in any way. They can hold their personal smartphone camera to the dispenser's display to scan the QR code. Once scanned, it replicates the dispenser's user interface on their screen. That makes it intuitive, safe, and seamless for them to choose from the full menu of brands and flavors on offer. The dispenser does the rest, then offers a full cup of the customer's choice beverage for them to pickup.").

27. *FAQ: What Is Glyde*, *supra* note 25.

28. Taylor Lyles, *Marriott Discloses Another Security Breach That May Impact Over 5 Million Guests*, Verge (Apr. 1, 2020), https://www.theverge.com/2020/4/1/21203313/marriott-database-security-breach-5-million-guests ("Personal information such as names, birthdates, and phone numbers may have been taken in the breach, along with language preferences and loyalty account numbers.").

at hotels. At the end of February 2020, the company identified that an unexpected amount of guest information may have been accessed using the login credentials of two employees at a franchise property." This data breach of customer data is just the latest in a string of high-profile breaches in the past two decades. For example, after its massive data breach nearly two years ago, which affected the sensitive credit-related data of 143 million Americans, Equifax agreed to a large settlement with the Federal Trade Commission that saw them dedicate approximately $425 million to assist those whose data had been compromised in the breach.[29] In 2018, Minnesota-based coffee chain Caribou Coffee experienced a data breach, which did not affect its customer loyalty accounts, but did nonetheless potentially expose customer names and credit card information from 265 of its stores.[30] In 2012, Barnes & Noble experienced a similar data breach of customer data at a number of its stores.[31] And, in 2016, the restaurant chain Wendy's experienced a similar breach.[32] These breaches reveal the dangers that accompany the benefits of having easy payment methods and account information at the fingertips of consumers. When all of that data is out there, it can be easily accessed for good reasons—when it is used for the purchases that it was intended to facilitate. But it can also be accessed for bad reasons—when hackers and others get it to extract money or other reward from unwitting consumers.[33]

When franchisees and other small business owners adapt to the business disruptions brought about by COVID-19, these dangers become magnified.

29. Tara Siegel Bernard, Tiffany Hsu, Nicole Perlroth & Ron Lieber, *Equifax Says Cyberattack May Have Affected 143 Million in the U.S.*, N.Y. Times (Sept. 7, 2017), https://www.nytimes.com/2017/09/07/business/equifax-cyberattack.html ("The attack on the company represents one of the largest risks to personally sensitive information in recent years, and is the third major cybersecurity threat for the agency since 2015."); Tara Siegel Bernard, *Equifax Breach Affected 147 Million, but Most Sit out Settlement*, N.Y. Times (Jan. 22, 2020), https://www.nytimes.com/2020/01/22/business/equifax-breach-settlement.html ("Roughly two years ago, nearly half the American population had their personal information compromised by hackers in Equifax's enormous database."); *Equifax Data Breach Settlement*, Fed. Trade Comm'n (Jan. 2020), https://www.ftc.gov/enforcement/cases-proceedings/refunds/equifax-data-breach-settlement.

30. Martin Moylan, *Caribou Coffee Says Data Breach Exposed Customer Info*, MPR News (Dec. 20, 2018), https://www.mprnews.org/story/2018/12/20/caribou-coffee-says-data-breach-exposed-customer-info.

31. Michael S. Schmidt & Nicole Perlroth, *Credit Card Data Breach at Barnes & Noble Stores*, N.Y. Times (Oct. 23, 2012), https://www.nytimes.com/2012/10/24/business/hackers-get-credit-data-at-barnes-noble.html, ("Hackers have stolen credit card information for customers who shopped as recently as last month at 63 Barnes & Noble stores across the country . . . .").

32. Dave Lee, *Food Chain Wendy's Hit by Massive Hack*, BBC (July 8, 2016), https://www.bbc.com/news/technology-36742599.

33. *See* David B. Ramsey, *Data Security: Evolving Legal Duties and Challenges for Franchise Systems*, 20 J. Internet L. 3, 7 (2016) ("In today's networked world, a signature aspect of contemporary franchising is that the franchisor often will impose certain requirements for types of computer systems or software that franchisees must use for certain purposes in their businesses. The purpose of imposing uniformity of such systems or software is to protect the brand and achieve efficiency and uniformity throughout the franchise system. Uniformity is something that franchise systems strive for, naturally, as part of having a strong, identifiable brand. However, with the uniformity in franchise systems comes the danger of responsibility on the part of the franchisor should a problem arise with regard to those computer systems, software programs or practices that it mandates.").

Franchisees and other business owners will, now and in the future, turn to these mobile payment platforms—mobile apps, rewards and loyalty programs, contactless payment, etc.—to keep business alive as consumers will be wary about in-store and in-person interactions for years to come since the pandemic, and the fear that accompanies it, show little signs of abating.[34] As the *Wall Street Journal* noted recently, "Executives who were bracing for a months-long disruption are now thinking in terms of years. Their job has changed from riding it out to reinventing. Roles once thought core are now an extravagance. [35] Strategies set in the spring are obsolete."[36] As these business owners and franchisees turn towards these mobile ordering and payment systems, they will have an increasing amount of customer data to handle and protect. In their haste to survive the pandemic, these companies could potentially overlook the serious risks that are associated with handling so much data—risks that are evident in the myriad of data breaches over the last two decades, only a few of which were mentioned above.

Recent articles and scholarship on data security risks summarize the dangers well. For instance, since the entire franchise system is, in its simplest form, a party (the franchisor) allowing other parties (franchisees) to use its trademarked and proprietary methods and material, if a franchisee were to suffer a security breach, the franchisor—and the brand as a whole—could be negatively impacted, even if the security breach had nothing to do with the franchisor and was entirely the doing of one franchisee in the system.[37]

34. *See*, *e.g.*, Chip Cutter & Doug Cameron, *U.S. Companies Lose Hope for Quick Rebound from Covid-19*, Wall St. J. (July 19, 2020), https://www.wsj.com/articles/u-s-companies-lose-hope-for-quick-rebound-from-covid-19-11595151000?mod=hp_lead_pos1 ("The fierce resurgence of Covid-19 cases and related business shutdowns are dashing hopes of a quick recovery, prompting businesses from airlines to restaurant chains to again shift their strategies and staffing or ramp up previous plans to do so. They are turning furloughs into permanent layoff, de-emphasizing their core businesses and downsizing production indefinitely."); Jan Hoffman, *Mistrust of a Coronavirus Vaccine Could Imperil Widespread Immunity*, N.Y. Times (July 18, 2020), https://www.nytimes.com/2020/07/18/health/coronavirus-anti-vaccine.html, ("A growing number of polls find so many people saying they would not get a coronavirus vaccine that its potential to shut down the pandemic could be in jeopardy.").

35. Cutter & Cameron, *supra* note 34.

36. *Id.*

37. Ramsey, *supra* note 33 ("For franchisors, the cost to reputation can be particularly grave. That is because franchisors' most essential assets are their brands, and the goodwill engendered thereby . . . a breach at the franchisee level, having little or nothing to do with actions by the franchisor, may cause immense harm to the reputation of the entire brand in the eyes of the public, and can have an immediate and drastic impact on the entire franchise system."); Morgan Ben-David, *Managing Catastrophic Risks in Franchise Systems*, 38 Franchise L.J. 207, 212–13 (2018) ("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. Information collected also includes private data on franchisees and employees. Therefore, when a franchise falls victim to a 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 their 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.").

These risks are particularly prone to happen in franchise systems that have smaller, less financially stable franchisees:

> Especially vulnerable are small- and mid-sized franchised businesses. Many of these small- and mid-sized businesses are not large enough on their own, or knowledgeable enough about basic data security practices, to have and to implement sophisticated data security defenses. The technology networks that franchisors use to collect and transmit business data (e.g., sales tracking, royalty payments, customer credit card information) are only as secure as their "weakest link," and the computer systems of franchisors often are linked to the systems of their franchisees. Thus, a single franchisee that has not invested the time or money necessary to ensure its computer systems are protected, can compromise a whole franchise system.[38]

And these smaller franchisees are the ones most likely to quickly adopt mobile apps, contactless payment systems, and other measures to survive the pandemic.[39] In other words, the parties who were already the most vulnerable to data and security breaches prior to the pandemic are the ones who are likely to be even more at risk as the need to survive financially necessitates rapid development of tools that allow for remote customer and consumer interaction. So how will franchisors and franchisees respond to this inevitable shift towards mobile payments and mobile ordering systems? The next section of this article will provide some guidance on what franchisors can expect in the future as the business disruptions from COVID-19 continue.

III. How the Franchise System Will Respond to the Increase in Mobile Ordering, Mobile Payment, and Other Mobile-Based Infrastructure

As previously stated, the heart of the franchise system is the licensing of intellectual property by the franchisor to the franchisee. The franchisee is licensed to use the franchise trademarks, branding, merchandise, advertisements, and other products to open a franchise location. This license allows the franchise business to grow quickly and with little financial involvement by the franchisor because the franchisee remains, essentially, its own small business. In this regard, the franchise agreement has always been the fundamental contract that protects the intellectual property of the franchise. Since the franchise agreement is so fundamental to the franchise system, it is a fitting place to include added protections for both the franchisor and the franchisee as the disruptions from COVID-19 force many franchisees to wrestle with the lack of in-person contact that used to be so essential for business.

Franchise agreements may utilize three key ways to address the risks associated with mobile payment systems and apps and their increased use during and after the pandemic. First, the franchise agreement can demand

38. Ramsey, *supra* note 33.

39. *See* Amy Haimerl, *Staying Nimble: How Small Business Can, and Do, Shift Gears*, N.Y. Times (Apr. 23, 2020), https://www.nytimes.com/2020/04/23/business/coronavirus-small-businesses-adapt.html.

cybersecurity insurance and put forth who, the franchisor or the franchisee, owns the customer data generated by all of the digital interaction of apps and online ordering. Second, the agreement can require that the infrastructure that makes mobile payments and ordering possible be up-to-date. This requirement could, importantly, mean that franchisors might need to raise, or require for the first time, a franchise-technology fee owed by the franchisee to update and maintain this infrastructure. Finally, the agreement should include an "invention" clause, so the franchisor can benefit from the innovations that its franchisees might develop in response to the pandemic.[40]

A. *Mandating Cybersecurity Insurance in the Franchise Agreement*

Cybersecurity insurance protects against various risks associated with maintaining a digital presence in the business world, and, as indicated earlier, those risks are significant. Succinctly, this type of insurance can be described in this manner:

> Cybersecurity insurance is designed to mitigate losses from a variety of cyber incidents, including data breaches, business interruption, and network damage. A robust cybersecurity market could help reduce the number of successful cyberattacks by: (1) promoting the adoption of preventative measures in return for more coverage; and (2) encouraging the implementation of best practices by basing premiums on an insured's level of self-protection.[41]

Franchisors should consider two important aspects in mandating cybersecurity insurance in their franchise agreements. First, and perhaps most importantly, the insurance should include coverage for business-continuity issues that might arise by a network outage. As more and more systems go online amidst the pandemic, having insurance for when one of these online systems goes down is important to maintaining revenue. No business wants to have to shut down and lose money because of a system outage. But it does happen, and having insurance can relieve some of those losses. Second, as businesses move to more electronic business models, cybersecurity insurance policies should address the crime and fraud risks of an all-digital environment. Closely related to this point is the necessity for any cybersecurity insurance policy to protect against the loss of personal or financial information stored in these digital systems.

The key benefit to mandating cybersecurity insurance in the franchise agreement is the possibility, reflected in the definition above, that requiring it would lead to franchisees adopting preventative measures on their

40. *See* Michael Gray, *Revisiting Franchise Agreements in Light of Covid-19*, Law360 (Apr. 2, 2020), https://www.law360.com/articles/1258162/revisiting-franchise-agreements-in-light-of-covid-19, ("Creative franchisees find a way to be successful in difficult times. Many develop unique processes, procedures, products and methods to overcome adversity and stay in business. No doubt, countless franchisees are developing ways to keep their businesses operating despite the challenges presented by COVID-19. Some of these methods of operation could become the 'new norm' in the future.").

41. *Cybersecurity Insurance*, Cybersecurity & Infrastructure Sec. Agency (June 22, 2015), https://www.cisa.gov/cybersecurity-insurance.

own to reduce premiums. Just as car insurance companies offer discounts for safe driving—and often can directly monitor one's driving—cybersecurity insurance companies could encourage lower rates by helping franchisees implement greater safety measures. These measures may include keeping employees knowledgeable about keeping their passwords private and making sure that the software is up to date.[42] By mandating cybersecurity insurance in the franchise agreement, franchisors would not only be helping limit their out-of-pocket costs, they would also be raising awareness of preventative measures that can be taken to reduce risks (and premiums). This awareness is especially important for franchisees and other businesses that are new to the mobile app and mobile ordering ecosystem—those franchisees and businesses that have had to adopt these new programs in order to survive the pandemic and the post-pandemic future.[43] Exploring and discussing these options during the franchise agreement negotiations will be a step in the right direction as franchisees and other small business owners continue to adapt their business to meet customer needs during the pandemic.[44]

B. *Insisting That Infrastructure Be Up-to-Date*

Closely related to having security measures in place to keep cybersecurity premiums as low as possible is the need to keep essential infrastructure—the physical components that keep mobile systems operating—up-to-date. This is the hardware equivalent of keeping system software on the latest version. Larger business and franchisees are probably more financially well-equipped to keep their infrastructure up to date, and any requirement can easily be supplemented by the franchisor requiring that the franchisee pay

42. *See* Dennis Nishi, *The Ins and Outs of Cybersecurity Insurance*, Wall St. J. (June 4, 2019), https://www.wsj.com/articles/the-ins-and-outs-of-cybersecurity-insurance-11559700180 ("How much network security a company has can also influence premiums. Insurance companies will often ask companies to detail what kind of security they have during the application process, such as whether employees have been trained to recognize cyber fraud or if company software is routinely updated. Insurers also want to know how frequently companies change their passwords and how much network access third-party vendors and service providers have.").

43. The pandemic has amplified the need for small businesses owners, including franchisees, to expand on their knowledge in order to keep their businesses afloat in these uncertain times. *See* Steve Nicastro, *25 Best Small-Business Apps*, Nerd Wallet (Apr. 21, 2020), https://www.nerdwallet.com/article/small-business/20-apps-small-business-owners ("Problem solver. Communicator. Financial whiz. Running a small business involves wearing a lot of hats. If you're looking to increase productivity and organization—or just make your life as an entrepreneur a little easier—a good business app might be just what you need.").

44. *See* David J. Baldwin, Jennifer Penberthy Buckley & D. Ryan Slaugh, *Insuring Against Privacy Claims Following a Data Breach*, 122 Penn. St. L. Rev. 683, 706 (2018) ("[T]here are myriad risks confronting companies relating to privacy claims that are asserted following a cybersecurity event. As with most risk, prudent businesses should seek, and in some cases may be required, to hedge against those risks through insurance coverage. These risks, however, are relatively new and are rapidly developing as a result of new technology and responsive legislation that has given rise to new liabilities. These developments have made potential damages extremely difficult to predict. Because the policies underwriting these risks are similarly new and developing, it can be difficult for companies to know what type of coverage they should employ to cover their bases.").

additional technology fees.[45] It might not be possible for a smaller franchisee to maintain infrastructure to the degree needed to keep data safe, especially if, as will probably most often be the case, that franchisee is using third-party systems to host its mobile capability (think GrubHub or the use of third-party payment terminals such as Square). However, this requirement can still be useful to have in the franchise agreement. By the franchisor insisting that system infrastructure be up-to-date, the franchisee will have reason to inquire about the security measures of the third-party systems that it uses. In other words, each party holds the other accountable in some way, even if indirectly.

C. *Future Franchise Agreements Should Include an Invention Clause*

This concept is not new: franchisors should put into their franchise agreements a clause that at least puts forth who owns what in terms of innovations or inventions that the franchisee puts in place down the road to maintain business during the pandemic.[46] Doing so would not only allow franchisors to have access to valuable customer data that is a byproduct of mobile information systems, but it would also ensure that franchisors benefit from any future innovations franchisees develop.[47] At the very least, having contract language that spells out who owns what would be beneficial, even if the financial windfall does not go to the franchisor. The clarity that such a clause would bring would limit fights and litigation in the future. The future of the pandemic is unknown—having clarity is always beneficial.

Invention clauses are not necessarily new, but, in light of COVID-19 and the increase in small businesses and franchisees having to adapt to the new normal, their presence will become more prevalent, and their wording all the more important. For example, see the following invention clause from the Rocky Mountain Chocolate Factory:

> All copyrightable works created by the Franchisee or any of its owners, officers or employees in connection with the Store shall be the sole property of the Franchisor. The Franchisee assigns all proprietary rights, including copyrights, in these works to the Franchisor without additional consideration. The Franchisee hereby assigns and will execute such additional assignments or documentation to effectuate the assignment of all intellectual property, inventions, copyrights and trade secrets developed in part or in whole in relation to the Store, during the term of this Agreement, as the Franchisor may deem necessary in order to enable it, at its expense, to apply for, prosecute and obtain copyrights, patents or other proprietary rights in the United States and in foreign countries or in order to transfer to the Franchisor all right, title, and interest in said property. *The Franchisee shall promptly disclose to the Franchisor all inventions, discoveries, improvements,*

45. *See generally* Keith Gerson, *Tech Fees by the Numbers*, Int'l Franchise Ass'n (July 18, 2019), https://www.franchise.org/franchise-information/technology/tech-fees-by-the-numbers.

46. Gray, *supra* note 40.

47. *Id.* ("If the franchise agreement does not have a provision whereby the franchisee automatically assigns these new 'inventions' to the franchisor, it may be difficult for the franchisor to adopt them and roll them out to the entire franchise system. Adding such a provision could eliminate disputes about who owns the 'invention' in the future.").

> *recipes, creations, patents, copyrights, trademarks and confidential information relating to the Store which it or any of its owners, officers or employees has made or may make solely, jointly or commonly with others and shall promptly create a written record of the same. In addition to the foregoing, the Franchisee acknowledges and agrees that any improvements or modifications, whether or not copyrightable, directly or indirectly related to the Store, shall be deemed to be a part of the Licensed Methods and shall inure to the benefit of the Franchisor.*[48]

The italicized language of this example provides a good starting point for how franchisors might phrase invention clauses in light of innovations developed by franchisees to respond to COVID-19. The increased use of mobile technologies by franchisees is likely just the beginning; expect more innovations from franchisees in the future as businesses are forced to confront the lingering presence of the pandemic.

IV. Conclusion

The COVID-19 pandemic has created shockwaves that have spread throughout the entire U.S. economy. No one, and no business, have been spared from the devastating consequences of the pandemic. People are rightly wary of in-person and in-store interaction and are looking for ways to limit contact so as not to contract, or spread, the virus. Even if a vaccine becomes available, these fears will undoubtedly remain. These economic trends have forced mobile apps and mobile payments to proliferate. These technologies were already on the rise, but the pandemic has only hastened their arrival, driving the economy towards a truly cashless future—and a future where every business has a stake in the mobile app game and the loyalty points, customer accounts, and consumer data collection that comes with it. Franchise systems will have to adapt to these changes because the risks that accompany such technologies are significant. By keeping cybersecurity insurance, updating infrastructure regularly, and putting an invention clause into franchise agreements, franchisors should be well protected from the pandemic's significant business disruptions.

48. *Rocky Mountain Chocolate Factory, Inc. Franchise Agreement*, SEC, https://www.sec.gov/Archives/edgar/data/785815/000095013405013229/d26962exv10w4.htm (last visited Aug. 10, 2020).

ASC 606 and Its Impact on the Franchise Industry

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I. Introduction

Revenue is a key component of all businesses, including franchisors, and it is important that counsel to franchisors have an understanding of the potential effects that accounting changes relating to revenue recognition can have on a franchisor. An important change in the rules related to revenue recognition became effective in 2019 and 2020 due to the adoption of Accounting Standards Codification, "Revenue from Contracts with Customers" (Topic 606)[1] (ASC 606) by the Financial Accounting Standards Board[2] (FASB) on May 28, 2014.[3]

1. Fin. Acct. Standards Bd., Accounting Standards Update, Revenue from Contracts with Customers (Topic 606), No. 2014-09 (2014) [hereinafter ASC 606].

2. The FASB is a non-profit organization that determines generally accepted accounting principles (GAAP), which are principles followed in financial accounting and reporting for public, non-public, and non-profit entities. GAAP comprises a set of accounting standards and guidance that companies follow when preparing their financial statements and is intended to ensure a minimum level of consistency in the preparation of financial statements. Fin. Acct. Found., About GAAP, https://www.accountingfoundation.org/jsp/Foundation/Page/FAFBridgePage&cid=1176164538898&pf=true (last visited Aug. 12, 2020); Fin. Acct. Found., About Us, https://www.accountingfoundation.org/jsp/Foundation/Page/FAFLandingPage&cid=1175805317591 (last visited Aug. 12, 2020).

3. ASC 606 went into effect for public companies for annual reporting periods beginning after December 15, 2017 (calendar year 2018) and nonpublic companies and organizations

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For many businesses, the impact of ASC 606 has been minimal; however, for the franchising industry, the impact of the new rules is sweeping. Before ASC 606, franchisors were generally allowed to recognize initial franchise fees as revenue when a franchise opened for business under ASC 952-605.[4] In contrast, ASC 606 results in the allocation of the initial franchise fee on a straight-line basis over the term of the franchise agreement unless the franchisor demonstrates that certain pre-opening services comprise a "distinct" deliverable.[5] For most franchisors, the new standard causes some portion of the initial franchise fee to appear as a contract liability (deferred revenue) on the balance sheet, as opposed to revenue on the income statement.

ASC 606 has largely been met with confusion and concern by the franchise industry. In particular, the franchise industry has raised concerns about the varying interpretations of timing of revenue recognition under ASC 606 for initial franchise fees, and the costs of implementing ASC 606.[6] In addition, although the underlying cash flows and operations of a business are unchanged, ASC 606 could negatively impact financials and may have a considerable effect on key valuation inputs, such as earnings before interest, taxes, depreciation, and amortization (EBITDA). The deferred recognition of initial franchise fee revenue could ultimately hinder growth in the franchise segment and potentially result in business closures and job losses.[7]

On April 8, 2020, in response to these concerns and citing the coronavirus pandemic, the Financial Accounting Standards Board (FASB) announced the delayed implementation of ASC 606 for franchisors that are not public entities.[8] On July 22, 2020, the FASB stated that it intends to add a project to its technical agenda to provide franchisors with a practical expedient for the recognition of initial franchise fees that is designed to reduce the implementation costs related to applying ASC 606 to initial franchise fees, and it will accept public comment on an alternative standard for private sector franchisors.[9]

(including nonprofits), for annual reporting periods beginning after December 15, 2018 (calendar year 2019). Fin. Acct. Standards Bd., Acct. Standards Update, Revenue from Contracts with Customers (Topic 606), No. 2015-14 (2015); *see also* ASC 606, *supra* note 1, at 9–10.

4. Acct. Standards Codification, Franchisors Revenue Recognition, ASC 952-605 (superseded 2014) [hereinafter ASC 952-605].

5. ASC 606, *supra* note 1, ¶ 606-10-25-19.

6. *See* Letter from Int'l Franchise Ass'n FASB Task Force, to Susan M. Cosper, Tech. Dir., Fin. Acct. Standards Bd. (Oct. 22, 2018), www.franchise.org/sites/default/fi les/2020-02/IFA_letter_to_Sue_Cosper_re_ASC_606_-_10-22-18.pdf.

7. See Letter from Nydia M. Velazquez, Chairwoman U.S. House of Representatives Committee on Small Business, to William D. Duhnke III, Chairman Public Company Accounting Oversight Board (Feb. 11, 2020), https://www.franchise.org/letter-to-chairman-duhnke-iii-re-requesting-information-re-enforcement-of-accounting-standards.

8. *See* Ken Tysiac, *FASB Effective Date Delay Proposals to Include Private Company Lease Accounting*, J. Acct. (July 9, 2020), https://www.journalofaccountancy.com/news/2020/apr/fasb-proposes-effective-date-delays-revenue-recognition-lease-accounting-for-certain-entities-coronavirus-pandemic.html.

9. Fin. Acct. Standards Bd., Tentative Board Decisions: Wednesday July 22, 2020 FASB Board Meeting, https://www.fasb.org/cs/ContentServer?c=FASBContent_C&cid=1176174930217&d=&pagename=FASB%2FFASBContent_C%2FActionAlertPage (last visited Aug. 12, 2020).

Part II of this article provides a detailed explanation of revenue recognition rules for three major types of revenue streams for franchisors, including initial franchise fees, royalties, and advertising fund contributions, both before and after the implementation of ASC 606. Specific examples illustrating the impact of ASC 606 on a franchisor's balance sheet, income statement, and cash flows statement and common valuations are provided in Part III. In addition, Part IV provides an overview of the impact of ASC 606 on the franchising industry, including a discussion of the benefits and disadvantages associated with ASC 606 according to CPAs, CFOs and other franchisor executives. Finally, Part V discusses additional changes to the revenue guidance for franchisors that are likely on the horizon.

II. Revenue Recognition Rules for Franchisors Before and After the Adoption of ASC 606

A. *Before ASC 606*

1. General Revenue Recognition Rules Under ASC 605

The FASB's former rules associated with revenue recognition are included within Revenue Recognition (Topic 605) (ASC 605).[10] ASC 605 provided that, to recognize revenue, revenue must be both "realized" (or "realizable") and "earned."

(a) *Realized/Realizable Revenue.* Revenue is "realized" when products (goods or services), merchandise, or other assets are exchanged for cash (or a claim to cash). Revenue is "realizable" when related assets received or held are readily convertible to known amounts of cash (or a claim to cash).[11]

(b) *Earned Revenue.* Revenue is "earned" when the entity has substantially accomplished what it must do (i.e., the entity's "revenue-generating activities") to be entitled to the benefits represented by the revenues. An entity's "revenue-earning activities" include delivering or producing goods, rendering services, or other activities that constitute its ongoing major or central operations.[12]

2. Franchisor-Specific Guidance Under ASC 952-605

In addition to ASC 605, the FASB provided industry-specific guidance for certain types of franchisor-specific revenue under ASC 952-605. Among other areas, ASC 952-605 specifically addressed revenue recognition associated with initial franchise fees, royalties, and advertising fees.[13]

(a) *Initial franchise fees*. ASC 952-605-25 permitted the recognition of initial franchise fees when all material services or conditions relating to the

10. Fin. Acct. Standards Bd., Fin. Acct. Standards Update, Revenue Recognition (Topic 605), No. 2009-13 (2009) [hereinafter ASC 605].

11. Fin. Acct. Standards Bd. Recognition and Measurement in Fin. Statements of Bus. Enters., Statement of Financial Accounting Concepts No. 5, ¶ 83(a) (1984).

12. *Id.* ¶ 83(b).

13. ASC 952-605, *supra* note 4.

sale were "substantially performed."[14] Substantial performance by a franchisor was deemed to have occurred when the franchisor had no remaining obligation or intent—by agreement, trade practice, or law—to refund any cash received or forgive any unpaid notes or receivables, and substantially all of the initial services of the franchisor required by the franchise agreement had been performed. ASC 952-605-25-2 added that the commencement of operations by the franchisee was presumed to be the earliest point at which substantial performance has occurred, unless it was demonstrated that substantial performance of all obligations, including services rendered voluntarily, had occurred before that time.[15]

In short, once a franchisee "opened its doors" or otherwise began operations, the franchisor had met substantial performance requirements and could, therefore, recognize initial franchise fees as revenue.[16] The guidance under 952-605 provided a simple and clear method to determine revenue recognition related to initial franchise fees.

(b) *Continuing franchise fees*. The Accounting Standards Codification defines "continuing franchise fees" as "[c]onsideration for the continuing rights granted by the franchise agreement and for general or specific services during its life."[17] The FASB provided that continuing franchise fees must be reported as revenue as the fees were earned and became receivable from the franchisee under ASC 952-605-25-12.[18] It is generally accepted that royalties and advertising fees meet the definition of "continuing franchise fees."

Under this guidance, some franchisors recognized these royalties on a "lag basis." This option means they recognized royalties as revenue in the period subsequent to when the sales occur at the franchisee level. The reason for this delay is due to the lack of available information at the end of the reporting period. Other franchisors recognize the revenue associated with the royalties in the month in which the sales occur at the franchisee level.

ASC 952-605-25-13 provided an important caveat for fees required to be segregated and used for a specified purpose that often applied to determine revenue recognition for advertising fund contributions. The recognition of advertising fund contributions largely turned on whether the franchisor was merely arranging the activities to occur (i.e., the franchisor was acting as an "agent" with respect to the fund) or was itself conducting the activities (i.e., the franchisor was acting as a "principal" with respect to the fund). Under this guidance, if the franchisor was acting as an agent, advertising

14. *Id.* ¶ 952-605-25-1.

15. If the franchise agreement did not require the franchisor to perform initial services, but a practice of voluntarily rendering initial services existed or was likely to exist because of business or regulatory circumstances, substantial performance could not be assumed until either the initial services had been substantially performed or reasonable assurance existed that the services will not be performed. Further, no material conditions or obligations related to the determination of substantial performance could exist. *Id.* ¶ 952-605-25-3.

16. *Id.*

17. *Id.* § 952-605-20 (glossary).

18. *Id.* ¶ 952-605-25-12.

fund contributions were recorded as a liability against which the specified costs were charged. If there was a surplus of fees collected for purposes of an advertising fund, then the franchisor was required to carry that surplus as a liability on its balance sheet. In addition, if expenditures from the fund were in excess of advertising fund contributions collected, this amount was reflected as advertising expense in the income statement of the franchisor. If, however, the franchisor was acting as a principal and itself conducting the advertising activities, revenues were recognized once the funds were earned and receivable, similar to royalties.[19]

B. *Revenue Recognition After ASC 606*

1. General

ASC 606 broadly impacts all businesses that enter into contracts with customers to transfer goods or services and replaces hundreds of industry-specific revenue recognition rules with a single comprehensive "principle-based" framework.[20] ASC 606 was the result of a joint project of the FASB and the International Accounting Standards Board to clarify principles of revenue recognition and develop a common revenue standard, and it arose from a concern that the industry-specific U.S. rules resulted in varying recognition for economically similar transactions making comparisons across industries (and internationally) difficult.[21] The goal in developing new revenue recognition rules was to establish a principle-based revenue-recognition model that would apply across different industries that would improve consistency in financial reporting.[22]

The FASB stated that the new guidance:

- Removes inconsistencies and weaknesses in existing revenue requirements.
- Provides a more robust framework for addressing revenue issues.
- Improves comparability of revenue recognition practices across entities, industries, jurisdictions, and capital markets.
- Provides more useful information to users of financial statements through improved disclosure requirements.
- Simplifies the preparation of financial statements by reducing the number of requirements to which an organization must refer.[23]

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19. *Id.* ¶ 952-605-25-13.
20. ASC 606, *supra* note 1, at 1.
21. *Id.*
22. *Id.* The FASB noted the problems associated with inconsistencies between U.S. revenue-recognition standards and the International Financial Reporting Standards. The FASB stated that "U.S. GAAP comprised broad revenue recognition concepts together with numerous revenue requirements for particular industries or transactions, which sometimes resulted in different accounting for economically similar transactions. In contrast, IFRS provided limited guidance and, consequently . . . could be difficult to apply to complex transactions." *Id.*
23. *Id.*

ASC 606-10-65-1d provides transition requirements that allow either full retrospective application of all periods presented in the financial statements or a modified retrospective application where, on the date of implementation, a cumulative effect of implementation is reflected in the financial statements.[24]

The underlying premise of ASC 606 is to "recognize revenue to depict the transfer of promised goods or services to customers in an amount that reflects the consideration to which the entity expects to be entitled in exchange for those goods or services."[25] ASC 606-10-05-4 provides a five-step process for applying this principle to revenue received under customer contracts:

> **Step 1: Identify the contract(s) with a customer**
>
> A contract is an agreement between two or more parties that creates enforceable rights and obligations. The guidance in [ASC 606] applies to each contract that has been agreed upon with a customer and meets specified criteria. In some cases, [ASC 606] requires an entity to combine contracts and account for them as one contract. [ASC 606] also provides requirements for the accounting for contract modifications.
>
> **Step 2: Identify the performance obligations in the contract**
>
> A contract includes promises to transfer goods or services to a customer. If those goods or services are distinct, the promises are performance obligations and are accounted for separately. A good or service is distinct if the customer can benefit from the good or service on its own or together with other resources that are readily available to the customer and if the entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract.
>
> **Step 3: Determine the transaction price**
>
> The transaction price is the amount of consideration in a contract to which an entity expects to be entitled in exchange for transferring promised goods or services to a customer. The transaction price can be a fixed amount of customer consideration, but it may sometimes include variable consideration or consideration in a form other than cash. The transaction price also is adjusted for the effects of the time value of money if the contract includes a significant financing component and for any consideration payable to the customer. If the consideration is variable, an entity estimates the amount of consideration to which it will be entitled in exchange for the promised goods or services. The estimated amount of variable consideration will be included in the transaction price only to the extent that it is probable that a significant reversal in the amount of cumulative revenue recognized will not occur when the uncertainty associated with the variable consideration is subsequently resolved.

24. *Id.* ¶ 606-10-65-1d.
25. *Id.* at 2.

> **Step 4: Allocate the transaction price to the performance obligations in the contract**
>
> An entity typically allocates the transaction price to each performance obligation on the basis of the relative stand-alone selling prices of each distinct good or service promised in the contract. If a stand-alone selling price is not observable, an entity estimates it. Sometimes, the transaction price includes a discount or a variable amount of consideration that relates entirely to a part of the contract. The requirements specify when an entity allocates the discount or variable consideration to one or more, but not all, performance obligations (or distinct goods or services) in the contract.
>
> **Step 5: Recognize revenue when (or as) the entity satisfies a performance obligation**
>
> An entity recognizes revenue when (or as) it satisfies a performance obligation by transferring a promised good or service to a customer (which is when the customer obtains control of that good or service). The amount of revenue recognized is the amount allocated to the satisfied performance obligation. A performance obligation may be satisfied at a specific point in time (typically for promises to transfer goods to a customer) or over time (typically for promises to transfer services to a customer). For performance obligations satisfied over time, an entity recognizes revenue over time by selecting an appropriate method for measuring the entity's progress toward complete satisfaction of that performance obligation.[26]

2. ASC 606's Application to Franchisor Revenue

First, and foremost, ASC 606 requires that a franchisor identify its major revenue streams. These revenue streams are identified based on review of the franchise agreement, which is the contract governing business between the franchisor and franchisee. Although this list is not all-inclusive and revenue streams will vary among franchisors, the most common significant revenue streams for franchisors are initial franchise fees, royalties, and advertising fees. The application of ASC 606 for each of these franchisor-specific revenue streams is described below.

(a) Initial franchise fee revenue. *For revenues associated with initial franchise fees:*

Step 1—Identifying the Contract: The contract utilized in assessing the revenue recognition process will be the franchise agreement. The franchise agreement provides the background information about the responsibilities of the franchisor and franchisee that is necessary to move forward with Steps 2 through 5.

Step 2—Identifying the performance obligations in the contract: Step 2 requires significant analysis, and it is best practice to conduct interviews with executives involved with management and other department heads within

26. *Id.* ¶ 606-10-05-4.

the franchisor to properly identify the goods and services that are delivered to the franchisee under the franchise agreement. Generally speaking, however, the performance obligation in a franchise agreement is primarily the franchise right that transfers over time, and, therefore, revenue from the initial franchise fee must be recognized over the life of the contract. But if any of the initial services that it provides to the franchisee are sufficiently "distinct" from the franchise right, they may be deemed separate performance obligations under ASC 606. If so, then a franchisor may be able to recognize a portion of the initial fee attributable to those services when those services are performed for or, in the case of goods, when those goods are provided to the franchisee.

Under ASC 606-10-25-19, a good or service that is promised to a customer is "distinct" if both of the following criteria are met:

> (1) The customer can benefit from the good or service either on its own or together with other resources that are readily available to the customer (that is, the good or service is capable of being distinct); and
>
> (2) The entity's promise to transfer the good or service to the customer is separately identifiable from other promises in the contract (i.e., the promise to transfer the good or service is distinct within the context of the contract).[27]

As noted above, typically the primary obligation under a franchise agreement is the grant of the license to use the franchisor's intellectual property. Other common performance obligations include training, market research and site selection, and the sale of equipment. Each of these performance obligations are analyzed below.

- *Training.* A franchisor must determine whether specific portions of the training are distinct from the franchise right, and from which the franchisee can benefit from in a general business context. Franchisors typically provide business training on operational and administrative matters, in addition to training on proprietary and brand-specific aspects of the system. Generalized training on topics such as accounting, recordkeeping, banking, payroll, and purchasing procedures may be performance obligations that can be considered separate from the franchise. Training on brand standards and franchisor-specific operating processes are unlikely to be considered a distinct performance obligation. Training on customized computer technology and food-preparation methods, for example, are probably not distinct, and, therefore, the value of the training (under Step 3) would be combined with the value of the intellectual property license granted to the franchisee for the purpose of recognizing revenue under ASC 606.
- *Market Research and Site Selection.* Site selection services might include market analysis and the review and assistance in the negotiation of a lease. These services are valuable services to many business owners, and

27. *Id.* ¶ 606-10-25-19.

a franchisor may conclude that these services are not specific to the brand. If so, under ASC 606, the transaction price (under Step 3) can be recognized when the site selection services are completed.

- *Equipment.* The franchisor's promise to provide start-up equipment is a performance obligation that is identifiable from other promises in the contract. If the equipment is able to be used in other businesses, a franchisor may reasonably conclude that the equipment is another performance obligation that is distinct from the franchise right. If the nature of the equipment is specific to the franchisor (e.g., signage, menu boards, or other branded or proprietary items) such that the franchisee cannot benefit from the equipment on its own, then the equipment value would be combined with the value of the intellectual property license granted to the franchisee for the purpose of recognizing revenue.

Step 3—Determining the transaction price: Transaction price will vary based on the pricing structure of the franchise. In many cases, it is a flat fee; in others, it will vary based on territory in which the franchisee will service its customers. Transaction price will be specifically identified within the franchise agreement.

Step 4—Allocate the transaction price: Management is responsible for assigning values associated with the performance obligations of the franchisor based on the relative fair values of those performance obligations. In many cases, this assignment involves a complicated analysis depending upon the sophistication of the franchisor and market data that is available to the franchisor. Determining some values will be more straight-forward than others. To determine values for the performance obligations noted above, a franchisor might take the following steps:

- *Training*—If the franchisor charges a standard rate for subsequent training of franchisees within their franchise agreement, it will use that same rate to determine the value of the training provided. If there is no predetermined value, then the franchisor may need to do market research to assess the value associated with the training. Some franchisors look at the costs charged by local colleges for educating students to determine an average hourly value for training costs. Others may look at the cost of specialized seminars covering similar topics.
- *Market Research and Site Selection*—A good resource for this information might be local consultants that perform similar services to determine hourly rates, fees, etc. This research will help the franchisor in determining the price associated with performing the service for the franchisee.
- *Equipment costs*—The value of the equipment would be the cost of the equipment to the franchisor, plus a reasonable mark-up.

Step 5—Recognize revenue when (or as) the entity satisfies a performance obligation: Following the allocation of the transaction price, the franchisor will recognize the revenue as it fulfills its obligations. If the values assigned to the distinct performance obligations included within the initial franchise fee exceeds the value of the initial franchise fee itself, then the franchisor will recognize 100% of that initial franchise fee upon fulfilling the performance obligations. If the values assigned to the distinct performance obligations included within the initial franchise fees are less than the value of the initial franchise fee, the remaining amount of revenues is recognized ratably over the life of the franchise agreement.

For the performance obligations identified above, let's consider the two scenarios:

	Scenario A	Scenario B
Initial Franchise Fee	$ 35,000	$ 100,000
Training	(10,000)	(10,000)
Marketing Research and Site Selection	(20,000)	(20,000)
Equipment Costs	(5,000)	(5,000)
Fee to Recognize Over Life of Franchise Agreement	$ -	$ 65,000

In Scenario A, the franchisor is in a situation where the value of the performance obligations equals the value of the initial franchise fee charged. Accordingly, there is no fee to recognize over the life of the franchise agreement.

In Scenario B, the initial franchise fees are less than the value of the performance obligations of the franchise agreement. In Scenario B, if we were to assume that all performance obligations were fulfilled by the franchisor on the last day of its fiscal year end, the franchisor would recognize $35,000 for the training, market research and site selection, and equipment costs, and the remaining $65,000 would remain on the balance sheet as a contract liability (deferred revenue) and recognized ratably over the life of the franchise agreement.

As mentioned previously, financial-statement preparers are required to apply retrospectively this guidance to all contracts that are in place on the date of implementation. Accordingly, financial-statement preparers must analyze the cumulative impact of this change with respect contracts that can be many years old, depending on how long the franchise system has been operating. This retrospective application can result in a significant reduction

in equity to create a contract liability to defer revenues that were previously recognized. This delay is another reason that this new revenue recognition model creates a new dynamic in financial reporting for franchisors. The impact of these changes on franchisors' financial statements will be later discussed in greater detail.

(b) *Royalties.* When analyzing sales-based royalties and applying the five steps above, the governing contract is the same as that for the initial franchise fee—the franchise agreement (Step 1). The performance obligation associated with the franchise agreement is the license conveyed to operate a franchise business (Step 2). To complete Steps 3 to 5 under ASC 606, the financial-statement preparer must determine the amount of royalties that would be received over the term of the franchise agreement without a significant reversal. Although royalty revenue recognition under ASC 606 is similar to ASC 605, one of the major changes under ASC 606 is that recording royalty revenues on a lag basis is no longer permitted.[28] The variable nature of sales-based royalties resulted in in special guidance for sales-based royalties under ASC 606. ASC 606-10 states that an entity should recognize revenue for sales-based royalties at the later of (i) the subsequent sale, or (ii) the satisfaction of the performance obligation to which some or all of the sales-based royalty has been allocated.[29] The new guidelines require financial-statement preparers to determine an estimate of royalties earned during the accounting period if enough information is not available.

(c) *Advertising fees.* Revenues from advertising fund contributions are treated very differently under the new revenue recognition rules. In general, under ASC 606, advertising fund contributions are recognized following the same approach as sales-based royalties.[30]

As described above, under ASC 605, advertising fund contributions were recorded as a liability against which the specified costs were charged, assuming that the relationship between the franchisor and the advertising fund was an agency relationship. Under ASC 606, however, a franchisor must record advertising fund contributions as revenue. In addition, under the former rule, where an agency relationship existed, the franchisor was required to record any surplus from year to year as a deferred revenue. However, under ASC 606, any surplus will be recognized as revenue. In this way, the new guidance potentially causes the advertising fund to become a source of profit for a franchisor despite it being contractually obligated to use the fund for the benefit of the franchise system.

28. ASC 606, s*upra* note 1. As noted previously, franchisors were previously allowed to record royalty revenues on a lag basis due to lack of information available to record these revenues. *See supra* Section II.A.b.2.

29. ASC 606, *supra* note 1, ¶ 606-10-55-65.

30. Under ASC 606, advertising is typically not considered distinct and, therefore, cannot be identified as a separate performance obligation for a specific franchisee. Instead, advertising is viewed as an activity that promotes the overall franchise brand. *Id.*

3. Capitalization of Certain Costs to Obtain a Contract

In addition to analyzing the revenues associated with contracts with customers, another important change related to ASC 606 is the addition of subtopic ASC 340-40, which introduces changes relating to capitalization of certain costs of obtaining a contract with a customer.[31] Under this guidance, franchisors can identify costs that can be specifically tied to its contracts and capitalize those costs to be amortized over the life of the franchise agreement.[32] The analysis provided under ASC 340 may partially offset the impact of the revenues that must be deferred under ASC 606.

As noted within the guidance, sales commissions and broker fees that relate directly to the sale of a specific franchise can be capitalized and amortized over the period in which the costs are expected to be recovered.[33] For franchisors, this means that these costs may be amortized over the term of the franchise agreement.

As previously mentioned, the recognition of the contract asset (deferred costs) results in an offsetting impact to the equity of a franchisor once they have deferred revenues associated with contracts with customers. However, under ASC 340-40, a franchisor can only defer costs incurred on a contract to the extent that they have the associated deferred revenues. Thus, a franchisor cannot defer costs that are in excess of the revenues deferred and inflate their equity position as a result of applying the guidance under ASC 340-40.[34]

III. The Impact of ASC 606 on Franchisor Financial Statements and Valuations

A. *Example of ASC 606's Impact on a Franchisor's Balance Sheet, Income Statement, and Cash Flows Statement*

A franchisor's balance sheet, income statement, and cash flows statement are routinely analyzed by financial institutions, investors, state regulators, and other readers of financial statements interested in determining the financial strength and profitability of a franchisor. Below is an example based on the franchisor described in Scenario B above that has been prepared to illustrate the impact of ASC 606 on these financial statements.

For this example, we'll assume the franchisor from Scenario B sold four franchises with an initial franchise fee of $100,000 (4 × $100,000 = $400,000) during the year, fulfilled all obligations related to training, market research, site selection, incurred equipment costs with stand-alone selling prices totaling $35,000 (4 × $35,000 = $140,000) by the last day of the franchisor's fiscal

31. *Id.* at 141.
32. *Id.* ¶ 340-40-25.
33. *Id.* ¶ 340-40-55-3.
34. *Id.* ¶ 340-40-55-9.

year, and paid a broker fee on each sale of $5,000 (4 × $5,000 = $20,000). Each franchise agreement has a ten-year term, and, for simplicity, performance obligations are considered fulfilled on the last day of the entity's fiscal year.

We'll also assume the entity collects a percentage of franchisees' sales as an advertising fund contribution as required by the franchise agreement.

Below is the balance sheet and income statement of the franchisor from Scenario B, reflecting the impact of the above assumptions both before ASC 606 and after ASC 606.

BALANCE SHEET

	Before 606	After 606
Assets:		
Cash	$ 400,000	$ 400,000
Royalties Recievable	80,000	80,000
Franchise Fees Recievable	100,000	100,000
Advertising Fund Fees Recievable	5,000	5,000
Deferred commissions (3)	-	2,000
Total Current Assets	585,000	587,000
Deferred commissions (3)	-	18,000
Total Assets	$ 585,000	$605,000
Liabilities and Equity:		
Accounts Payable	$ 60,000	$ 60,000
Deferred Franchise Fees (1)	-	26,000
Advertising Fund Liability (2)	10,000	-
Total Current Liabilites	70,000	85,000
Deferred Franchise Fees (1)	-	234,000
Total Liabilites	70,000	320,000
Equity	515,000	285,000
Total Liabilites and Equity	$ 585,000	$ 605,000

INCOME STATEMENT

	Before 606	After 606
Revenues:		
Royalties	$ 500,000	$ 500,000
Franchise Fees (1)	400,000	140,000
Advertising Fund Fees (2)	-	80,000
Total Revenues	900,000	720,000
Expenses:		
Initial Franchise Costs	140,000	140,000
Commissions (3)	20,000	-
Advertising Fund (2)	-	70,000
Other Operating Expenses	500,000	500,000
Total Expenses	660,000	710,000
Net Income	$ 240,000	$ 10,000

As noted above, the effect of adopting ASC 606 resulted in a decrease in total net income of $230,000. The driving factors of this change are (1) the deferral of a portion of the initial franchise fee that will be recognized over the franchise agreement term which decreased revenues by $260,000; (2) the required recognition of all advertising fees and expenditures resulting in a net increase of $10,000 to net income; and (3) the deferral of commission expenses, which will be recognized over the franchise agreement term that decreased expenses by $20,000.

From a balance sheet perspective, total assets have increased by $20,000 as a direct result of the deferral of commissions expense. Liabilities have increased by a net amount of $250,000 due to (1) the recording of deferred franchise fees of $260,000, and (2) the elimination of the previously recorded advertising fund agency liability of $10,000 as all advertising fund activity is now required to be presented as part of normal operations.

However, ASC 606 can have a significant impact on the results of operations, assets, and liabilities of an entity; as noted below, this standard has no bearing on an entity's ultimate cash flow, as illustrated in the excerpt from the statement of cash flows based on the Scenario B.

CASH FLOW FROM OPERATIONS

	Before 606	After 606
Net Income	$ 240,000	$ 10,000
Changes in Assets and Liabilities:		
Royalties Recievable	(80,000)	(80,000)
Franchise Fees Recievable	(100,000)	(100,000)
Advertising Fund Fees Recievable	(5,000)	(5,000)
Deferred commissions (3)	-	(20,000)
Accounts Payable	60,000	60,000
Deferred Franchise Fees (1)	-	260,000
Advertising Fund Liability (2)	10,000	-
	$ 125,000	$125,000

Based on this example, the negative consequences of ASC 606 are apparent. Under ASC 606, a franchisor's total net income may decrease while liabilities increase. However, here, ASC 606 has no impact on cash flow. Therefore, under ASC 606, assessing cash flows from operations becomes an even more important benchmark to determining the financial strength and profitability of a franchisor, particularly with respect to newer systems. Franchise companies with strong growth in cash flow from operations most likely have more stable net income, and more opportunities to expand and weather downturns in the general economy or their industry.

B. *Example of ASC 606's Impact on Valuations*

Common ratios analyzed by readers of financial statements include the following, shown before and after the adoption of ASC 606, using the previous example.

(i) Net Worth = Total Assets – Total liabilities

Before 606	After 606
$515,000	$285,000

(ii) Working Capital = Total Current Assets – Total Current liabilities

Before 606	After 606
$515,000	$502,000

(iii) Current Ratio = Total Current Assets ÷ Total Current liabilities

Before 606	After 606
8.4	6.8

(iv) Return on Equity = Net Income ÷ Equity

Before 606	After 606
47%	4%

As the most substantial impact of ASC 606 is the deferral of a portion of initial fees over the franchise term creating a long-term liability, there were no drastic changes to the example entity's current assets or current liabilities as noted with minimal deviations in the entity's working capital and current ratios. However, the deferral of the initial franchise fees and related commissions resulted in a decrease in net income of approximately 96% percent and increased total liabilities of approximately 357%, thus significantly reducing total net worth and overall return on equity.

Another calculation commonly used by state regulators looks at ensuring that the total cash and cash equivalents exceed the sum of:

- Current liabilities
- Cost to establish a franchisee times the number of projected opening during the coming fiscal year
- Cost to establish a franchisee times the number of franchisees signed but not yet open as of fiscal year end

For purposes of calculating this measure, readers of the financial statements must remove the current portion of deferred revenues calculated under ASC 606 from current liabilities. Conceptually, deferred revenues are not a liability that requires a cash outflow, as much as it is the obligation to perform services to a franchisee. This obligation is already considered, in part, with the calculation above of the cost to establish a franchisee times the number of franchisees signed but not yet open as of fiscal year end.

The example above illustrates the impact to a franchisor that is relatively new. In the event that the franchisor has revenues that have been recognized in previous years that are required to be deferred due to retrospective application of ASC 606, this delay could further reduce net worth and current ratio for the franchisor and impact the amount of the deferred revenue liability on the balance sheet.

Unfortunately, financial institutions, investors, state regulators, and other readers of financial statements may not currently have a thorough understanding of how ASC 606 impacts valuation. As noted, the change in accounting standards has no impact on an entity's cash flow from operations which represents an entity's ability to generate cash from its core business activities and is an indicator of operational efficiency. The expression "cash is king" becomes especially true when evaluating a franchisor's financial position under ASC 606. Regulators and other readers of financial statements should place more importance on liquidity-based ratios and measures, with consideration for how ASC 606 has impacted the inputs.

IV. The Practical Impact of ASC 606 on the Franchising Industry

As noted previously, the FASB delayed the required implementation of ASU 606 for private company franchisors in April 2020. Because a majority of franchisors had already completed their audited financials for 2019, we had the opportunity to interview several individuals including CPAs, CFOs, and executives of franchise companies regarding the benefits and disadvantages of ASC 606, and we have gained insights into obstacles encountered by franchisors in implementing the new standard.

Most of the franchise executives with whom we spoke did not find that ASC 606 had a significant impact on their companies' financial results, although in systems having a significant number of new franchise sales, there was some impact.[35] Some executives expressed concern that the application of ASC 606 could have serious negative consequences for new franchisors that have not reached royalty self-sufficiency. Under ASC 606, a franchisor might change from being a "profitable" and growing franchisor to being an "unprofitable" but growing franchisor after application of ASC 606.[36]

A primary concern of CFOs and franchise executives involved the complexities and burdens associated with implementing ASC 606.[37] Most agreed that the implementation of ASC 606 significantly increased the workload of the franchisor's accounting team and outside auditors. Franchise agreements had to be carefully reviewed and analyzed. The accounting staff built schedules to monitor and track revenues for the identified performance obligations over the life of the franchise agreement. In addition, past contracts were reviewed and revenue under those contracts that was previously recognized was reamortized. A few executives cautioned that engaging competent accounting personnel and auditors with experience with the preparation of financial statements for franchisors was paramount under ASC 606. They cautioned that the new rules involved a new and very complex accounting language that required translation by those with significant expertise in this area.[38]

35. Telephone Interview with CFO of Commercial Cleaning Franchisor (July 21, 2020); Telephone Interview with Development Officer of Recycling Services Franchisor (July 22, 2020); Telephone Interview with CFO of Staffing Services Franchisor (July 23, 2020); Telephone Interview with General Counsel of Retail Franchisor (July 23, 2020); Telephone Interview with CEO of Restaurant Franchisor (July 24, 2020); Telephone Interview with Controller of Multi-Brand Franchisor (July 24, 2020).

36. Telephone Interview with CFO of Staffing Services Franchisor (July 23, 2020); Telephone Interview with General Counsel of Retail Franchisor (July 23, 2020); Telephone Interview with CEO of Restaurant Franchisor (July 24, 2020).

One CFO shared that she was on the Board of another smaller franchise company whose owners had decided to sell the franchise because they believed that they would not be able to attract qualified franchisees due to the franchisor's financial position as reflected in its audited financials after application of ASC 606.

37. Telephone Interview with CFO of Commercial Cleaning Franchisor (July 21, 2020); Telephone Interview with Development Officer of Recycling Services Franchisor (July 22, 2020); Telephone Interview with CEO of Restaurant Franchisor (July 24, 2020); Telephone Interview with Controller of Multi-Brand Franchisor (July 24, 2020).

38. Telephone Interview with CFO of Commercial Cleaning Franchisor (July 21, 2020); Telephone Interview with CEO of Restaurant Franchisor (July 24, 2020); Telephone Interview with Controller of Multi-Brand Franchisor (July 24, 2020).

One CFO commented that he believed that ASC 606 will result in the need to prepare and maintain two sets of books and accounting records. His company's lender had insisted that the franchisors continue provide financials that are consistent with the way that it had historically viewed the business. Going forward, he predicted that many franchisors will have "bank financial statements," which show the franchisor's financial position without application of ASC 606, and the "GAAP financial statements" that are prepared to be in compliance with ASC 606.[39]

Another CFO commented that he saw tremendous value in going through the exercise of determining all of the various performance obligations and assessing the franchisor's direct costs of fulfilling its franchisor's performance obligations. He believed that the analysis assisted the franchisor in understanding its true costs involved in assisting a franchise outlet to open and could be helpful to justify the amount of the initial franchise fee to future prospective franchisees. However, he was strongly opposed to the treatment of advertising fees under the new rules. He explained that ASC 606 might result in a gross misstatement of a franchisor's revenue position with respect to the advertising fund revenue, and potentially its profit position. Further, the ability to count an end-of-year surplus in the advertising fund in profit could result in franchisors spending less of the advertising fund to enhance profits, when the reality is that the franchisor has a contractual obligation to spend the advertising funds on behalf of the franchisees.[40]

V. What Further Changes and Provisions Are on the Horizon Associated with ASC 606 and the Franchising Industry?

Implementation of ASC 606 provides challenges for franchisors, both large and small. While attempting to implement in 2020, many franchisors were faced with the additional challenges associated with the coronavirus pandemic. In response, the FASB released ASU 2020-05, which deferred the effective date of ASC 606, specifically for franchisors, for an additional year. As a result, franchisors who have not already issued financial statements in accordance with ASC 606 are now required to implement ASC 606 for annual reporting periods beginning after December 15, 2019 (i.e., calendar year 2020).[41]

Another reason for this delayed effective date is that franchising lobbyists and other members of the franchising community have voiced their concerns regarding the cost and complexity of implementing ASC 606. The FASB met on July 22, 2020, to discuss a project to reduce the cost and complexity of implementing ASC 606. The tentative board decisions are as follows:

39. Telephone Interview with Controller of Multi-Brand Franchisor (July 24, 2020).
40. Telephone Interview with CFO of Commercial Cleaning Franchisor (July 21, 2020).
41. Fin. Acct. Standards Bd., Acct. Standards Update, Revenue from Contracts with Customers (Topic 606) and Leases (Topic 842), No. 2020-05 (2020).

1. Add a project to its technical agenda to reduce the implementation costs related to applying ASC 606 to initial franchise fees for franchisors that are not public business entities. A franchisor that is not a public business entity may elect the practical expedient to account for initial services as a single performance obligation if:
   (a) Those services are the same as those included in a pre-defined list of services.
   (b) It is probable that the continuing fee will cover the cost of the continuing services provided by the franchisor with a reasonable profit.
2. Include the practical expedient for applying ASC 606 to initial franchise fees for franchisors that are not public business entities within Topic 952, Franchisors.
3. Require an entity that elects the practical expedient to disclose that fact.[42]

The intent of these tentative decisions is to ease the impact of implementation of ASC 606 by taking opening services included in the predetermined list (such as training, site selection, equipment purchases, etc.) and bundling it as one performance obligation to track as opposed to tracking each one individually. Preparers will still have to determine a stand-alone selling price for the value of that bundled obligation, but it is the FASB's intention to ease the tracking process of fulfillment and recognition of the value of those performance obligations.[43]

The FASB issued an exposure draft in the September 2020 which includes full text regarding how this expedient is expected to be applied and how it will benefit franchisors. The FASB is providing a comment period of forty-five days through November 5, 2020. Financial statement preparers, stakeholders, and other readers of financial statements for franchisors are encouraged to review and provide a response on this expedient to assist the FASB in providing relief to the franchising community.[44]

If a franchisor chooses to apply this practical expedient, they will be allowed to apply it as part of implementation of ASC 606. If a franchisor has already implemented ASC 606, they will be allowed to do a full retrospective application of this expedient going back to the franchisor's first reporting under ASC 606.[45]

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42. *See* Wednesday July 22, 2020 FASB Board Meeting, *supra* note 9.
43. *Id.*
44. FASB Exposure Draft, Proposed Accounting Standards Update, Franchisors—Revenue from Contracts with Customers (Subtopic 952-606) 9 (Sept. 21, 2020), https://www.fasb.org/cs/Satellite?c=Document_C&cid=1176175243207&pagename=FASB%2FDocument_C%2FDocumentPage&mc_cid=80cb7abe5f&mc_eid=918b016308 (last visited Sept. 22, 2020). Comments on the exposure draft can be made at FASB, Electronic Feedback Form (comment deadline of Nov. 5, 2020), https://www.fafsurveys.org/se/4CA36E9203F111E9?mc_cid=80cb7abe5f&mc_eid=918b016308.
45. *See* Wednesday July 22, 2020 FASB Board Meeting, *supra* note 9.

VI. Conclusion

Since the release of ASU 2020-05 in April 2020, delaying the effective date of ASC 606 for non-public franchisors, the franchise industry has been hopeful that the FASB would adopt new guidance that would fundamentally change how the new revenue-recognition rules apply to franchisor revenue. Some have speculated that the delayed effective date meant that the FASB had recognized the shortcomings of ASC 606 in the context of franchising and that it would adopt industry-specific revenue recognition rules for the franchise industry, similar to the former rules. However, the July 22, 2020, FASB meeting made it clear that the FASB is not abandoning its goal of providing a single comprehensive principle-based framework for revenue recognition. Although the FASB may attempt to simplify the process for revenue recognition under the practical expedient described in Part V, it is unlikely to implement substantive changes to the revenue-recognition rules for franchisors. As a result, it appears that franchise industry and financial institutions, investors, state regulators. and other readers of financial statements will need to adapt to ASC 606. Understanding ASC 606 and its impact on the financials and the valuation of franchise companies is a good first step.

A Primer on Franchising in China

*Dominic Hui & Danny Tsui**

I. Overview

Mr. Hui

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In the early 1980s, a Chinese family would walk into an American hamburger chain restaurant, one of the first international chain restaurants to ever set its foot onto Chinese soil, dressed up in smart-casual, with their hair combed perfectly, and be impressed by the slick operation of an international franchise brand. To a local Chinese person, such an extraordinary experience was beyond imagination.

The idea of franchising migrated to China as early as 1984. The successful expansion of foreign franchise brands in China quickly inspired the community. Local brands started to adopt similar models to develop their businesses. Franchising had also reportedly given some failing local companies a renewed business vitality. As the number of franchises surged across the country in mid-1990s, the then-Ministry of Domestic Trade of the People's Republic of China (PRC) promulgated the Administrative Measures for Commercial Franchise (for Trial Implementation) in 1997. This was the first prescriptive document about commercial franchising that ever existed in China. In the mid-2000s, the business of franchising grew rapidly in China, but there was a lack of laws in place to effectively regulate franchising activities. Commercial fraud ran rampant due to the flaws of the franchising system.

In 2007, the State Council of the People's Republic of China promulgated the first comprehensive set of franchise regulations under the Regulations on the Administration of Commercial Franchises,[1] which introduced a compulsory disclosure requirement and filing system. Since then, the 2007 Regulations have played a major role in franchising under the legal system of China.

1. Regulations on the Administration of Commercial Franchises, promulgated by the State Council of the People's Republic of China, Feb. 6, 2007, May 1, 2007 [hereinafter 2007 Regulations], http://www.fdi.gov.cn/1800000121_39_3485_0_7.html.

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A. *Legal System of the People's Republic of China*

1. The hierarchy of Laws and Regulations

The National People's Congress is the highest organ of state power and legislature of China. It is vested with the power to issue national laws and to interpret those laws, if so required. Under the national laws, the State Council and its departments as well as their local offices are vested with powers to implement regulations and rules at the administrative level on various matters or areas of business that are supervised and regulated by the government. Such governmental supervision is often performed by recorded process and prescribed disclosure of material information. Meanwhile, local rules may exist on the provincial, autonomous-regional, and directly administrated municipality level. Theoretically, the national law should be construed as the universal law, which ought to be followed at all times. However, due to the generality of the national laws, one may find more practical guidance from the administrative regulations and local rules.

Interestingly, there are also National Standards issued by the Standardization Administration, authorized by the State Council. Although they do not have the force and effect of laws, they are nonetheless valuable for reference purposes.

In large part, the franchising statutes discussed in this article were promulgated as administrative regulations.

2. The Judiciary

The Judiciary of China, which consists of the Supreme People's Court in Beijing and various local courts (high courts, intermediate courts, and elementary courts), share the same feature of hierarchy. In recent years, specialized courts have been set up in different cities, and some local courts have designated judges to deal with specific areas. For example, some judges in most of the first-tier cities specialize in franchising law.

The Supreme People's Court can issue judicial interpretations, but, so far, there is no standalone judicial interpretation on franchising law, and most of the time one should refer to the general contract law. Beginning about a decade ago, the courts started to encourage judges to issue more elaborate judgments. Although China is not a common-law jurisdiction, and judicial precedents are not binding on the courts, the case law's reference value is emerging.

B. *Main Regulations*

The 2007 Regulations provide the legal backbone for the franchising sector in China by imposing the disclosure and filing requirements as well as the basic rights and obligations of franchisors and franchisees in the franchisor-franchisee relationship. Practice directions are supplemented by administrative measures such as Administrative Measures for Information Disclosure of Commercial Franchises[2] and Administrative Measures for the Record Filing

2. Promulgated by Ministry of Commerce (MOFCOM) pursuant to the 2007 Regulations and effective Apr. 1, 2012.

of Commercial Franchises.[3] Although they are administrative regulations in nature, in practice, they impose civil law obligations on franchisors.

1. Definition of *Franchising*

The 2007 Regulations define a *franchise* broadly as a contractual arrangement whereby (1) an enterprise grants other operators the right to use its operating resources, such as registered trademarks, business logos, patents, and proprietary know-how or technologies;[4] (2) such operator undertakes business operations under a uniform mode of operations in accordance with such contract, and (3) the operator pays franchise fees to the grantor for the right to run the business.

Various local courts have tried to elaborate further on the definition of *franchising*. For example, the Beijing Second Intermediate People's Court published a research report (albeit non-binding) regarding franchising disputes, which summarized the characteristics of franchising as follows:[5]

a. Franchisors own the proprietary rights in, and have control over, the franchise rights. Such rights are often substantiated by intellectual property rights, such as registered trademarks, proprietary marks, proprietary or patented technologies, trade secrets, etc.[6]

b. Franchisors will license the aforesaid rights to the franchise to franchisees. During the franchise terms, franchisors will inevitably manage and monitor the franchise business operated by the franchisees, such as requiring the franchisees to operate the franchise business by way of a specific unified mode of business. Therefore, franchise rights include the rights to license the intellectual property and manage the business.[7]

c. Franchisors have the right to receive franchise fees from franchisees.[8]

The legal definition does not restrict the type of franchise model that can be used in China. However, there is always a discussion on where to draw the line between franchising and licensing. That being said, one should always note that whether an arrangement is a franchise or license is purely a matter of fact and not a linguistic differentiation, and the elements mentioned above will be adopted to examine if a relationship is a franchising one.

3. Promulgated by MOFCOM pursuant to the 2007 Regulations and effective Feb. 1, 2012.

4. While individuals and enterprises can engage in franchising activities, only an enterprise can conduct the activities as a franchisor in a franchisor-franchisee relationship. However, such enterprise does not have to be incorporated in China.

5. Court No. 5, Second Intermediate People's Court of Beijing Municipality, Research Report Regarding Several Questions on Commercial Franchise Agreement Disputes, J. L. Application 2–3 (2010).

6. *Id.*

7. *Id.*

8. *Id.*

2. "2+1" Requirement

Franchisors must satisfy the so-called "2+1" requirement,[9] as stipulated by the 2007 Regulations, before expanding the franchise business in China. The "2+1" refers to two direct-owned stores and one year of operation of the franchise business. In other words, franchisors must own at least two stores of the franchised business and must have conducted the franchised business for at least one year.

First, the requirement has no geographical restriction. The stores can be operated, in principle, anywhere around the globe. Although in practice, when it comes to registration, it would be less cumbersome to provide the relevant proof if the stores were operating in the same country because the proof is usually issued by the national franchise association of the franchisor's home country. Second, under the current practice, the stores can be owned and operated by the affiliates of the franchisor, including the franchisor's controlled shareholders (individual or corporate), the franchisor's parent company or wholly owned subsidiaries, or subsidiaries in which the franchisor has controlling shares.

Each and every franchisor-franchisee relationship in China is subject to the "2+1" requirement. In other words, theoretically, the requirement also applies to Master Franchisees and any subfranchisors in a franchise system.[10]

3. Disclosure

Franchisors are required to provide to all prospective franchisees accurate information on certain matters as specified under the Administrative Measures for Information Disclosure of Commercial Franchises at least thirty days before entering into any franchise agreement[11] in relation to a franchise in China.[12]

The information to be disclosed includes:[13]

a. Information of the franchisor, including but not limited to corporate information, descriptions of the franchised business, and goods and services to be offered by it and/or its affiliates;[14]

b. Details of the franchisor's registered trademarks (including their respective status), business logos, patents, proprietary technology, and business model;[15]

9. *See* 2007 Regulations, *supra* note 2, art. 7. The name "2+1" is not an official term but commonly referred to by local practitioners.

10. *Id.* art. 7.

11. Although not specified in the regulations, as the franchise agreement is part of the documents to be disclosed, a school of thought suggests that if the franchise agreement is amended during the thirty-day disclosure period, the thirty-day disclosure period should restart and run from the date of the amendment. This is certainly the most cautious approach to compliance.

12. 2007 Regulations, *supra* note 2, art. 21.

13. *Id.* art. 22.

14. The information regarding the affiliate is required if the products and services of the franchise business will be offered by the affiliate of the franchisor.

15. Where the proprietary resources are owned by an affiliate, the franchisor must also disclose the details of the affiliate, the scope of license(s), and the arrangements upon termination of license(s).

c. The type, amount, and method of payment of franchise fees, including but not limited to the deposit and repayment details, if any;

d. Where the franchisor or its affiliates will supply products, services, or equipment to the franchisee, and their price and trading terms;

e. The means and plan for the provision of continuous business and operational guidance, supervision, technical support, and training to the franchisee during the term of the franchise;

f. Estimated budget of investment for franchise outlets;[16]

g. Number, geographical distribution, authorized territory (exclusive or non-exclusive), and business status of existing franchisees in China;[17]

h. Anticipated number, geographical distribution, and authorized territory (exclusive or non-exclusive) of future franchisees in China;

i. Financial statement and audited report for the franchisor's business in the preceding two years;

j. Any material non-compliance with any regulations by the franchisor and its legal representative;

k. Any bankruptcy order or petition against the franchisor or its affiliate in the preceding two years; and

l. Any claims, motions, litigation, or arbitration with respect to the franchise business in the preceding five years.

In practice, not all of the above required information may be readily accessible by start-up franchisors, and the disclosure document should be carefully drafted in such situation.

Failure to comply with the regulation's disclosure requirements will attract a fine between ¥10,000 and ¥50,000.[18] The governing authority may also request that the franchisor rectify the breach. In the case of a serious breach, the franchisor can be found liable and fined between ¥50,000 and ¥100,000, and the breach will be noted in the public record.[19]

If the franchisor discloses false information or conceals any information which frustrates the purpose of the franchise agreement, the franchisee can unilaterally terminate the agreement and claim damages.[20]

4. Filing

The 2007 Regulations require franchisors to file specific documents within fifteen days of the execution of the first franchise agreement, although

16. Start-up franchisors may find difficulty in achieving this provision. Specific information may be required.

17. "Business status" means the existing franchisees' investment amount, average sales turnover, and gross profit, among other factors.

18. Administrative Measures for Information Disclosure of Commercial Franchises art. 28 (China).

19. 2007 Regulations, *supra* note 2, art. 28.

20. Administrative Measures for Information Disclosure of Commercial Franchises, *supra* note 19, art. 9; 2007 Regulations, *supra* note 2, art. 23.

any failure to complete the process does not nullify any agreement signed.[21] The filing should be submitted to the relevant local Bureau of Commerce in the province, autonomous region, or municipality in which the franchise business will be conducted pursuant to the first franchise agreement, or to the Ministry of Commerce (MOFCOM) if the franchise business will be conducted in more than one province, autonomous region, or municipality.

Specifically, the franchisor must file the following documents:[22]

a. The basic information of the commercial franchise (e.g., business nature, field of industry, date of commencement of the franchise business, etc);

b. The distribution of all franchise stores in China (exclusive of Taiwan, Hong Kong, and Macau);

c. The marketing plan of the franchisor;

d. The business license or any other proof of corporate identity of the franchisor;

e. The registration certificate of trademarks, patents, and any other franchise operational resources;

f. Proof of compliance with the "2+1" requirement;

g. The first franchise agreement entered into between the franchisor and the franchisee in relation to the franchise in China;

h. A sample of the relevant franchise agreement;

i. The table of contents of the operations manual for the franchise business (the page number of each chapter and the total page number of the manual must be expressly stated); and

j. An undertaking signed by the authorized representative of the franchisor (undertaken to comply with the 2007 Regulations).

Of course, the governing authority has the power to request the franchisor provide additional documents.[23]

Failure to meet the filing requirements will attract a fine of between ¥10,000 and ¥50,000.[24] The governing authority will impose a deadline for the franchisor to rectify the breach; and, upon further failure, it will be liable for a fine between ¥50,000 and ¥100,000.[25] Further, the breach will be noted on public record.[26]

In the international franchising context, the filing is subject to examination by MOFCOM. This process may take months due to the immense amount of applications handled by MOFCOM as well as possible back and

21. The filing requirement was supplemented by the Administrative Measures for the Record Filing of Commercial Franchises.

22. 2007 Regulations, *supra* note 2, art. 8.

23. *Id.*

24. 2007 Regulations, *supra* note 2, art. 25.

25. *Id.*

26. *Id.*

forth following any requests for information. As a result, the fifteen-day deadline is practically very challenging. If genuine reasons exist, an explanation should be given to MOFCOM to explain any delay.

In addition, international franchisors are also required to report the following information to MOFCOM prior to March 31 each year:[27]

a. Number of new franchise agreements concluded during the preceding year;
b. Number of franchise agreements terminated during the preceding year;
c. Number of franchise agreements being carried out as of the date of report;
d. Total number of franchise stores;
e. Total sales turnover of all franchise stores;
f. Total number of direct stores (if any); and
g. Total sale turnover of all direct stores (if any).

5. Essential Contents and Compliance with Contract Law

The 2007 Regulations include a few mandatory contractual requirements, such as the franchisee's right of rescission[28] and refund of deposit in case of rescission.[29] Usually, other specific provisions relate to foreign-exchange control, withholding tax, intellectual property rights, and other practical aspects to address certain issues arising from the local regulatory environment.

Apart from the 2007 Regulations, franchise agreements are also subject to the Contract Law of the People's Republic of China (Contract Law). Under the Contract Law, franchisors and franchisees must abide by the principle of fairness in prescribing their respective rights and obligations under the contract, as well as the principle of good faith in exercising their rights and performing their contractual obligations.[30] The party not at fault can apply to the local courts to rescind the contract if such party was caused to enter into the relevant contract under unfair circumstances.[31]

The Contract Law also provides the contractual formalities requirement, which provide that an agreement is valid and legally binding if (1) there is an offer and an acceptance of the offer,[32] (2) there is consensus on the material terms of the agreement,[33] and (3) the contracting parties have the legal capacity to be bound by the agreement.[34]

27. *Id.* art. 19.
28. *Id.* art. 12.
29. *Id.* art. 16.
30. Contract Law art. 5 (China).
31. *Id.* art. 54.
32. *Id.* arts. 13, 14.
33. *Id.* art. 14.
34. *Id.* art. 9.

Franchise agreements do not have to be written in Chinese to be legally binding. The Contract Law allows the agreement to be drafted in any language and in more than one language.[35] If there is any inconsistency, the agreement will be interpreted in accordance with the purpose of the agreement in the absence of a prevailing language clause.[36]

C. *Taxation and Customs Duty*

Taxation plays a big part in the business plan in how the franchise should be structured. In China, royalties and other payments are subject to various kinds of tax, such as the value-added tax, and the withholding tax if such fees are payable to foreign franchisors. Given the tax treaty between China and the United States, the withholding tax rate is ten percent, and the value-added tax and the surcharges thereon are usually around six percent for U.S. franchisors.[37] There is judicial support of allocating the tax payment responsibility without altering the respective statutory tax liabilities of the parties in a franchise agreement,[38] and "gross up" provisions are widely used.

Chinese tax laws require service fees and other payments to be subject to withholding tax if they form the view that any such payments are designed to reduce royalties.[39] Therefore, franchisors are encouraged to carefully define the nature of each kind of payment. Meanwhile, the location of service and how the invoices are prepared are also relevant when the tax authority makes an assessment.

If products, ingredients, and/or equipment will be imported into China, there are customs duty and value-added taxes to be paid.[40] A thorough study of the customs duty and tax exposure should be conducted as it affects the profitability of both sides, especially given that the trade environment has been constantly changing in recent years. The supply chain and any local subsidiaries should also be taken into account to fully evaluate the corporate income tax and transfer pricing consequences.

D. *Competition*

The competition law in China neither specifically regulates franchise activities, nor does it have a block-exemption regulation as in European Union countries. Meanwhile, franchisors are usually advised to consider the Anti-Monopoly Law of the People's Republic of China (Anti-Monopoly

35. *Id.* art. 125.
36. *Id.*
37. For example, the rate of VAT and surcharges in Shanghai is about 6.12 percent.
38. Hainan Liufu Fenglin Shiye Ltd. & Ors v. Qionghai Boao Huacheng Real Estate Dev. Ltd., Hainan First Intermediate People's Ct., Hainan No.1 Civil Case Second Instance Ruling No. 29 (2015) (China).
39. *Id.* art. 47.
40. See Regulations of the People's Republic of China on Import and Export Duties (issued on Nov. 23, 2003; effective on Jan. 1, 2004 and further revised by Decision of the State Council on Amending Some Administrative Regulations in 2011, 2013, 2016 and 2017) and Interim Regulations of the People's Republic of China on Value-Added Tax (2008 Revision) (issued on Nov. 10, 2008; effective on Jan. 1, 2009).

Law), and the Anti-Unfair Competition Law of the People's Republic of China (Anti-Unfair Competition Law). In a franchisor-franchisee relationship, in spite of very limited judicial guidance, it has become the norm, as recognized by the Chinese courts, that the post-term non-compete covenant between the franchisors and the franchisees should not be more than two years. The Anti-Monopoly Law imposes restrictions on geographical exclusivity as well as price fixing and product tying.[41]

1. Geographical Exclusivity

Operators with a dominant market position are prohibited from establishing exclusive geographical areas without justifiable cause.[42] An operator is considered having a dominant market position if it has the power either to control the price or quantity of commodities or other trading conditions in the relevant market or to block or affect the entry of other business operators into the relevant market.[43]

Under the Anti-Monopoly Law, "justifiable causes" refer to those that have positive impact on economic efficiency, social and public interests, and economic development.[44] In China, most franchise systems provide exclusive territories. Such exclusivity is often justified in the context of international franchising for the purposes of protecting the franchise system as a whole.

2. Product-Tying

Product-tying without justifiable cause is expressly prohibited by the Anti-Monopoly Law if the operators are considered having a dominant market position.[45] The catchphrase in the analysis of product-tying is therefore "dominant market position."[46] The issue of monopoly by way of product-tying is rather significant when the operator is considered having a dominant market position, as product-tying will likely extinguish the vertical competition of the relevant business. Particular attention must also be paid when the bundled sales involve the sale of intellectual property rights.[47]

In determining whether a franchisor has a dominant market position, franchisors should take into account the various factors which contribute to the market share, such as possible choices of alternative products or services, and the difficulty for outsiders to join the competition.[48] When structuring the franchise to be introduced into China, franchisors should consider

41. Anti-Monopoly Law art. 17 (China).
42. Interim Provisions on Prohibiting Abuse of Dominant Market Positions art. 18(3) (issued by the State Administration for Market Regulation on June 26, 2019; effective on Sept. 1, 2019) (China).
43. *Id.* art. 18.
44. *Id.* art. 15.
45. Anti-Monopoly Law art. 17(5) (China).
46. *Id.* art. 17.
47. Prohibition of Abuse of Intellectual Property Rights to Eliminate or Restrict Competition art. 9 (issued by the State Administration of Industry of Commerce on Apr. 7 2015; effective on Aug. 1, 2015) (China).
48. Interim Provisions on Prohibiting Abuse of Dominant Market Positions art. 5.

their share of the relevant market based on existing data and the anticipated expansion rate of the franchise business in China before imposing product-tying or purchasing restrictions on franchisees. Meanwhile, under the general contract law, there are also restrictions if product-tying takes place in licensing of patents and proprietary technologies.[49]

3. Price Fixing

Franchisors should also observe the price fixing restrictions under the Anti-Monopoly Law. The Anti-Monopoly Law prohibits traders from forming agreements that seek to undermine the market competition by, among other things, fixing the resale price of the products or restricting the minimum resale price.[50]

The current law is unclear as to whether franchises are exempt from the price-fixing and minimum resale price prohibitions under the Anti-Monopoly Law. Minimum advertised price policy, which is a relatively mature practice in the United States, is practiced, but its legality remains a controversial topic. Academic discussions have shed light on the need for an express exemption for franchising under this umbrella of restrictions due to the inherent need in franchise systems to fix prices in order to safeguard the sustainability and other inherent qualities of a franchise system.[51] However, neither the legislature nor any governmental authorities have taken any action so far.

E. *Intellectual Property*

In practice, franchisees are usually granted licences to use the intellectual property rights in the trademarks, operations manual, and confidential know-how of the franchisor so that they may operate their franchised business. Franchisors often expressly reserve the right to develop or require new intellectual property and improvements created in the course of the franchise business under the Patent Law and Copyrights Law of the PRC. The parties also commonly agree that new intellectual property and improvements created in the course of the franchise business are otherwise deemed to be the property of the franchisor.

Chinese franchise agreements also usually expressly provide that the franchisee will assign any new intellectual property and improvements to the franchisor where they are not deemed to be the property of the franchisor. However, the franchisor must pay particular attention to the Regulations on Technology Import and Export Administration of the PRC and the relevant

49. Contract Law art. 329 (China); *see also* Circular concerning Summary on Certain Issues on the Determination of Disputes over Technical Contracts, issued by Supreme People's Court of PRC ¶ 1.1 (issued June 19, 2001).

50. Anti-Monopoly Law art. 14 (China).

51. Xiang Jing, *Issues of Anti-Monopoly in the Context of Franchising*, 37, J. Sw. Univ. (Social Sciences ed.) (Jan. 2011).

circular.[52] Together, they provide that, if a Chinese licensee makes improvements to the licensed technology (including know-how), the improvements belong to the Chinese licensee, and the assignment or the grant of an exclusive licence of them to a foreign transferor must be given consideration (i.e., they must be paid for).

II. Entrance Strategies

As mentioned earlier, the franchising laws do not restrict the type of franchise model that can be used in China. Local or foreign franchisors can adopt several franchise models in China.

A. *Master Franchising, Area Development, and Hybrid Arrangement*

In the context of international franchising, master franchising and area development are probably the most widely used models in China due to the massive geographical size of China, which calls for an enormous supply of a wide variety of products and services. As opposed to single-unit franchising, master franchising, area development agreements, and hybrid arrangements (i.e., the mix of master franchising and area development with conditions for exercising certain franchising) are far more likely to grow successfully given market demands.

Master franchising and area development are not only useful in that they help the franchise business to grow exponentially, but they also allow the franchisors to delegate functions to an entity of their choice to deal with the complicated tax issues and compliance with the local rules imposed by the local administrative and regulatory units, which foreign franchisors usually do not have the necessary administrative power or knowledge to address. Indeed, master franchisors are often highly versatile and experienced franchisees themselves, as they are typically required to assume the primary functions of the franchisor, such as provision of operational support to the franchisees, recruitment and selection of franchisees, and handling payments of franchise fees from the franchisees to the franchisor.

Chinese master franchisees and area developers often request exclusivity for the whole country, or at least in certain regions of China, particularly the major cities such as Guangzhou, Shenzhen, Shanghai, and Beijing. Franchisors should carefully consider any decision regarding the geographical scope of a proposed master franchise by evaluating the franchisee's financial strength, commitment, and managerial capability. Due to the scale of franchised operations, some franchisees may expect financing or introducing new investors at a certain point in time, and it is better to ascertain their intention and plan in advance.

52. Circular Concerning Summary on Certain Issues on the Determination of Disputes over Technical Contracts, issued by Supreme People's Court on June 19, 2001.

Like in many other jurisdictions, one major concern of the franchisor in a master franchising and area development arrangement is inevitably the degree of control over the franchisees and sub-franchisees. In this context, some franchisors have local subsidiaries housing teams of experienced franchise managers, and they will need to take these costs into account when planning their development in China.

Finally, in any master franchise or area development arrangement, foreign franchisors should be aware of the "2+1" requirement mentioned above. Master franchisees and area developers are required to comply with the "2+1" requirement when sub-franchising to a third party.[53]

B. *Direct Franchising to Single-Unit/Several-Units Chinese Franchisees*

Direct franchising to single-unit/several-units Chinese franchisees has been very common in educational franchise systems. While single-unit/several-units franchisees are less common, this kind of structure is relatively simple and easier to manage than master franchise and area development arrangements. But due to the size of the Chinese market, few foreign franchisors use this model.

C. *Joint Venture*

Joint venture franchising is another feasible option for entering the Chinese market and has been receiving more attention in recent years. The fundamental framework involves the establishment of a joint-venture vehicle between a foreign franchisor and a China-based franchisee. The foreign franchisor grants certain rights, especially the key intellectual property rights, to the joint venture vehicle so that the joint venture may carry on the business as a franchisor or master franchisee as the case may be. Use of offshore entities as joint venture vehicles, such as Hong Kong-based companies, is common due to corporate governance, and more importantly, for tax reasons.[54]

III. Protection of Franchisors' Intellectual Property in China

A. *Trademarks*

Under the Trademark Law of the People's Republic of China, franchisors must register their trademarks with the Trademark Office of the China National Intellectual Property Administration (Trademark Office) to secure their rights over the registered trademarks. The reasons are twofold. First, for obvious reasons, franchisors cannot licence their products bearing the trademarks to franchisees without licensing the trademarks, which require

53. 2007 Regulations, *supra* note 2, art. 7.

54. Hong Kong SAR adopted a low-tax regime. The profit tax rate (i.e., the corporate income tax) is currently 16.5%, and the enterprise income tax rate in Mainland China is generally 25%. There are also various preferential withholding tax rates for monies moving from Mainland China to Hong Kong.

registration in China. Second, China is a "first-to-file" country, which means that the franchisor who registers the trademark first gets all the exclusive rights to deal with the trademark.[55] Most franchisees will use a Chinese transliteration of the brand to market the business, and it is necessary to secure protection of such Chinese transliteration through filing trademark applications.

In a franchisor-franchisee relationship, it is equally important for franchisors to register the relevant trademark licence with the Trademark Office. Failure to register a trademark and the trademark license may not be fatal to the franchise business, but franchisors may risk losing their proprietary rights in the trademarks. Trademark squatters or third parties may apply to the Trademark Office to cancel the franchisor's trademark for non-use in the preceding three years. In such case, the franchisor will have to produce evidence of the use of the trademarks in China in the preceding three years[56] and, in most cases, show that the trademarks were used by the franchise through licensing to the franchisee. Where the trademark licence agreement was not properly registered, the franchisor will not be able to prove valid use of the trademark by the franchisee.

The State Administration of Market Regulation (SAMR or AMR for local Administration of Market Regulation) (formerly known as the State Administration of Industry and Commerce (AIC))[57] is the governmental authority that can offer assistance to the brand owners in case of infringement, and indeed SAMR anti-counterfeiting actions are generally considered as a low-cost and quick option. Of course, SAMR can only deal with relatively straightforward situations where the acts of infringement can be easily proved beyond reasonable doubt. When controversies arise, such as an outstanding contractual dispute, courts are a better venue to handle the situation.

B. *Trade Secrets*

Trade secret is defined under the Anti-Unfair Competition Law of the People's Republic of China (Anti-Unfair Competition Law) as technology or business information unknown to the public and of a commercial value for which the owner (i.e., the franchisor) has taken corresponding confidentiality measures.[58] Trade secrets may include—as the parties may define them in the franchise agreement—for example, recipes, prices, and customer lists.

Franchisors should include restrictive clauses to prohibit the franchisees from disclosing or otherwise dealing with the franchisor's trade secrets for any purpose other than the franchised business. Franchisors may also

55. Trademark Law of the People's Republic of China art. 31.
56. *Id.* art. 49.
57. Since 2018, the State Administration for Industry and Commerce (SAIC) was restructured as State Administration for Market Regulation. That said, many relevant regulations still refer to the SAIC instead.
58. Anti-Unfair Competition Law art. 9 (China).

consider expanding the definition of trade secrets in the franchise agreement by listing out particular items constituting trade secrets. As a matter of formality, all trade secrets and confidential information should be expressly marked "confidential."

Although the SAMR can theoretically handle trade secret situations, courts are usually the preferred venue for handling disputes arising from alleged misuse of trade secrets.[59]

C. *Copyrights*

Under the Copyright Law of the PRC, copyright is defined as works of literature, art, natural science, social science, or engineering technology that can be reproduced in a tangible form.[60] A copyright entitles the franchisor to copy, reproduce, and license its work in whatever manner may be used by the franchisee or third party.[61] In China, although copyright protection arises automatically with its creation, proof of ownership of copyrights in practice would become less cumbersome upon voluntary registration. Franchisors can accomplish registration by filing with the National Copyright Administration. Registration provides a public record which serves as prima facie evidence of ownership in case of dispute.[62] There are local authorities designated to deal with copyright infringement,[63] but most of the time courts are the preferred venues of dealing with copyright infringement due to the complex legal issues usually involved in copyright disputes and the conclusiveness of court judgments.

D. *Patents*

Similar to trademarks, patents are granted and thus protected on "first-to-file" basis.[64] Under the Patent Law of the People's Republic of China (Patent Law), patents include inventions, utility models, and designs.[65] Franchisors must register patents with the State Intellectual Property Office (SIPO), and franchisors may enforce their patent rights in the Chinese court where interim injunctions are available.[66]

Franchisors should also be aware of the relevant regulation on "service invention."[67] Service invention refers to an invention created by employees[68]

59. Nothing in law restricts the authority of SMAR in this respect; but in actual practice the officers may be reluctant to resolve cases with complex legal issues that may be better resolved by the courts.

60. Copyright Law art. 3 (China).

61. *Id.* art. 10.

62. *See* Creative Power Entertaining v. Lin Po, Hunan Province Intermediate People's Ct. (2015) (China) (2015).

63. Now the local authorities are grouped under the State Administration for Market Regulation.

64. Patent Law art. 9 (China).

65. *Id.* art. 2.

66. *Id.* art. 66.

67. *Id.* art. 6; Rules for Implementation of the Patent Law of PRC art. 10 (China).

68. In this context the reference to "employees" refers to the employees of the franchisee.

in the course of performing their own duties.[69] The patent rights in the service invention will belong to the employer,[70] but the employer must reward the relevant employees for inventions they create in accordance with the Rules for Implementation of the Patent Law of PRC.[71] Where the franchisee fails to reward its employees for any such invention, the franchisor may pay on behalf of the franchisee. In this sense, the franchisor's interests will extend to such service invention where the franchise agreement provides for the ownership of or entitlement to the invention of the franchisee.

Local authorities are designated to deal with patent infringement,[72] but the majority of patent disputes are handled by courts due to complex legal issues usually involved in patent disputes and the conclusiveness of court judgments.

E. *Domain Names and Social Media*

Under the Measures for the Administration of Internet Domain Names, China Internet Network Information Centre (CNNIC), the Ministry of Industry and Information Technology of the People's Republic of China is responsible for registration of domain names in China.[73] The domain name is protected on "first come, first served" basis.[74] The CNNIC will, upon approval, issue a domain name registration certificate to a franchisor. Similar to trademark squatting, domain-name squatting is an issue that franchisors come across often.

When fighting domain-name squatters, franchisors have to establish that (1) they have legitimate and effective rights in the use of domain name, (2) the franchisee or third party has no such right over the domain name in issue, and (3) the squatters acted in bad faith.[75]

If franchisors wish to set up a China-based website, they must apply for the Internet Content Provider (ICP) License.[76] However, foreign companies without a local presence in China cannot apply for an ICP License.[77] One of

69. Patent Law art. 6.

70. Employer refers to the franchisee.

71. *Id.* art. 16; Rules for Implementation of the Patent Law of PRC arts. 71 & 72 (China).

72. Now the local authorities are grouped under the State Administration for Market Regulation.

73. Measures for the Administration of Internet Domain Names art. 3 (issued by Ministry of Industry and Information Technology on Nov. 1, 2017; effective on Aug. 24, 2017) (China).

74. *Id.* art. 26.

75. Interpretation of the Supreme People's Court on Application of Laws in the Trial of Civil Disputes over Domain Names of Computer Network art. 4 (issued by the Supreme People's Court on Jan. 17, 2001; effective on July 24, 2001) (China).

76. There are two kinds of ICP licenses. One is more of a recordal, which is required where the China-based website is purely informational. Another one is more of a permit, which is required where the China-based website generates profits. For the purpose of this discussion, we collectively refer to them as "ICP License."

77. Measures for the Administration of Telecommunications Business Licensing (2017 Revision) art. 9 (issued by Ministry of Industry and Information Technology on Mar. 7, 2017; effective on Sept. 1, 2017) (China).

the prevailing practices is that the franchisor will set up a local subsidiary or representative office in China to hold the ICP License.

Major social media platforms, such as Wechat and Weibo, are also widely utilized by local franchisees in China. In the absence of an express arrangement, there is a likelihood that the local franchisees will register such major social media platforms for the purpose of the franchise. Thus, the use of social media should be regulated by the franchise agreement.

IV. The Franchisor-Franchisee Relationship in China

A. *The Franchise Agreement—Contract Law Aspect*

The relationship between the franchisor and the franchisee is primarily contractual due to the "practice" that all franchise agreements concerning a franchise in China must be filed with the authority for either registration or verification purposes.[78] Accordingly, the formation of the franchisor-franchisee relationship in China is constructed on the principle of good faith imposed by the Contract Law,[79] as opposed to the common law doctrine of *caveat emptor* (buyer beware). As a result, the franchise agreement inevitably must comply with the formality requirements under the Contract Law.

The franchise agreement governs the respective rights and obligations of the franchisor and the franchisee in a franchisor-franchisee relationship. However, the agreement must observe the 2007 Regulations, which impose certain duties on franchisors towards franchisees, such as disclosure and ongoing assistance. Typically, franchisors reserve the right, to a certain degree, to monitor or otherwise control the franchisees under the franchise agreement, such as the right of inspection and the right to access the franchisees' computer systems and point-of-sale data.

Nonetheless, any failure to comply with the 2007 Regulations will only attract penalties on the administrative level and will not invalidate the franchise agreement *per se*. Accordingly, with respect to the enforceability of the franchise agreement, it is advisable to consider using PRC law as the governing law of the agreement.

In most cases, the foreign franchisors favor the laws of their respective home country as the governing law of the franchise agreement. Under the Contract Law, an agreement can be governed by foreign law if the contracting parties so agreed.[80] However, in practice, if the agreement will be, actively or passively, brought before the Chinese courts for determination of issues arising from the franchise, foreign law as the governing law of the agreement will bring about practical difficulties in enforcing the contract. In some instances, the Chinese court may simply apply the laws of the PRC.

78. While the very first franchise agreement must be registered, additional franchise stores after the very first franchise agreement has to be "verified" by the Bureau of Commerce in practice.

79. Contract Law art. 6 (China).

80. *Id.* art. 126.

Further, the languages of the franchise agreement should also be treated with care, especially the Chinese version or translation. Although under the Contract Law any foreign language can be the governing language of the agreement, the Chinese court will not determine an issue on the agreement without the Chinese translation of the same.[81] In any event, bilingual agreements with prevailing governing language provisions should be incorporated; however, practically speaking, the Chinese version or translation will be considered primarily.

B. *Employment Versus Independent Contractor?*

A big question as to the existence of employer-employee relationship is seen in franchisor-franchisee context, especially from the U.S. law perspective. The position of the franchisee in such a contractual relationship has a great impact on the extent of liability of the franchisor—that is, whether the franchisor will be vicariously liable for the franchisee's acts and, more specifically, whether the franchisor will be vicariously liable for the acts of the franchisee's personnel.

Typically, and as most franchise agreements will expressly state, a franchisee is an independent contractor of the franchisor. Indeed, insofar as courts are concerned, the Chinese courts are inclined to view that franchisors and franchisees are independent contractors in the sense that the franchisors and the franchisees are independent entities who should be accountable for their own human resources and finance.[82]

C. *Multi-level Selling*

China has general prohibitions against multi-level selling, which involves a network of independent representatives who sell and market products to family, friends, and acquaintances, or otherwise take the form of a pyramid scheme where the compensation is primarily based on the collection of member's fee directly or indirectly by recruiting persons to participate in the sales network.[83] In practice, a genuine franchise will not be seen as a form of multi-level selling. For reference, MOFCOM identified three major areas of difference between franchise and multi-level selling as follows:[84]

a. The organizational structure. The level of structure of a multi-level selling network is generally unrestricted, whereas the level of structure of a franchise is strictly organized. Typically, a franchise adopts a two-tier, or maximum of a three-tier, structure.

81. Civil Procedure Law art. 262 (China).

82. For example, see Challenge Petrochemical and Kunming Dongqiao Petrochemical Co., Ltd, Yunan Supreme's People Ct., Yun Min Zhong No. 149 (2016).

83. *See* Regulation on the Prohibition of Pyramid Selling arts. 2, 7 (issued by the State Council on Aug. 23, 2005; effective on Nov., 1 2005) (China).

84. Commercial Reform and Development Division of the Ministry of Commerce of the People's Republic of China, Questions & Answers Regarding Franchise (2007) (http://www.mofcom.gov.cn/article/zhengcejd/bp/200706/ 20070604820258.shtml)

b. The legal capacity of the new members. The chain of multi-level selling networks is comprised of natural persons in their individual capacity, while a franchise in China is generally operated through a corporation.
c. Profit distribution mechanisms. In multi-level selling networks, persons on the upper level of the chain earn commissions from persons on the lower level, whether on the basis of their performance or their procurement of new members. In a franchise, profits are yielded from lawful operation of a business.

In short, the determination of the existence of multi-level selling lies on the substance of operations. As one may infer from the above, a self-proclaimed franchise arrangement by which the so-called franchisors and sub-franchisors can sustain profitability merely through admission fees from new franchisees without having to worry about loss and expenses incurred from the operation of the business may as well be regarded as multi-level selling.

V. Practical Issues

A. *Foreign Exchange Control*

China has implemented a foreign exchange control regime. Under the foreign exchange control regime, the purchase of foreign currency with Chinese currency is subject to an annual quota, beyond which the approval from State Administration of Foreign Exchange (SAFE) is required.[85]

The local administration of foreign exchange and the banks is vested with powers to approve different kinds of foreign exchange remittance.[86] Supporting documents, such as the tax records (in certain situations), underlying contracts (i.e., the franchise agreement) and invoices, must be provided to the remitting banks.[87]

Therefore, the first practical implication of such system is that no payment can be paid before the conclusion of any contract, and it usually takes several weeks to secure such approval. Many franchise agreements will stipulate the timeframe, having such process taken into account. In the meantime, if the principal or certain group entities of the franchisee will provide a

85. *See* Regulations of the People's Republic of China on Foreign Exchange Control (as revised by the Decision of the State Council on Amending the Regulation of the People's Republic of China on Foreign Exchange Control issued by the State Council on Aug.1, 2008; effective Aug. 5, 2008).
86. *Id.* art. 12.
87. Detailed Rules for the Implementation of the Guidelines for the Foreign Exchange Administration of Trade in Services art. 6(4) (as revised by the Notice of the State Administration of Foreign Exchange on Repeating and Amending Relevant Regulatory Documents Involving the Reform of the Registration System for Registered Capital (issued on May 4, 2015; effective May 4, 2015) (China); *see also* Guide to Administration of Common Foreign Exchange Items (published by local branch of State Administration of Foreign Exchange).

guarantee, there is a need to register such guarantee. Otherwise, remittance will not be allowed in the future.

B. *Leasing of Premises*

When investing in China to purchase any not-for-self-use real estate, an overseas institution or individual must abide by the principles of commercial presence and establish a foreign investment enterprise according to the relevant provisions on foreign investment in real estate.[88] Further, a foreign franchisor must establish a PRC legal entity before entering into a leasing or sub-leasing agreement in China.[89]

The common customary terms of the lease arrangement vary from city to city. If the lease is a retail business lease that has multiple outlets in shopping centers, the landlord will typically dictate the material terms of the leasing agreement as it has greater bargaining power. Generally, the lease term is much shorter in major cities, and there are extreme situations where the landlord will only grant a "probationary" period to observe the business performance of the tenant before a longer lease is granted. This will sometimes affect the drafting of the certain documents.

C. *Insurance*

It is common for franchisors to require franchisees to secure insurance policies to cover losses or damages arising from the franchisees' development and operation of the franchise stores, and at the same time the franchisors are named as additional insureds to the extent that they have insurable interest.

In China, there is limited choice of insurance products, and, more importantly, naming the foreign franchisor as an additional insured is rare in practice. Therefore, it is not unusual to see franchisees procuring supplemental insurance coverage adding the name of the franchisors as co-insured from elsewhere, notwithstanding that the Insurance Law requires all insurance policies be taken out locally.

VI. Franchise Litigation

A. *Litigation and Remedies*

1. Franchise Litigation in General

The law with respect to civil procedure is relatively straightforward compared to many common-law jurisdictions. In China, the stages of franchise litigation include the following: (1) filing of pleading, (2) submission of

88. Opinions of the Ministry of Construction, the Ministry of Commerce, National Development and Reform Commission, the People's Bank of China, the State Administration for Industry of Commerce and the State Administration of Foreign Exchange on Regulating the Access to and Administration of Foreign Investment in the Real Estate Market art. 1 (China).
89. *Id.*

evidence, (3) court investigation,[90] and (4) court debate.[91] In the midst of the litigation, the judge may conduct mediation upon the consent of the parties.[92] The usual advice is to take part in voluntary mediation.

Franchisors should be aware that there is no automatic discovery of documents in franchise litigation. Therefore, franchisors are encouraged to collect and seek ways to secure the evidence on their own for the purpose of franchise litigation. More importantly, documentary evidence must be presented in its original form.[93] If the document is not in Chinese, it must be translated by an authorized translation agency for the purpose of submission of evidence to the court.[94] A notary public must be instructed to authenticate evidence.[95] In sino-foreign franchise disputes, the foreign franchisor must also be aware that documentary evidence formed outside China must be properly notarized and legalized at the relevant Chinese consulate in the jurisdiction from its origin country.[96]

Strategically, the franchisor should obtain the requisite evidence before commencement of franchise litigation because there may be the risk of alerting franchisees or other alleged infringers for which they will destroy or remove the evidence. Where it is likely that the evidence may be destroyed or hard to obtain at a later time, the Civil Procedure Law empowers the court to enter a preservation order.[97] However, franchisors who wish to seek quick injunctive relief are advised to resort to administrative proceedings at the same time, if such administrative proceedings are available. For example, in case of trademark infringement or anti-counterfeiting, the claimant may resort to local Administration for Market Regulation (AMR) for quick administrative relief and investigation.

One must also bear in mind that the Chinese courts rarely grant preliminary injunctive relief in non-intellectual-property related claims, though some local courts are willing to grant orders to a similar effect. In general, injunctive relief is not as widely used in China as in many common-law jurisdictions. As a result, the remedies in civil litigation are mostly monetary compensation.

2. Administrative Actions

Where the franchisees are found to be infringing on the franchisor's intellectual property rights, administrative proceedings enable the franchisor to suppress the infringement in a relatively expeditious manner. The procedure of administrative proceedings is not as onerous as litigation.

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90. Civil Procedure Law art. 138 (China).
91. *Id*. art. 141.
92. *Id.* art. 9.
93. *Id.* art. 70.
94. Certain Provisions of the Supreme People's Court on Evidence in Civil Procedure art. 17 (issued by the Supreme People's Court on Dec. 21, 2001; effective on Apr. 1, 2002) (China).
95. *Id.* art. 16
96. *Id.*
97. *Id*. art. 81.

The AMR is the key administrative body that is empowered to take actions against the infringers in trademark infringement cases.[98] It offers a relatively fast and cost-effective way to deal with infringements of the franchisor's intellectual property rights. The relief includes orders to (1) seize or destroy the infringing goods, (2) raid the infringer's premises, (3) force the infringer to desist, and (4) impose fines on the infringer. Other authorities may offer assistance in intellectual property infringement situations in local cities, but AMR is generally considered to be more effective.

B. *Alternative Dispute Resolution*

For international franchising, the parties usually opt for arbitration in the event of a dispute due to the conclusiveness of arbitral awards in China. That is to say, assuming that the losing party has the necessary financial resources to pursue an appeal in litigation, arbitration can put an end to the dispute sooner than litigation. Apart from the benefit of conclusiveness, if the franchisee has assets outside China, arbitral awards can be enforced more "conveniently" in foreign countries who are party to the New York Convention[99] than Chinese court judgments.

Further, arbitration in China enjoys the Chinese court-ordered interim measures, albeit limited, in aid of the arbitral proceedings.[100] Since 2014, PRC commercial arbitral institutions— including but not limited to Shanghai International Economic and Trade Arbitration Commission, China International Economic and Trade Arbitration Commission, and Beijing Arbitration Commission—have adopted the mechanism for emergency arbitrator proceedings in which urgent interim relief such as preservation orders and prohibitory injunctions may be granted.[101] The emergency arbitrator proceedings provide a procedurally less cumbersome choice for the parties to acquire the interim relief with the aim to preserve the status quo in aid of the arbitral proceedings.

Multi-tiered dispute resolution has also been widely adopted by China-related franchise parties. However, parties who wish to adopt multi-tiered dispute resolution should use definitive terms and set out how the dispute resolution will be conducted when drafting a multi-tiered dispute resolution clause to increase enforceability.

The position of the PRC law on the enforceability of a multi-tiered dispute resolution clause is not entirely clear. However, precedents state that

98. Trademark Law art. 2 (China).

99. Convention on the Recognition and Enforcement of Foreign Arbitral Awards (June 10, 1958).

100. This will soon extend to Hong Kong arbitrations. On April 2, 2019, the Hong Kong Special Administrative Regional government (HKSAR) and the Supreme People's Court entered into an arrangement that extends the court-ordered interim measures by the PRC courts to Hong Kong arbitration. Such arrangement will come into effect in the near future upon the promulgation of a judicial interpretation by the Supreme People's Court and completion of relevant procedures in the HKSAR.

101. Arbitration Law of the People's Republic of China art. 28 (China); Civil Procedure Law art. 101 (China).

the Chinese courts will only enforce such clauses where the details of each level of dispute resolution intended by the parties are clearly set out and defined.[102]

Mediation is not a prerequisite requirement for litigation or arbitration, although it remains a viable option in lieu of informal negotiation.

VII. Conclusion

All in all, the world has witnessed the rapid growth of franchising in China. As mature as the existing framework seems, legal principles continue to develop to cope with the commercial needs of the importation of international franchising into China. Along with economic reform, the sector will continue to flourish.

102. *See* Mawan Elec. (Shenzhen) Co., Ltd. V. Runhe Dev. Co., Ltd., Reply of the Supreme People's Court to the Hunan High People's Court's Judicial Review on Runhe Company's Application of Non-enforcement of Arbitral Award, [2008] Min Si Ta Zi No.1.

Franchising & Distribution Currents

Kevin Shelley, Briar Siljander & Larry Weinberg

ANTITRUST

Mr. Shelley

Mr. Siljander

Mr. Weinberg

***Turner v. McDonald's USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,641, 2020 WL 3044086 (N.D. Ill. Apr. 24, 2020)**

The United States District Court for the Northern District of Illinois denied McDonald's' motion to dismiss an antitrust case brought by an employee of a McDonald's franchisee who alleged that McDonald's violated the Sherman Act by agreeing with its franchisees not to hire each other's employees or each other's former employees for a period of six months after employment (so-called "no-hire" clauses). This case is interesting because these no-hire clauses have received substantial public attention and debate recently, leading many franchise systems to discontinue their use.

In this case, the plaintiff, Stephanie Turner, alleged that McDonald's violated the Sherman Act by inserting such no-hire clauses in its McDonald's franchise agreements with its franchisees. Plaintiff alleged that the no-hire clause in her employer's franchise agreement caused her wages to be depressed, such that she was paid less than she would have been paid absent the no-hire clause in the franchise agreements. In its motion to dismiss, McDonald's argued that the plaintiff lacked Article III and antitrust standing and that the plaintiff's claim was barred by the statute of limitations.

Turning to the Article III standing issue, the court noted that the United States Constitution limits a federal court's jurisdiction to cases and controversies, such that a plaintiff must have (1) suffered an injury in fact (2) that is fairly traceable to the challenged conduct of the defendant, and (3) that is likely to be redressed by a favorable judicial decision. Here, the plaintiff alleged that she suffered reduced wages due to the no-hire clause. Specifically, she alleged that the fact that she could not even apply for other positions at other McDonald's restaurants contributed to downward pressure on her wages with her employer, as she could not use a competing offer to negotiate for better wages. She thus

alleged that the restraints constrained competition among McDonald's restaurants and caused her wages to be depressed during her employment.

McDonald's argued that the plaintiff cannot have been injured by the no-hire clause unless she applied for and was rejected on account of the no-hire policy. The court quickly rejected this argument, concluding that the plaintiff's allegation that she suffered depressed wages—that is, the wages that she was actually paid were less than the wages she would have been paid absent the allegedly unlawful no-hire policy—and the loss of those wages was a sufficient injury in fact. Next, McDonald's argued that the depressed wages could not confer standing in this case because such depressed wages are not fairly traceable to the alleged antitrust violation. Again, the court quickly dismissed this argument and concluded that the plaintiff's causation allegations were plausible due to basic principles of economics: if fewer employers compete for the same number of employees, wages will be lower than if a greater number of employers are competing for those employees. The plaintiff's allegation that she suffered injury was, therefore, fairly traceable to McDonald's alleged antitrust violation. Thus, the court concluded that the plaintiff adequately alleged Article III standing by alleging the no-hire agreement depressed her wages.

Turning to the antitrust standing argument, the court noted that a plaintiff asserting an antitrust claim must prove antitrust injury, which is to say injury of the type the antitrust laws were intended to prevent and that flows from that which makes defendant's act unlawful. The injury should reflect an anticompetitive effect either of the violation or of anticompetitive acts made possible by the violation.

Here, the plaintiff alleged injury to competition, namely the injury of depressed prices (wages) to sellers (employees) due to anticompetitive behavior of buyers (employers). In conformity with Seventh Circuit precedent, the court concluded that the plaintiff an alleged antitrust injury in this case. As an aside, the court cited two other federal district courts in Ohio and Kentucky that had recently concluded that a plaintiff had antitrust standing to bring claims arising from similar no-hire or no-poach agreements.

Turning to the statute of limitations issue, the court denied McDonald's motion to dismiss the plaintiff's claim under the applicable four-year statute of limitations set forth in 15 U.S.C. ¶ 15b. The court noted that the period of limitations for antitrust litigation runs from the most recent injury caused by the defendant's activities, rather than from the violation's inception. Thus, each time a plaintiff is injured by an act of the defendant, the cause of action accrues to him to recover the damages caused by that act, and, as to those damages, the statute of limitations runs from the commission of the act. In other words, in this case, each time the plaintiff was paid a depressed wage for her labor, she was injured, and the four-year statute of limitations for that injury began. Failure to comply with the statute of limitations is an affirmative defense, and the court may not dismiss on the basis of an affirmative defense unless the plaintiffs alleges the elements of the affirmative defense.

Because the plaintiff alleged that she was paid a depressed wage for her labor as recently as one year prior to the filing of the complaint in August 2019, plaintiff had not alleged or omitted the ingredients of defendant's statute of limitations affirmative defense, and, as a result, the court denied McDonald's motion to dismiss on statute of limitations grounds.

ARBITRATION

Aguilera v. Matco Tools Corp., Bus. Franchise Guide (CCH) ¶ 16,617, 2020 LEXIS 43283 (S.D. Cal. Mar. 12, 2020)

The U.S. District Court for the Southern District of California issued a preliminary injunction to prevent a franchisor from arbitrating claims against franchisees on the basis that the franchisees were likely to prevail in voiding the arbitration and venue provisions of their franchise agreements.

The dispute began with two franchisees filing a class action in California Superior Court in December 2018, alleging that they and similarly situated franchisees were misclassified by Matco Tools Corporation (Matco) as independent contractors and thus were entitled to expense reimbursements, wage statements, overtime pay, meal and rest breaks, and other wages. The franchisees also alleged that Matco made unlawful deductions from their wages and that Matco engaged in unfair business practices and usury. The franchisees concurrently filed a Notice of Intention to pursue a private attorney general action (PAGA) based on the same misclassification argument. The state court case was removed to the United States District Court for the Northern District of California. Two months later, in March 2019, the parties agreed to dismiss the lawsuit without prejudice after Matco filed a motion seeking to dismiss the lawsuit or transfer it to the Northern District of Ohio, where Matco's principal place of business is located.

While the state court case was pending, on January 29, 2019, a different franchisee (the Fleming Franchisee) filed a putative class action against Matco. *Fleming v. Matco Tools Corp.*, Bus. Franchise Guide (CCH) ¶16,418, 384 F. Supp. 3d 1124 (N.D. Cal. 2019). On May 3, 2019, the court in the *Fleming* case held that the arbitration and forum selection clauses at issue (which were materially equivalent to those in the *Aguilera* case) were unenforceable because the arbitration provision encompassed PAGA claims and contained a non-severability provision which prevented the carving out from arbitration only the PAGA claims. Since the arbitration provision was thus voided by its terms, the *Fleming* court held that the forum selection clause was voided by California law, which was not, in the absence of an enforceable arbitration agreement, superseded by the Federal Arbitration Act. Matco's petition for writ of mandamus with the Ninth Circuit was denied, as was a subsequent petition for rehearing *en banc*. The United States Supreme Court also denied Matco's Petition for a Writ of Certiorari on May 26, 2020.

On March 25, 2019, the day before the California Superior Court entered the stipulated order dismissing the franchisees' complaint, Matco filed a

petition in the Northern District of Ohio, seeking to compel the franchisees to arbitrate any claims arising from their distribution agreements, including those claims that were dismissed by stipulation in the California Superior Court. Then, in June 2019, Matco filed separate claims in arbitration with the American Arbitration Association in Ohio against the same franchisees, alleging that the franchisees failed to pay their promissory notes to Matco. One of the franchisees unsuccessfully contested the validity of the arbitration provisions contained in the distribution agreements in the arbitration and the other franchisee's challenge remained pending.

In August 2019, the franchisees filed their complaint in the United States District Court for the Southern District of California, seeking to enjoin both arbitration proceedings in Ohio and to declare the arbitration and venue provisions in the distribution agreements void and unenforceable. The complaint also alleged that Matco's efforts to enforce the arbitration and venue provisions violated California's unfair competition laws.

Matco filed a motion to dismiss the litigation in October 2019, alleging that (1) its filing of the writ of mandamus to the Ninth Circuit and its filing in the Northern District of Ohio warranted dismissal or stay of the case; (2) based on the distribution agreements, the arbitrator, and not the court, was supposed to decide arbitrability; (3) the franchisees' claims based on the California Unfair Competition Law (UCL) failed for lack of standing; and (4) the doctrine of *forum non conveniens* warranted dismissal or transfer.

In December 2019, the franchisees sought a preliminary injunction and then, in January 2020, a temporary restraining order (TRO) to enjoin Matco from pursing its arbitrations in Ohio. The court issued the TRO in January 2020.

In March 2020, the court issued its order granting in part and denying in part Matco's motion to dismiss the franchisees' claims and granting the franchisees' motion for preliminary injunction, enjoining the franchisor from arbitrating its claims against the franchisees. The court agreed with Matco that the franchisees did not state a claim under the UCL to the extent that the UCL claim related to Matco's filing of the petition to enforce arbitration in the Northern District of Ohio or for restitution (since no funds were received by Matco). The court could find no authority to enjoin the proceedings in the Northern District of Ohio. However, the court denied the balance of Matco's motion to dismiss. Regarding Matco's argument that the case should be dismissed because Matco had first filed the writ of mandamus with the Ninth Circuit and the petition to enforce arbitration in the Northern District of Ohio, the court disregarded application of the first-to-file rule because it found that Matco's petition in the Northern District of Ohio was filed in anticipation of another lawsuit to be filed by the franchisees. As to Matco's argument that the arbitrator should decide whether the agreement to arbitrate was enforceable, the court— noting that the strong federal policy favoring arbitration does not extend to deciding questions of arbitrability—determined that the parties did not clearly agree that issues of arbitrability would be decided by the arbitrator. Despite the fact that the

arbitration provision incorporated the American Arbitration Association's (AAA) rules, which provide for the arbitrator to determine arbitrability, the court noted that the franchisees were not sophisticated and did not, by incorporating the AAA rules, manifest a clear intent to delegate to the arbitrator the question of arbitrability.

Regarding the franchisees' request for a preliminary injunction, the court determined that the franchisees were likely to succeed in voiding the arbitration and venue provisions in the distribution agreements. Because Matco's writ for certiorari to the United States Supreme Court was pending at the time of its order, the court did not base its ruling on collateral estoppel resulting from the decisions in the *Fleming* case. It did, however, find that the Ninth Circuit's ruling on Matco's writ of mandamus was persuasive.

Even if collateral estoppel did not apply, the court noted, the franchisees demonstrated a likelihood of success on the merits. The arbitration provision at issue contained the following "blow-up provision": "If the provision prohibiting classwide or private attorney general arbitration is deemed invalid, then the provision requiring arbitration of breaches between the parties shall be null and void and there shall be no obligation to arbitrate such breaches." The court first cited to well-established Ninth Circuit law for its position that the PAGA waivers in the franchise agreements were invalid and, because they were invalid, the franchise agreement's "blow-up provision" nullified any requirement to arbitrate.

The court also found that the forum selection clause was likely invalid under California Business and Professions Code section 20040.5. Again citing to the *Fleming* case, the court determined that it was likely the forum selection clause requiring litigation outside of California would not be enforced. Notably, as the court in *Fleming* discussed, and the Ninth Circuit affirmed, because the arbitration provision was void and unenforceable, the FAA did not preempt California law invalidating the forum selection clause. The court, with ease, then found that the franchisees would suffer irreparable harm if arbitration were permitted and that the balance of the hardships and consideration of the public interest strongly favored the franchisees. Closing out the matter, the Northern District of Ohio dismissed Matco's petition to compel arbitration for lack of standing. In short, PAGA claims may not be made subject to arbitration, and an arbitration provision that does not permit severability of PAGA claims from its arbitration agreement will result in a franchisor being required to litigate against its franchisees in California.

***Billie v. Coverall North America, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,619, 2020 WL 1185251 (D. Conn. Mar. 12, 2020)**

The United States District Court for the District of Connecticut denied a janitorial service franchisor's motion to dismiss a complaint filed against it by two franchisees on jurisdictional and substantive grounds, but granted the franchisor's motion to stay the action and refer the dispute to arbitration pursuant to arbitration agreements in the franchisees' franchise agreements.

Plaintiffs Caribe Billie and Quincy Reeves commenced an action against Coverall North America, Inc. (CNA), alleging that CNA misclassified them as independent contractors and withheld portions of plaintiffs' wages in violation of Connecticut law. The complaint alleged that CNA employed workers to perform cleaning work for commercial customers and that CNA required its workers to sign janitorial franchise agreements in order to obtain work. Plaintiffs signed franchise agreements with R&B Services, Inc. d/b/a Coverall of Connecticut & Westchester (R&B), a CNA franchisee operating in the Connecticut area. The complaint alleged that, pursuant to these franchise agreements, CNA and R&B exercised considerable control over the plaintiffs' work, including determining what amount to be charged to the customer and the amount paid to the cleaning workers. The complaint further alleged that the plaintiffs were classified as independent contractors and paid sums of money as franchise fees in order to obtain cleaning work and that the plaintiffs were required to pay both initial and ongoing fees to R&B, a portion of which was passed directly to CNA. The complaint alleged that CNA misclassified the plaintiffs as independent contractors and withheld portions of the plaintiffs' wages in violation of section 31-71e of the Connecticut General Statutes. CNA filed a motion to dismiss the action pursuant to Rule 12(b)(2) for lack of personal jurisdiction or Rule 12(b)(6) for failure to state a claim. Alternatively, CNA requested an order staying the action and compelling arbitration.

After reviewing the applicable standards under Rules 12(b)(2) and 12(b)(6), along with the Federal Arbitration Act, the court first addressed CNA's motion to dismiss for lack of personal jurisdiction. The personal jurisdiction question is subject to a two-part inquiry. First, the district court must determine whether the state law permits the court's exercise of jurisdiction over the defendant. Second, the district court must assess whether the court's assertion of jurisdiction under these laws comports with the requirements of due process.

Connecticut's long-arm statute, section 33-929(f) of the Connecticut General Statutes, permits exercise of personal jurisdiction over a foreign corporation in actions arising out of any contract made in Connecticut or to be performed in Connecticut. CNA argued that this prong of the long-arm statute was inapplicable because it is not a party to the franchise agreements at issue. However, the court noted that CNA derives significant benefit from the franchise agreements between plaintiffs and R&B—agreements that CNA itself drafted. Indeed, the court noted that CNA's motion to stay the action and compel arbitration is based upon arbitration provisions in these very same franchise agreements. Thus, based on CNA's significant benefit arising from the franchise agreements that it drafted, plaintiffs made a *prima facie* showing that CNA is subject to the jurisdiction of this court under the Connecticut long-arm statute.

The second part of the inquiry, due process, requires the satisfaction of three conditions for the exercise of specific jurisdiction over a non-resident

defendant. First, the defendant must purposely avail itself of the privilege conducting activities within the forum state or have purposely directed its conduct into the forum state. Second, the plaintiff's claim must arise out of or relate to the defendant's forum conduct. And finally, the exercise of jurisdiction must be reasonable under the circumstances.

The court found that the plaintiffs had plausibly alleged facts sufficient to satisfy these conditions. First, the plaintiffs alleged that CNA had sufficient contacts and that the plaintiffs' claims arose out of CNA's forum conduct. As a result, the court concluded that the assertion of personal jurisdiction was reasonable and comported with fair play and substantial justice such that the due process component of the personal jurisdiction analysis was satisfied. As a result, the court denied CNA's motion to dismiss pursuant to Rule 12(b)(2) for lack of personal jurisdiction.

The court next addressed CNA's motion to dismiss the case for failure to state a claim under Rule 12(b)(6). Specifically, CNA argued that the plaintiffs' claim should be dismissed because CNA had "no connection" to any of the unlawful fees and deductions alleged in the complaint. The court summarily denied this motion, finding that the plaintiffs had plausibly alleged that they were employees of CNA and that, therefore, the deductions and fees allegedly implemented and collected by CNA violated Connecticut wage laws. CNA attempted to avoid liability by noting that CNA was not a party to the franchise agreements and that the plaintiffs' fee obligations were to R&B, not CNA. However, such payments were made pursuant to contract terms drafted by CNA, and CNA's contract with R&B made clear that a portion of the fees paid by the plaintiffs to R&B were passed on directly to CNA. As a result, because the plaintiffs plausibly alleged that they were employees of CNA and that the deductions and fees allegedly implemented and collected by CNA violated Connecticut wage laws, CNA's motion to dismiss for failure to state a claim was denied.

Finally, the court turned to CNA's motion to compel arbitration, based on the arbitration provisions in the plaintiffs' respective franchise agreements entered into with CNA's franchisee R&B. After summarizing applicable provision of the Federal Arbitration Act (FAA), the court noted that, when determining whether to compel arbitration pursuant to the FAA, a court looks to four factors: (1) whether the parties agreed to arbitrate their dispute; (2) whether the asserted claims fall within the scope of the arbitration agreement; (3) whether Congress intended the federal statutory claims asserted by the plaintiff, if any, to be non-arbitrable; and (4) if the court concludes that some, but not all, of the claims in the case are arbitrable, it must then decide whether to stay the remaining claims pending arbitration. Only the first two factors and the defense of unconscionability were in dispute in this case.

As to the first factor, whether the parties agreed to arbitrate, the court applied Connecticut law. Although CNA was not a party to the franchise agreement containing the arbitration provision, the court concluded that,

under Connecticut law, a third party can enforce a contractual right where contractual terms demonstrate that the intent of the parties to the contract was that the promisor should assume a direct obligation to the third party. The court reviewed the language of the arbitration provisions and concluded that the parties agreed to arbitrate this dispute and that the plaintiffs' claims fell within the scope of their arbitration obligations. Specifically, the court concluded that the contractual terms evidenced the parties' intent to include CNA within the scope of the plaintiffs' arbitration obligation.

Second, the court summarily dismissed the plaintiffs' contention that CNA's motion to compel was premature because the issue of class certification had not yet been decided by the court. The court disagreed, finding that because both plaintiffs asserting the claims had signed a contract with an arbitration provision, the motion to compel was not premature. Third, the court addressed the central challenge to the enforceability of the arbitration provisions and specifically the delegation clause (i.e., the provision which provided that the parties agreed to arbitrate "gateway" questions of arbitrability, including whether the arbitration agreement is unconscionable) therein: whether the agreement was unconscionable.

As an initial matter, the court concluded that based on the delegation provision, the plaintiffs cannot challenge the validity of the arbitration provisions as a whole in this action; such challenges were reserved for the arbitrators. However, the court addressed the plaintiffs' unconscionability arguments solely with respect to the delegation clause.

The court began its analysis with a recitation of the law of Connecticut: "The classic definition of an unconscionable contract is one which no man in his senses, not under delusion would make, on the one hand, and which no fair and honest man would accept, on the other." *Smith v. Mitsubishi Motors Credit of America, Inc.*, 721 A.2d 1187, 1190 (Conn. 1998). Substantive unconscionability focuses on the content of the contract, as distinguished from procedural unconscionability, which focuses on the process by which the allegedly unfair terms found their way into the agreement.

As to procedural unconscionability, the plaintiffs contended that the provisions were void because the delegation clause was adhesive, was not explained to the plaintiffs, and was obscure and buried in the franchise agreements. However, the court noted that, as a matter of Connecticut law, the court cannot deem the delegation clause to be unconscionable based solely on the adhesive nature of the contract and the unequal standing of the parties. Thus, the plaintiffs' contention that the delegation clause was the subject of unequal bargaining power or was hidden in the three- or four-page franchise agreements was insufficient. Instead, under Connecticut law, a court cannot find procedural unconscionability unless the party opposing enforcement has introduced some specific evidence of overreaching by the other party in the formation of the agreement. In short, because the plaintiffs' claim that the delegation clauses were buried in the form franchise agreements was not supported by the record and the remaining claims

(relating to the adhesive nature of the contract and the parties' unequal bargaining power) were legally insufficient. As a result, the plaintiffs' claim of procedural unconscionability failed as a matter of law.

Because the court determined that Connecticut law was not clear concerning whether a contract must be both procedurally and substantively unconscionable to be voided, the court considered the plaintiffs' assertions regarding substantive unconscionability of the delegation provisions despite the absence of procedural unconscionability. The plaintiffs argued that the delegation clauses were substantively unconscionable because (1) they contained a cost-splitting provision; (2) they contained a provision requiring the losing party to pay the prevailing party's attorneys fees; and (3) they contained a confidentiality provision. The court initially noted the lack of controlling authority concerning these arguments but that it was nonetheless guided by the well-established rules defining unconscionability in *Smith*.

First, the plaintiffs argued that the cost-splitting provisions rendered the delegation clauses substantively unconscionable. The plaintiffs asserted that the requisite arbitration filing fees would prevent the plaintiffs—janitorial workers of modest means—from vindicating their rights (the so-called "effective vindication" doctrine). However, the court concluded that the effective vindication doctrine did not apply in this context and, in any event, the plaintiffs failed to meet their burden of establishing substantive unconscionability as to the cost-sharing provision because they failed to provide evidence in the record before the court as to the fees likely to be incurred and as to the plaintiffs' financial situations. As a result, the court concluded that, based upon the record before it, any costs beyond the initial filing fee were, at that point, speculative and that the evidence did not otherwise support the conclusion that the cost-sharing provision rendered the delegation clause substantively unconscionable.

Second, the plaintiffs argued that the fee-shifting provision that required the losing party to pay the prevailing party's attorney's fees was substantively unconscionable. Again, faced with the lack of controlling Second Circuit or Connecticut precedent, the court declined to conclude that the fee-shifting provision was substantively unconscionable.

Third, the plaintiffs argued that the confidentiality provision in the franchise agreements were substantively unconscionable. The plaintiffs argued that the confidentiality obligation provided CNA with a "repeat player" advantage where the plaintiffs would be left ignorant of any favorable decisions by other cleaning workers that successfully challenged the validity of the agreement or other threshold issues. However, the court noted that the single case cited by the plaintiffs for this proposition had been overturned, with the appellate court ruling noting that the California Court of Appeals had rejected the policy argument that such confidentiality provisions inhibited employees from discovering evidence from each other. The court further concluded that the policy argument considering confidentiality provision unconscionability was likely foreclosed by the Supreme Court in

AT&T v. Concepcion, 563 U.S. 333 (2011), in which the court stated: "The point of purporting parties' discretion in deciding arbitration processes is to allow for efficient, streamlined procedures tailored to the type of dispute. It can be specified, for example, that the decision maker be a specialist in the relevant field, or that proceedings be kept confidential to protect trade secrets." *Id.* at 345. The court concluded that the confidentiality clause did not render the agreement substantively unconscionable.

As a result, the court granted CNA's motion to compel arbitration.

ATTORNEYS FEES

Chong v. 7-Eleven, Inc., Bus. Franchise Guide (CCH) ¶ 16,613, 2020 LEXIS 39402 (E.D. Pa. Mar. 4, 2020)

The U.S. District Court for the Eastern District of Pennsylvania granted 7-Eleven, Inc.'s (7-Eleven) motion for summary judgment, dismissing all of the franchisee's claims and awarding damages of nearly $160,000 plus interest and costs for the franchisor's counterclaims.

The franchisee, which operated two stores in the 7-Eleven system for twenty-one years, sued the franchisor after its franchise agreements were terminated for alleged inaccurate transaction reporting. The franchisee claimed that the termination was in bad faith and alleged an assortment of claims, including breach of contract, breach of the covenant of good faith and fair dealing, unconscionability, unjust enrichment, impracticability, conversion, and fraud. The franchisor filed a motion to dismiss and a counterclaim, alleging breach of contract by the franchisee for underreporting merchandise sales. At 7-Eleven's request, the court stayed certain of the franchisee's breach of contract claims, which were required to be arbitrated pursuant to the franchise agreements. The court subsequently dismissed two of the franchisee's breach of contract claims and its claims for impracticability, unconscionability, and fraud. The parties separately stipulated to dismissal of additional breach of contract and conversion claims alleged by the franchisee, leaving only two claims for breach of contract and the claim for breach of the covenant of good faith and fair dealing against the franchisor, as well as 7-Eleven's counterclaim against the franchisee for breach of contract. 7-Eleven moved for summary judgment of the franchisee's remaining claims and its counterclaim.

In the first of the two remaining breach of contract claims, the franchisee alleged 7-Eleven failed to treat it as an independent contractor because 7-Eleven required the franchisee to sell certain products that the franchisee did not order and 7-Eleven interfered with the franchisee's management of its employees by communicating directly with them. The franchisee pointed to language in the franchise agreement wherein the franchisee agreed to "control the manner and means of the operation of the Store" and "to exercise complete control over and responsibility for all labor relations and the conduct of [the franchisee's] agents and employees." The court, however, disagreed, finding that the plain language of the franchise agreement section

cited by the franchisee placed no duties or obligations on 7-Eleven and that the franchisee could not, as it attempted, create an affirmative obligation for 7-Eleven by equitable estoppel. The court further stated that interpreting the independent contractor-related provisions of the franchise agreements in the manner urged by the franchisee would require completely disregarding direct language in the franchise agreements that permitted 7-Eleven to require the franchisee to carry and sell the inventory specified by 7-Eleven. The court also determined that 7-Eleven's employees were not prohibited from talking with the franchisee's employees and the testimony did not otherwise show that 7-Eleven attempted to control the franchisee's employees.

In its second remaining breach of contract claim, the franchisee alleged that the franchisor failed to maintain the franchisee's HVAC equipment despite repeated requests. In dismissing the claim, the court noted that the franchise agreement only required the franchisor to maintain the HVAC equipment when the franchisor determined that it needed to be maintained. Since the court was not convinced that the franchisor subjectively believed maintenance was required, no breach could be sustained. The court's decision may have been aided by evidence that the franchisor had previously replaced and maintained the HVAC system. Nonetheless, responding to the franchisee's claim that the franchisor had an obligation to exercise its discretion in good faith, the court cited prior district court decisions in the Third Circuit refusing to extend the duty of good faith in the franchise context, beyond decisions by a franchisor to terminate a franchisee, and dismissed the claim.

The court next addressed the franchisee's claim that 7-Eleven terminated the franchise agreements in bad faith, violating the covenant of good faith and fair dealing. Reviewing the testimony and evidence, the court found that the franchisee had significantly understated its merchandise sales and therefore underpaid royalties. On this basis, the court determined that 7-Eleven had the right to, and appropriately terminated, the franchise agreements. Based on the same evidence, the court entered judgment in favor of 7-Eleven on its counterclaims against the franchisee and its guaranteeing principal for underpaid royalties of nearly $160,000, with instructions for the parties to submit evidence to support an award for interest and costs, including attorneys fees.

CHOICE OF FORUM

***Aguilera v. Matco Tools Corp.*, Bus. Franchise Guide (CCH) ¶ 16,617, 2020 LEXIS 43283 (S.D. Cal. Mar. 12, 2020)**

This case is discussed under the topic heading "Arbitration."

***CajunLand Pizza v. Marco's Franchising*, Bus. Franchise Guide (CCH) ¶ 16,615, 2020 LEXIS 40944 (E.D. La. Mar. 10, 2020)**

The U.S. District Court for the Eastern District of Louisiana granted the franchisor's motion to transfer a lawsuit filed by an area developer who also operated six franchise locations in Louisiana.

The case stemmed from allegations by the area developer that the franchisor, after approving the sale of the franchise locations, requested that the area developer sell to a different party and, ultimately, revoked its approval of the sale, causing it to fall through.

Opposing the franchisor's motion to transfer the case to the Northern District of Ohio, where the franchisor was based, the area developer argued that, despite a broad and enforceable forum selection clause, its claims against the franchisor were not based on the franchise agreements; rather, the area developer's claims related to its agreement with a third-party purchaser of its franchise locations and the franchisor's tortious interference with that agreement.

The court disagreed, finding that the broad forum selection clause (applying to "any action" between the parties) encompassed the area developer's claims and was valid and enforceable. The court quoted the Supreme Court's decision in *Atlantic Marine Construction Co. v. United States District Court*, 571 U.S. 49, 60 (2013), stating that "a valid forum-selection clause controls the *forum non conveniens* inquiry '[i]n all but the most unusual cases." Noting that the presence of the forum-selection clause precluded consideration of private-interest factors in a U.S.C. § 1404 transfer analysis, the court briefly reviewed the five public-interest factors and determined that only one (the local interest in having localized controversies decided at home) might have weighed in favor of not transferring. It did not create the sort of "extraordinary circumstance" necessary to override the parties' forum-selection clauses.

***Lakeside Surfaces, Inc. v. Cambria Co.*, Bus. Franchise Guide (CCH) ¶ 16,618, 2020 WL 1227047 (W.D. Mich. Mar. 13, 2020)**

This 2020 case from the U.S. District Court for the Western District of Michigan addressed a forum selection clause dispute. The court granted the defendant's motion to dismiss the complaint for failure to state a claim. The court's decision turned on a forum-selection clause agreed to by the parties in their Business Partnership Agreements (BPA). This clause, which also appeared in the credit agreement between the parties, designated Minnesota as the proper forum for any and all claims and disputes arising out of the agreement. The plaintiff wanted the case to be heard in Michigan, thus subjecting the parties to the Michigan Franchise Investment Law (MFIL), which requires good cause before termination of a franchise agreement. However, the plaintiff did not plead any of the necessary considerations to strike a forum-selection clause, and the court dismissed the case on this ground.

The plaintiff, Lakeside Surfaces, Inc. (Lakeside), is a Michigan corporation that sells and fabricates quartz, stone, and other solid-surface countertops. The defendant, Cambria Company, LLC (Cambria) is a Minnesota company that manufactures and sells its own brand of quartz countertops. Cambria approached Lakeside in 2011 to enter into an agreement to make Lakeside one of their "Lexus Partners." This plan required Lakeside to meet several conditions: first, to maintain a broad customer base; second, to have

a sales history averaging two truckloads of Cambria product per month; and third, the ability to fabricate at least 10,000 square feet of Cambria product monthly. Among several other terms in the agreement, Lakeside agreed to maintain eighty percent of its business offering Cambria countertops, to advertise only Cambria on its trucks, to employ at least two full-time Cambria-specific salespeople, to have personnel attend Cambria's training in Minnesota, and to "purchase more than $50,000 in 'Cambria point of sales materials' per year."

The relationship between the parties was lucrative for some time. In 2017, Lakeside constructed a $1,000,000 design gallery with Cambria's branding, and a $6,000,000 facility capable of fabricating 50,000 square feet of Cambria slabs per month. This work was allegedly done with the expectation that Cambria would designate Lakeside as the sole provider of Cambria products in Michigan. However, the relationship disintegrated in January 2018 after Cambria learned of Lakeside offering its customers a new quartz product, Aurea Stone. Cambria effected a unilateral termination of the relationship, telling Lakeside that "supplying other quartz is an immediate termination of our partnership as well understood." Lakeside alleges that this unilateral termination caused significant harm to its reputation because Cambria cancelled orders for 120 slabs of quartz, leaving Lakeside with $500,000 worth of unfulfilled customer orders.

Lakeside's claimed (1) breach of the BPA and its implied covenant of good faith and fair dealing; (2) failure to comply with the MFIL by committing fraud under Michigan Compiled Laws § 445.1505(c) by "deceitfully encourag[ing]" Lakeside to build the new facility; (3) failure to disclose the information required by Mich. Comp. Laws § 445.1508 for the sale of a franchise; (4) breach of good faith and reasonable notice of termination required by *§ 2-309* of the Uniform Commercial Code; and (5) promissory estoppel. Lakeside wanted to have the case decided in Michigan rather than Minnesota because of the protection granted under the MFIL, requiring good cause for termination of a franchise agreement. After a discussion of the applicable dismissal standard, the court explained its reasons for dismissal based on the forum-selection clause.

The basis for Cambria's motion to dismiss was that Lakeside had executed an enforceable forum-selection clause in the BPA. The Credit Agreement between the parties provided that: "This agreement shall be governed by and construed in accordance with the laws of the State of Minnesota. Any proceeding involving this Agreement and/or any claims or disputes relating to the agreements and transactions between the parties shall be in the District Court of Le Sueur County, State of Minnesota." The forum-selection clause is particularly broad and encompassed "all of Lakeside's claims because they all 'relate to' the agreements and transactions between the parties." The court noted that it is also a mandatory, not permissive, clause, meaning the action *must* be brought in the named court. The court rejected Lakeside's argument that the forum-selection clause was invalid under Michigan law based on

two considerations: first, federal law, not state law, "governs the enforceability of a forum-selection clause in these proceedings," and second, the parties contractually agreed to the forum-selection clause. The court concluded that the forum-selection clause was therefore valid and enforceable.

In determining whether the forum selection clause was enforceable under federal procedural law, the court looked at three factors: (1) whether the clause was obtained by fraud, duress, or other unconscionable means; (2) whether the designated forum would ineffectively or unfairly handle the suit; and (3) whether the designated forum would be so seriously inconvenient such that requiring the plaintiff to bring suit there would be unjust. The court noted that none of these factors was addressed in Lakeside's briefs, and therefore Lakeside had not overcome the burden of proving unenforceability of the forum-selection clause.

The court looked at the *Restatement (Second) of Conflict of Laws*, Michigan's authority on choice of law, to decide whether to enforce the forum selection clause. Section 127 (a) of the *Restatement* states that the parties' choice of law will govern unless there is no substantial relationship to the parties and their agreement. The court rejected this outright, because the plaintiff had no problem sending their employees to Minnesota for training.

Section 127 (b) of the *Restatement* says that the chosen forum will govern unless the application of the law would be contrary to a fundamental policy of a state that has a materially greater interest than the chosen state. The court concluded that the MFIL represents the public policy of Michigan, and Michigan has a materially greater interest over protection of its franchisees, but applying Minnesota law would not be contrary to Michigan's fundamental public policy. The plaintiff failed to show that it would suffer from substantial loss of protection by applying Minnesota law instead of Michigan law. The court noted that the only substantial difference between the Minnesota Franchise Act (MFA) and the MFIL is that the MFIL prohibits the use of the forum selection clause—in all other regards, the MFA offers *more* protection.

The plaintiff claimed that being subject to Minnesota law would "deprive it of a meaningful remedy" because the MFA does not apply to out-of-state franchisees. The text of the MFA, however, indicates that that it *does* apply to out of state franchisees, and no Minnesota state court has held the contrary. The court held that only one provision of the MFA (the anti-waiver provision) is expressly limited to franchisees located in Minnesota. Using the plain meaning of the MFA's text, the court concluded that it was not the legislature's intention that it should not apply to out-of-state franchisees.

A final consideration on whether the BPA was governed by Minnesota Law was whether the forum-selection agreement was obtained under unequal bargaining power and, therefore, contrary to Michigan's public policy. The court noted that the parties were similar in bargaining power when the contract was signed—the evidence suggested that Cambria considered

Lakeside a successful business partner. Therefore, no inherent Michigan public policy reason existed to invalidate the forum-selection clause.

Citing *Atlantic Marine Construction Co. v. United States Dist Court*, 571 U.S. 49, 52 (2013), the court held that the proper way to dismiss the case was through the doctrine of forum non-conveniens, since the court was unable to transfer it to another state court. As Lakeside, the party acting in violation of the forum-selection clause, was unable to demonstrate any public interest factors that overwhelmingly disfavor dismissal per *Atlantic Marine*, the claim was dismissed in order to properly enforce the forum-selection clause of the BPA.

The court specifically noted that it made no comment as to whether Lakeside's claim had a reasonable chance of success.

CHOICE OF LAW

***Aguilera v. Matco Tools Corp.*, Bus. Franchise Guide (CCH) ¶ 16,617, 2020 LEXIS 43283 (S.D. Ca. Mar. 12, 2020)**

This case is discussed under the topic heading "Arbitration."

***CajunLand Pizza v. Marco's Franchising*, Bus. Franchise Guide (CCH) ¶ 16,615, 2020 LEXIS 40944 (E.D. La., Mar. 10, 2020)**

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

CONTRACT ISSUES

***Chong v. 7-Eleven, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,613, 2020 LEXIS 39402 (E.D. Pa. Mar. 4, 2020)**

This case is discussed under the topic heading "Attorneys Fees."

***Fabius v. Medinexo USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,629, 2020 LEXIS 59029 (E.D. Mo. Apr. 3, 2020)**

The United States District Court for the Eastern District of Missouri dismissed the majority of claims made by a franchisee of a telehealth franchise system but permitted the franchisee an opportunity to amend the complaint to correct pleading deficiencies.

The franchisee's complaint included claims against the franchisor and its officers for violations of the New York State Franchise Sales Act (NYFSA) and New Jersey Consumer Fraud Act (NJCFA), fraud in the inducement, and breach of contract. The franchisor and its officers filed motions to dismiss, which the court considered concurrently.

The franchisee alleged fraud in the inducement based on statements made by the franchisor at a franchise expo. Applying Missouri law, the court stated that predictions about future profitability and success are not misrepresentations about past or present facts. Therefore, the court ruled that statements by the franchisor's officers that the franchisee would earn approximately $75,000

in the first year and $400,000 in the second year, and would make so much money that it would not want to renew amounted to puffery, not fraudulent misrepresentations, and dismissed that portion of the franchisee's fraud claim.

The franchisee also alleged that it received documents containing specific representations and projections from the franchisor. Because the franchisee's complaint relied on collective, and not specific, allegations, the court dismissed the claim, but granted the franchisee leave to amend the complaint. The franchisor also sought dismissal on grounds that the franchisee in the complaint alleged to have expertise in the industry and conducted extensive due diligence and, as the franchisor argued, therefore could not reasonably rely on the alleged misrepresentations. Although predicting that it might be hard for the franchisee to prove otherwise, the court refused to dismiss the claim because it presented factual issues that were not appropriately decided by a motion to dismiss under Federal Rule of Civil Procedure 12(b)(6).

The court next considered the franchisee's claims for violation of the NYFSA. The court held that whether the NYFSA applied to the franchisee, which was a New York limited-liability company, raised questions of fact that could not be decided at the motion-to-dismiss stage. The court did, however, find that the franchisee did not sufficiently specify how one of the individual officers of the franchisor was implicated, and therefore dismissed the claim as to the officer, granting the franchisee leave to file an amended complaint with allegations particular to the officer. The court also dismissed with leave to amend the franchisee's claim that the franchisor violated New York's franchise registration law's requirements because the franchisee failed to plead how it was damaged.

The court made short work of the franchisee's NJCFA claim, citing to case law stating that it did not apply to franchise sales except for a very narrow exception based on an offering that targeted the general public and required less than a $100 payment. The court dismissed the claim.

Finally, the court dismissed the franchisee's breach of contract claim because the franchisee and its owner did not affirmatively plead, as required by Missouri law, that they had fulfilled their obligations under the franchise agreement. The court, again, granted the franchisee leave to amend its pleadings.

***Real Estate Visionaries v. RE/MAX of New England*, Bus. Franchise Guide (CCH) ¶ 16,642, (Mass. Super. Ct. Apr. 16, 2020)**

This Massachusetts Superior Court case addressed fair dealing and fraudulent inducement. The claims arose in the context of a breakdown of the parties' relationship. The plaintiff franchisee, Real Estate Visionaries, Inc., d/b/a Leading Edge (Leading Edge), operated several Re/Max locations in the Boston area, which were all subject to different expiration dates, per the franchisor's policy. When no contract renewal occurred and the parties were in dispute, the defendant franchisor attempted to recruit agents from some of the franchisee's locations whose franchise agreements had not yet expired. The court found that the defendant franchisor, Re/Max of New England,

Inc. (Re/Max), had breached the parties' franchise agreements and the implied covenant of good faith and fair dealing, as well as having violated the Massachusetts Unfair Trade Practices Act, G.L. c. 93A, §§2 and 11 (Chapter 93A), leading to an award of damages totalling $22,565. The plaintiff's' claims for fraudulent inducement and tortious interference were dismissed, as were the defendant's counterclaim.

The plaintiffs were a franchisee of Re/Max called Leading Edge, and its four owners, Stephen Chuha, Paul Mydelski, Eileen Hamblin, and Linda O'Koniewski. In 2016, they owned nine successful franchised locations in the Boston area, including three "satellite" locations, operated under a total of six franchise agreements per Re/Max's policy to have different agreements govern each location. Each agreement had a term of five years, resulting in staggered expiration dates. At the end of each term, the Franchise Disclosure Document explained that Re/Max may provide for a longer term, or month-to-month renewal. The Re/Max franchise agreements included non-compete clauses: "both (1) an 'in-term' non-compete clause, which barred franchisee/owners from participating in *any* other real estate services, and (2) a 'post-term' non-compete clause, which barred franchisee/owners from participating in any *franchised* real estate brokerage for one year after Re/Max franchise expiration." The post-term non-compete was not included in franchise agreements prior to 2012, and Re/Max had waived this condition several times between 2012 and 2016.

The shift in the business relationship came in 2016, when Leading Edge was considering acquiring several locations affiliated with Hammond realty brokerage. They approached Re/Max to attempt to negotiate a unified termination date for their franchise agreements. Representatives from Leading Edge travelled to Toronto to speak with Re/Max senior representatives regarding the proposed acquisition. They requested a uniform expiration date, removal of the post-term non-compete, and ending the requirement that Leading Edge principals personally guarantee Leading Edge obligations. Despite initially refusing the request, by the meeting's conclusion, Re/Max president Walter Schneider assured Leading Edge that they would "work it out" and to go ahead with their proposed expansion. These requests, however, resulted in mutual hard-bargaining negotiations that lasted from June 2016 to July 2018. Leading Edge tied the renewal of the franchise locations to the request for a unified termination date and the elimination of the post-term non-compete. While Re/Max offered fee reductions and promotional funds to make renewal more attractive, it repeatedly declined to implement a unified termination date and to remove the post-term non-compete. In 2018, after the expiration of the franchise agreements for two Leading Edge franchise locations, Re/Max insisted on its strict contract terms, which prevented Leading Edge from continuing to operate the two expired franchise businesses or opening competing brokerages at these locations while the other franchise locations were still in operation through the in-term non-compete clauses. After a failed attempt at a court injunction, Leading Edge was forced

to cease operations at those locations pending the expiration of the other franchise agreements.

In 2013, Re/Max issued Policy Directive No. 1, which expressly forbade "predatory recruiting activity" between existing Re/Max offices and sales associates. In particular, the Directive discouraged recruiting that "through predatory practices aimed purposefully to induce existing Sales Associates to change their Re/Max office affiliation." On June 26–28, 2018, Re/Max was alleged to have done exactly that: through a mass email and a dinner for other area franchisees that encouraged active recruitment of Leading Edge associates, Re/Max intended to poach as many Leading Edge employees as possible for other Re/Max locations. The court said that since Re/Max's breach was material, Leading Edge's move to terminate performance of the unexpired contracts was within its rights.

The court noted that each independent action by Re/Max would not be actionable, until Re/Max attempted to recruit Leading Edge agents. This illuminated the intent behind the business practices as a whole: Re/Max wanted it to be nearly impossible for former franchisees to conduct business independent of Re/Max. The court noted that, not once during questioning on this point did a Re/Max executive allude to an acceptable scenario where a former Re/Max multi-point franchisee would be able to successfully disengage with Re/Max while still maintaining a lucrative real estate career. The court rightfully surmised that the intent behind the staggered terms and non-compete clauses, then, was to ensure Re/Max's grip over future competition. Taken as a whole, the court found Re/Max's behavior sufficient to warrant an unfair business practice breach under Chapter 93A.

The basis of Leading Edge's claim for fraudulent inducement of the franchise agreements was Item 17(a) of certain Franchise Disclosure Documents, which identified the five-year term and explained that Re/Max *may* provide for an extension. Leading Edge claimed that Re/Max failed to inform Leading Edge that, in reality, Re/Max's position was to deny multi-point franchises longer term franchise agreements or month-to-month extensions. In Massachusetts, to succeed in a claim for fraudulent inducement, the plaintiff must show "misrepresentation of a material fact, made to induce action, and reasonable reliance on the false statement to the detriment of the person relying." Applying this standard to the facts, the court found that Leading Edge's claim did not satisfy the reasonable reliance or causation requirements of fraudulent inducement. This was because the contract term at issue said that Re/Max *may* extend the contract if needed for business expansion purposes, but not that it *must* do so. Because both parties were sophisticated business entities, little evidence suggested that Leading Edge reasonably or in fact relied upon this term. Rather, Leading Edge was aware of the difficulties that the staggered terms and post-term non-compete clauses posed but elected to enter the franchise agreements regardless.

Leading Edge also claimed that Re/Max's failure to consolidate Re/Max promotions with its parent Re/Max in financial statements included in their

Franchise Disclosure Documents constituted fraudulent inducement, with which the court disagreed on the basis that no testimony showed that if the financial statements had been correct, Leading Edge would not have entered into the franchise agreements. Thus, there was no reliance on these terms.

The court then turned to Leading Edge's claims for breach of contract and breach of the implied covenant of good faith and fair dealing. These claims were based on the actions surrounding the four unexpired franchise agreements between June 26–28, 2018. The court agreed with Leading Edge that Re/Max breached the terms of the franchise agreements when it violated its own Policy Directive No. 1 in its efforts to recruit Leading Edge associates to other Re/Max franchised locations. The court noted that there was no dispute that this Policy Directive supplements every franchise agreement and was always intended to constitute a term of contract. The court rejected Re/Max's claim that the Policy Directive does not apply to Re/Max itself, but only to its franchisees, on the basis that it "eviscerates the very protection offered franchisees by the Policy Directive." Re/Max's attempt to point to a contract term that allowed it to contact franchisee agents upon the *termination* of a franchise agreement was likewise rejected, because "termination" and "expiration" of a franchise agreement are treated expressly differently in the contracts themselves. The court concluded that these terms regardless must be interpreted in congruence with Policy Directive No.1 and that any predatory recruiting is therefore prohibited.

The court concluded that Re/Max breached the implied covenant of good faith and fair dealing that exists in each contract, regardless of whether the parties are sophisticated business entities or not. This breach occurred when it recruited Leading Edge sales agents to join other Re/Max franchises, despite the four ongoing franchise agreements between the parties. The court qualified this act as a material breach, thus immediately excusing Leading Edge's continued performance under the remaining franchise agreements. However, the court awarded only limited damages in the amount of $22,565 from losses due to breach of contract and the implied covenant, because the only actual damages caused by the breach were those incurred during a rapid de-identification and rebranding that Leading Edge undertook between June 28 and July 3, 2018. The other costs would have been incurred regardless of whether or not Re/Max committed the material breach.

Next, the court approached the question of tortious interference with contract. Leading Edge claimed that Re/Max's solicitation of its agents constituted tortious interference in its contracts with those agents. To succeed in this claim, the court noted that Leading Edge must prove that (1) they had contracts with a third party; (2) Re/Max knowingly induced Leading Edge agents to break their contracts with Leading Edge; (3) Re/Max's alleged interference, in addition to being intentional, was improper in motive or means; and (4) Leading Edge was harmed by Re/Max's actions. The first and third prongs of this test were met, but the second and fourth were not;

namely, no evidence showed that Re/Max managed to induce any employees to break their contracts with Leading Edge, and the court rejected the inference that the reduction in sales agents was a direct result of their recruitment by Re/Max. Therefore, Leading Edge's claim for tortious interference with contract failed.

Finally, the court undertook an examination of the unfair, deceptive, or anticompetitive conduct claim under Chapter 93(A). The court noted that the statute makes unlawful "unfair methods of competition" and "unfair or deceptive" acts or practices in trade or commerce." This claim was based upon two aspects of Re/Max's conduct: first, that they misrepresented and failed to disclose material facts in their franchise disclosure documents in connection with Leading Edge's franchise agreement renewal; and second, that their contract practices and enforcement towards Leading Edge were in violation of Chapter 93(A). The court disposed of the first claim in the same manner as the fraudulent misrepresentation allegation; there was no proven causation between the loss suffered and Re/Max's conduct. Leading Edge's reliance on the contract term which permitted, but did not oblige, Re/Max to renew franchise agreements was not a sufficient basis for the claim.

However, the court did find that Re/Max's overall course of dealing with their franchisee Leading Edge constituted unfair conduct. The court specifically noted that, taken separately and before the events of late June 2018, no unfair dealing had occurred according to Chapter 93(A). It was not until Re/Max's attempt to solicit Leading Edge's sales agents that their entire business position towards the franchisee was illuminated. The court held that, taken together, the post-term non-compete provision, the staggered franchise agreement expirations, and finally, the attempted poaching of agents, demonstrated Re/Max's practice of making it nearly impossible for a former franchisee to carry on a similarly successful business after ending a relationship with Re/Max. The anti-competitive tactics of Re/Max were found to be unfair commercial conduct in violation of Chapter 93(A). The court attributed the former damages awarded to this claim ($22,565) but also added attorneys' fees for the violation.

The court went on to dismiss Re/Max's counterclaim asking to recover fees and penalties on the basis that Leading Edge breached the franchise agreements and was not entitled to recovery under the unexpired agreements. The court elected not to comment on whether the non-compete agreements were invalid overall because the parties were no longer bound by them.

DAMAGES

***Chong v. 7-Eleven, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,613, 2020 LEXIS 39402 (E.D. Pa. Mar. 4, 2020)**

This case is discussed under the topic heading "Attorneys Fees."

***Fabius v. Medinexo USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,629, 2020 LEXIS 59029 (E.D. Mo. Apr. 3, 2020)**
This case is discussed under the topic heading “Contract Issues.”

***Orange Rabbit, Inc. v. Franchoice, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,650, 2020 WL 2191947 (D. Minn. May 6, 2020)**
The United States District Court for the District of Minnesota granted a kickboxing business franchisee and its owner leave to amend their complaint to assert a claim for punitive damages against the defendant franchise consultant under Minn. Stat. ¶ 549 based upon the defendant’s specific representations about the franchisor made without investigating or verifying them, when such representations were false and were known or should have been known to the defendant to be false. However, the court denied the franchisee’s motion to the extent that it sought to assert a claim for punitive damages arising from other allegations, which the court deemed insufficient to state a claim for punitive damages under the statute.

In this case, the franchisee alleged fraud and sought punitive damages, not against the franchisor, but against a franchise consultant who the franchisee alleged committed fraud by knowingly making false representations to the franchisee for the purpose of inducing it to purchase an “I Love Kickboxing” (ILKB) kickboxing franchise. The franchisee alleged that the representations proved to be untrue; that the franchisee reasonably relied on the information in deciding to purchase an ILKB franchise, and that as a result, the franchisee and its owner suffered damages in excess of $500,000.

In the proposed second amended complaint, the franchisee alleged that the defendant failed to perform any systematic or professional due diligence upon ILKB but, instead, merely accepted ILKB’s representations as true and passed them along to the franchisee. The second amended complaint also alleged that the defendant made affirmative misrepresentations about ILKB without investigating or verifying them, when such representations were false and were known or should have been known to defendant as false.

Under Rule 15, leave to amend “shall be freely given when justice so requires.” In the Eighth Circuit, amendment of a pleading is allowed liberally to ensure that a case is decided on the merits, but no absolute right to amend exists. Denial of leave to amend may be justified by, *inter alia*, futility of the amendment or unfair prejudice to the opposing party. In this case, the defendants argued that the motion should be denied because it is futile. Thus, the question presented to the court was whether the proposed second amended complaint plausibly alleged facts showing that the acts of the defendants showed deliberate disregard for the rights or safety of others as defined in Minn. Stat. ¶ 549.20.

Under the criteria set forth in sec 549.20, a defendant operates with “deliberate disregard” by acting with intent or indifference to threaten the rights or safety of others. As such, the mere existence of negligence or gross

negligence does not rise to the level required so as to warrant a claim for punitive damages. Further, a plaintiff must allege that defendant was aware of a high probability that its conduct would cause injury to the plaintiff. Put another way, the court looks to whether the allegations in the proposed complaint plausibly allege that a defendant knew of facts, or intentionally disregarded facts, that created a high probability that the defendant's actions would harm the rights or safety of the plaintiff.

Applying this standard, the court found that the plaintiffs' general allegations of misconduct in connection with the sale of the franchise failed to plausibly allege misconduct in violation of the Minnesota statute. However, the court determined that the plaintiffs' allegations that the defendant made specific representations about ILKB without investigating or verifying them, when such representations were false and were known or should have been known to the defendant as false, did meet the strict standards in the Minnesota statute. These allegations of specific misrepresentations set forth a plausible claim that the defendant knowingly, or with indifference, provided the plaintiffs with inaccurate information about ILKB to entice them to invest in an ILKB franchise, thereby creating a high probability that the defendant's actions would harm the plaintiffs. As a result, the court granted the plaintiffs' motion to amend only to the extent that it sought to add a claim for punitive damages in relation to the specifically alleged fraudulent misrepresentation made by the defendant to the plaintiffs, which the court set forth in detail in its opinion.

And, finally, the court concluded its analysis by reminding the plaintiffs that the analysis was conducted under the liberal pleading standard of Rule 15 and that the court granted them leave to amend did not imply that they are likely to succeed with their claims for punitive damages.

DEFINITION OF FRANCHISE

***Trade Links, LLC v. BI-QEM SA de CV*, Bus. Franchise Guide (CCH) ¶ 16,664, 2020 WL 1335688 (D. Conn. Mar. 23, 2020)**

This case is discussed under the topic heading "Jurisdiction."

DISCRIMINATION

***Chavez v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 16,623, 2020 WL 1322864 (D. Colo. Mar. 20, 2020)**

In this United States District Court for the District of Colorado decision, the court granted the defendants' motion to dismiss a U.S.C. *§ 1981* equal rights claim for racial discrimination. The plaintiffs were Theresa and Natalie Chavez, a mother and daughter, who visited a McDonald's franchised location, operated by the franchisee Ultra Mac, on April 26, 2018. While at the location, the store manager Ms. Juarez-Batista allegedly engaged with them in an altercation that was discriminatory in nature. After Natalie Chavez

requested fries without salt, Ms. Juarez-Batista allegedly swore at the women, asking them whether they spoke English before throwing their bag of food in the garbage near the women, resulting in a laceration to Theresa Chavez's chest. The police were called, and Ms. Juarez-Batista ultimately pled guilty to a charge of disorderly conduct. Theresa Chavez later called a complaints hotline at the restaurant, which connected her to the McDonald's Corporation. As a result of this incident, the plaintiffs brought a claim under § 1981 against the franchisee, Ultra Mac, as well as the franchisor. The franchisor's motion to dismiss the action against the franchisor was granted.

After a discussion of the legal standard for dismissal of a claim, the court launched into its analysis of the defendants' liability under § 1981. The court initially dismissed the claim because other courts have held that, to be liable for a discriminatory action, the employer must have been directly involved in the event. The plaintiffs did not allege that the defendants had any direct involvement in the discriminatory events, so the claim failed on this ground. However, because the Tenth Circuit had never addressed the issue directly, the court went on to dismiss the claim in the alternative based on the definition of *employer*.

This question turned on whether the defendant entities were "considered an 'employer' of that employee and thus could be held liable for the actions of that employee." The court noted that the parties placed incorrect emphasis on the question of whether the franchisor was in an agency relationship with the employee, which is not the correct test. Rather, the court employed the "joint employer" test because the defendants and Ultra Mac are separate entities, rather than hybrid entities or a single employer. Citing *Bristol v. Board of County Commissioners*, 312 F.3d 1213, 1219 (10th Cir. 2002), the court explained that two entities are joint employers "if they share or co-determine those matters governing the essential terms and conditions of employment. Both entities are employers if they both exercise significant control over the same employees." The three factors for this analysis are (1) whether the entity has the right to terminate; (2) whether the entity has control of records, including payroll, insurances, taxes and the like; and (3) whether the entity maintains day-to-day supervision, including employee discipline.

Regarding the first factor, the plaintiffs claimed that the franchisor "operate[s] or significantly control[s]" the Ultra Mac franchise. They also claimed that the defendants controlled the day-to-day business operations over the franchise. However, they offered no details to support these claims, so they were dismissed. The plaintiffs made no mention of control over termination, which is the most important factor in the analysis. This gap weighed greatly in the defendants' favor. The plaintiffs made no allegations that the franchisor maintained control over Ultra Mac records, so the second factor failed. Regarding the third factor, the plaintiffs claimed that uniformity in branding supported a conclusion that the franchisor has control of the franchisee. The court noted that this argument was dispelled by *McKinnon v. YUM! Brands, Inc.*, 2017 WL 3659166, at *9 (D. Idaho Aug. 24, 2017). The plaintiffs also alleged that the complaint hotline is evidence of employee control, but the court did

not find this argument persuasive due to the holding in *Allen v. Greenville Hotel Partners, Inc.*, 2006 U.S. Dist. LEXIS 33771, 2006 WL 1389812, at *2 (D.S.C. May 17, 2006), which found a complaint hotline was insufficient evidence to indicate control. Thus, the court found that the franchisor was not a joint employer with the Ultra Mac franchisee, and the claims against the franchisor were dismissed. The court further dismissed the state law claims based on 28 U.S.C. § 1367(c)(3), which entitles a district court to decline to exercise supplemental jurisdiction over a claim if the district court has dismissed all claims over which it has original jurisdiction. Because the plaintiffs did not argue that the court should retain jurisdiction, this claim was also dismissed.

EARNINGS CLAIMS

***Fabius v. Medinexo USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,629, 2020 LEXIS 59029 (E.D. Mo. Apr. 3, 2020)**
This case is discussed under the topic heading "Contract Issues."

FRAUD

***Fabius v. Medinexo USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,629, 2020 LEXIS 59029 (E.D. Mo. Apr. 3, 2020)**
This case is discussed under the topic heading "Contract Issues."

***Real Estate Visionaries v. RE/MAX of New England*, Bus. Franchise Guide (CCH) ¶ 16,642, (Mass. Super. Ct. Apr. 16, 2020)**
This case is discussed under the topic heading "Contract Issues."

***The Orange Rabbit, Inc. v. Franchoice, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,650, 2020 WL 2191947 (D. Minn. May 6, 2020)**
This case is discussed under the topic heading "Damages."

GOOD FAITH AND FAIR DEALING

***Chong v. 7-Eleven, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,613, 2020 LEXIS 39402 (E.D. Pa. Mar. 4, 2020)**
This case is discussed under the topic heading "Attorneys Fees."

***Real Estate Visionaries v. RE/MAX of New England*, Bus. Franchise Guide (CCH) ¶ 16,642, (Mass. Super. Ct. Apr. 16, 2020)**
This case is discussed under the topic heading "Contract Issues."

INJUNCTIVE RELIEF

***Aguilera v. Matco Tools Corp.*, Bus. Franchise Guide (CCH) ¶ 16,617, 2020 LEXIS 43283 (S.D. Cal. Mar. 12, 2020)**
This case is discussed under the topic heading "Arbitration."

***JTH Tax LLC v. McHugh*, Bus. Franchise Guide (CCH) ¶ 16,631, 2020 WL 1689731 (W.D. Wash. Apr 7, 2020)**

The U.S. District Court for the Western District of Washington granted the plaintiff franchisor a preliminary injunction against a former franchisee who, after allegedly abandoning her franchise in 2019, opened a new tax business within twenty-five miles, allegedly violating the noncompete clause of their franchise agreements.

The plaintiffs, Liberty Tax Service and SiempreTax+ (JTH Tax) are a tax preparation franchisor with thousands of locations nationally. One such franchise was operated by defendants Lorraine McHugh and Richard O'Brien. The parties entered into a Franchise Agreement in 2015, which granted McHugh a territory near Federal Way, Washington, and restricted use of the "confidential and proprietary business information that would be provided to her as a franchisee." The non-compete clause included in the Franchise Agreements stated that, for two years after termination of the Agreement, the defendants would not prepare or file income tax returns for a charge within twenty-five miles of the boundaries of the franchisee's territory. In addition, non-solicit and non-disclosure clauses contained in the Franchise Agreements allowed the plaintiffs to request a temporary restraining order, or a preliminary or permanent injunction for the breach of these duties. The plaintiffs alleged that, in 2019, McHugh effectively abandoned the franchise, which prompted them to send her a termination letter on August 2, 2019. In this letter the plaintiffs offered evidence that the defendant owed them thousands of dollars. Following the termination, McHugh opened her own tax preparation business, KVC Tax Services (KVC), less than ten miles away from her territory. The plaintiffs claim that several of KVC's clients were solicited by McHugh from her former JTH Tax franchise location. According to JTH Tax, these actions were a knowing and intentional breach of the parties' franchise agreements.

JTH Tax sought to enjoin the defendants from holding themselves out as being associated with the plaintiffs, owning, maintaining, engaging in, or having any interest in any other business that sells similar products and services within twenty-five miles of the former franchise for two years, employing or seeking to employ any person employed by the plaintiffs or any of their franchisees, using any confidential information provided by the plaintiffs, and diverting or attempting to divert any customer or business from the plaintiffs or attempting to solicit the business of any person who has been a customer of JTH Tax. The court applied the test for preliminary injunction as stated in *Winter v. NRDC, Inc.*, 555 U.S. 7 (2008). According to the *Winter* test, the moving party must show that (1) it is likely to succeed on the merits; (2) it is likely to suffer irreparable harm in the absence of preliminary relief; (3) the balance of equities tips in its favor; and (4) an injunction is in the public interest. Applying the first factor, the court found that the plaintiff's pleadings sufficiently indicated that the defendants likely breached or may intend to breach the noncompetition, nonsolicitation, and nondisclosure clauses. The court had earlier granted a temporary restraining order against the defendant

and built from this ruling to find that JTH Tax was likely to suffer irreparable harm from loss of customer goodwill and damage to the franchise system. The court held that the balance of equities favored the defendant and that a preliminary injunction "is in the public interest as it could prevent customer confusion." Therefore, the test for a preliminary injunction was met.

The defendants attempted to argue that the noncompetition clause was void and unenforceable under the Revised Code of Washington § 49.62 (Act), Washington State's new anti-noncompete law, which went into effect January 1, 2020. The court concluded that the non-compete clause in the Franchise Agreement was not subject to this law because the parties are not independent contractors to each other (despite the wording of their franchise agreement), but franchisee and franchisor, which is expressly excluded by the Act. The court granted a preliminary injunction against the former franchisee in this case.

***New Jersey Coalition v. Mazda Motor of America*, Bus. Franchise Guide ¶ 16,643, 957 F.3d 390 (3d Cir. Apr. 28, 2020)**

This case is discussed under the topic heading "Statutory Claims."

JURISDICTION

***Billie v. Coverall North America, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,619, 2020 WL 1185251 (D. Conn. Mar. 12, 2020)**

This case is discussed under the topic heading "Arbitration."

***Fidrych v. Marriott International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16, 610, 952 F.3d 124 (4th Cir. 2020)**

In an action brought by South Carolina residents in federal district court in South Carolina against Marriott International, Inc. (Marriott) after one of the plaintiffs was injured at the Boscolo Milano, a Marriott-affiliated hotel in Milan, Italy, the Fourth Circuit affirmed the district court's dismissal of the action against Marriott for lack of personal jurisdiction, but vacated the district court's denial of sanctions against Marriott and remanded that issue for reconsideration.

During a stay at the Boscolo, plaintiff Bud Fidrych (Fidrych) was injured when a glass shower door shattered in his hand, severing a tendon in his thumb. Fidrych and his wife subsequently filed suit against Marriott in federal district court in South Carolina, where they reside.

Marriott is incorporated in Delaware, with its principal place of business in Maryland. Of the 6,200 hotels in the Marriott system, ninety (1.54%) are in South Carolina. Marriott does not own any of those ninety hotels; sixty-three are franchises, and the remaining twenty-seven are licensed or managed by Marriott. Marriott has a Certificate of Authority issued by the South Carolina secretary of state, as is required of all foreign corporations transacting business in the state. Marriott's website permits online booking and is accessible in South Carolina. The Boscolo is not owned or managed

by Marriott, but is part of Marriott's "Autograph Collection" of hotels. The operation of the Boscolo is governed by a franchise agreement to which Marriott is not a party.

After Marriott was served with the complaint, it tendered defense of the action to the management of the Boscolo, in light of the Boscolo's contractual indemnification obligations. Boscolo failed to take appropriate action, and no answer was filed. At the plaintiffs' request, the district court clerk made an entry of default, and the district court subsequently granted the Fidrychs' motion for default judgment and set a date for damages hearing. The district court sent Marriott notice of the default and the hearing and, within a few days, Marriott filed a motion to set aside the default in which it asserted good cause to be relieved of the default and argued that the district court lacked personal jurisdiction over it.

The district court granted the motion to set aside the default under the standard set out in Rule 55 of the Federal Rules of Civil Procedure, and, in that order, the court invited the plaintiffs to file a motion for sanctions against Marriot as a result of the default. After the default was set aside, Marriott filed a motion to dismiss for lack of personal jurisdiction, and plaintiffs filed a motion seeking sanction of more than $86,000 in attorneys fees and expenses. The district court granted Marriott's motion to dismiss and denied plaintiffs' motion for sanctions, and an appeal to the Fourth Circuit followed.

On appeal, the court first examined whether the district court correctly proceeded under Rule 55, rather than Rule 60, when granting Marriott's motion to set aside the default. The court reviewed the language of Rule 55, which incorporates a good-cause standard, and Rule 60(b), which incorporates an excusable-neglect standard, and distinguished the two based upon Rule 60's application only to final judgments. Applying that distinction, the court concluded that because no damages were awarded in the district court's "default judgment," the order operated as nothing more than an entry of default, albeit one made by the court rather than the clerk, and was therefore not a "final judgment" for purposes of Rule 60(b). As a result, the court concluded that because no final judgment of default had been entered, Rule 60 was inapplicable, and the district court properly applied Rule 55's good-cause standard when considering Marriott's motion to set aside the default. The court therefore affirmed the district court's decision to set aside the default.

Turning to the central jurisdictional issue, the court discussed, at some length, controlling principles of general and specific jurisdiction under federal law guided by two relatively recent decisions from the U.S. Supreme Court—*Daimler AG v. Bauman*, 571 U.S. 117 (2014) and *Goodyear Dunlop Tires Operations, S.A. v. Brown*, 564 U.S. 915 (2011).

Broadly speaking, the validity of an order of the federal court depends upon that court's having jurisdiction over both the subject matter and the parties. Subject matter jurisdiction—an Article III requirement—functions as a restriction on a federal power and cannot be conferred on the court

by the actions of the parties. The requirement that the court have personal jurisdiction, however, springs not from Article III of the Constitution, but from the Due Process clause. Because the personal jurisdiction requirement recognizes and protects an individual liberty interest, the requirement may be waived by defendant's express or implied consent to the personal jurisdiction of the court.

Absent consent, the exercise of personal jurisdiction must comport with the requirements of the Due Process clause: valid service of process, "as well as . . . 'minimum contacts' with the forum so that the exercise of jurisdiction 'does not offend traditional notions of fair play and substantial justice.'"

The nature and quality of forum-state contacts required depends on whether the case involves the exercise of "specific" or "general" jurisdiction. General jurisdiction permits the court to hear any and all claims against the defendant, regardless of where the claims arose or the plaintiffs' citizenship. General jurisdiction may be exercised when the defendant has contacts with the forum jurisdiction that are "so constant and pervasive as to render it essentially at home in the forum State." *Daimler AG*, 571 U.S. at 122. If the defendant does not have sufficient contacts to be at home in the forum, the court may exercise specific jurisdiction if the defendant has continuous and systematic contacts with the forum state and the claims at issue arise from those contacts with the forum state. *Id.* at 126–27. The plaintiffs contended that both specific and general jurisdiction were present in this case.

Turning first to plaintiffs' claim that Marriott had sufficient contacts with South Carolina to subject it to general jurisdiction, the court began with a detailed discussion of the *Daimler* and *Goodyear* cases cited above. After summarizing the jurisdictional principles set out in *Goodyear* and *Daimler*, the court had no difficulty concluding that Marriott's contact with South Carolina were insufficient to make it "at home" in South Carolina, as is required for the exercise of general jurisdiction. Marriott's contacts with South Carolina were generally limited to its filing of a Certificate of Authority; its affiliation with ninety hotels in South Carolina, none of which it owned; and, its maintenance of an interactive website accessible in South Carolina. The court held that while these contacts certainly qualify as systematic and continuous, they are not substantial enough to "render [Marriott] essentially at home in the forum State" as required by *Daimler*. Because there is nothing that would distinguish Marriott's relationship with South Carolina from its relationship with any other of the states where it does business but where it is not incorporated or headquartered, this is not the exceptional case for general jurisdiction contemplated by the *Daimler* Court. Indeed, the court noted that accepting the plaintiffs' jurisdictional arguments in this case would mean that Marriott would be subject to general jurisdiction in every state where its hotels, whether owned, franchised, or managed, are located. As the Supreme Court explained, "[a] corporation that operates in many places can scarcely be deemed at home in all of them." *Daimler*, 571 U.S. at 139 n.20. The court therefore concluded that because Marriott's contacts

with South Carolina are not sufficient to render it "at home" in South Carolina, the requirements for the exercise of contact-based general jurisdiction were not satisfied.

However, plaintiffs also contended that, even if Marriott's contacts were insufficient to support the exercise of general jurisdiction, Marriott consented to general jurisdiction in South Carolina when it obtained Certificate of Authority to conduct business in the state. After considering older precedent on this issue in light of *Daimler*, the court concluded that a Certificate of Authority does not automatically subject a foreign corporation to jurisdiction in South Carolina courts and that jurisdiction instead depends on sufficient South Carolina contacts by the foreign corporation. As a result, the court held that the district court properly concluded that Marriott did not consent to the exercise of general jurisdiction by obtaining the Certificate of Authority.

Turning to plaintiffs' claim that South Carolina may properly exercise specific jurisdiction, the court noted that the Due Process clause permits the exercise of specific jurisdiction over a defendant if "the defendant [has] purposefully established minimum contacts in the forum State such that it should reasonably anticipate being hailed into court there." These requirements are met, and specific jurisdiction may be exercised, if the defendant has purposefully directed his activities at residents of the forum, and the litigation results from alleged injuries that arise out of relate to those activities. When determining whether specific jurisdiction exists, the court shall consider (1) the extent to which the defendant purposefully availed itself of the privilege of conducting business in the State; (2) whether the plaintiffs' claims arise out of those activities directed at the State; and, (3) whether the exercise of personal jurisdiction would be constitutionally reasonable.

Addressing these factors, the court first discussed whether the litigation arose out of Marriott's contacts with South Carolina. For a state court to exercise specific jurisdiction, the action must arise out of or relate to the defendant's contacts with the forum. When no such connection exists, specific jurisdiction is lacking, regardless of the extent of a defendant's unconnected activities within the state. The only action by Marriott arguably relevant to the claims asserted was the operation of its website. Although Fidrych did not make his own reservation, his Complaint alleges that a travel agent used by his employer did use Marriott's website to make his reservation at the Boscolo. The court concluded that whether the use of the website to make the reservations means that Fidrych's personal injury claims arise from or relate to Marriott's operation of the website is a difficult question, which the court need not definitively resolve because Marriott's operation of a website accessible in South Carolina is insufficient to satisfy the minimum-contacts requirement of personal jurisdictional inquiry, discussed immediately below. The purposeful-availment requirement ensures that a defendant will not be hailed into a jurisdiction solely as a result of random, fortuitous, or attenuated contacts, or of the unilateral activity of another party or third person. In this case, none of the wrong that Marriott

is alleged to have committed took place in South Carolina, and, accordingly, the court was again left with Marriott's operation of its website as the only arguable jurisdictional hook connecting this case to South Carolina. The question, then, was whether Marriott's operation of the website amounts to activity purposefully directed at South Carolina residents. After reviewing the jurisdictional analysis of Internet usage, the Court concluded that the Marriott website, although interactive, is not used to target South Carolina residents in particular. As a result, the court concluded that Marriott's case-related contacts with South Carolina are too tenuous and too insubstantial to constitutionally permit the exercise of specific jurisdiction over Marriott. Because neither general nor specific jurisdiction may be exercised in the case, the district court properly granted Marriott's motion to dismiss for lack of personal jurisdiction.

Finally, the court addressed plaintiffs' claim that the district court erred by denying their motion for sanctions as a result of Marriott's failure to file a timely answer. In its order setting aside Marriott's default, the district judge noted the possibility of awarding sanctions to compensate the plaintiffs for costs incurred as a result of Marriott's failure to answer. Plaintiffs subsequently filed a motion seeking more than $86,000 in attorney's fees and costs. After the motion was filed, the case was transferred to a different district judge, who denied plaintiffs' motion for sanctions, concluding that the requested amount was excessive and that plaintiffs failed to show an adequate causal link between the default judgment and the total requested fees.

The court first dismissed Marriott's argument that the lack of personal jurisdiction precluded the court from entering any sanctions order. Instead, the court held that even if a judgment on the merits of plaintiffs' claims would be void for lack of personal jurisdiction, that does mean that the district court lacks jurisdiction to impose sanctions.

Turning to the merits of the denial of the request for sanctions, the court concluded that the district court's explanation of its discretionary ruling was insufficient to permit meaningful appellate review and therefore vacated the district court's denial of sanctions and remanded that issue for reconsideration by the district court.

***New Jersey Coalition v. Mazda Motor of America*, Bus. Franchise Guide ¶ 16,643, 957 F.3d 390 (3d Cir. Apr. 28, 2020)**

This case is discussed under the topic heading "Statutory Claims."

***Trade Links, LLC v. BI-QEM SA de CV*, Bus. Franchise Guide (CCH) ¶ 16,664, 2020 WL 1335688 (D. Conn. Mar. 23, 2020)**

The United States District Court in the District of Connecticut denied a foreign manufacturer's motion to dismiss a complaint brought by its longtime distributor on jurisdictional grounds, but granted the manufacturer's motion to dismiss a claim under the Connecticut Franchise Act because the parties' contractual relationship did not constitute a franchise under the

statute. The court also denied the manufacturer's motion to dismiss various additional statutory and common law claims.

Trade Links is a Connecticut limited-liability company owned and operated by a Connecticut resident. On November 9, 1999, Trade Links executed a sales representative agreement (SRA) with defendant BI-QEM SA de CV (BI-QEM), pursuant to which BI-QEM appointed Trade Links as the "sole and exclusive representative to develop business, in, sale and promote" the covered products of BI-QEM and its affiliates in the United States, Puerto Rico, and Canada. The initial term of the SRA was for three years, and, thereafter, it renewed on an annual basis automatically so long as Trade Links exceeded the minimum sales requirement set forth in the SRA for the preceding twelve-month period and Trade Links was not in default of the performance of any of its obligations under the SRA.

In 2017, the parties' relationship began to deteriorate, culminating in BI-QEM's issuance of a notice of termination, the effectiveness of which was contested by Trade Links. Trade Links filed a demand for arbitration with the American Arbitration Association to address BI-QEM's interference with Trade Links' rights under the SRA. In response, BI-QEM filed petitions to stay the arbitration in the New York and Massachusetts state courts. BI-QEM was unsuccessful in securing a stay in either forum. The AAA panel similarly rejected BI-QEM's efforts to stay the arbitration and held hearings in October 2018. On October 30, 2018, the day after Trade Links testified before the arbitration panel, BI-QEM sent a letter withdrawing the notice of termination. Thereafter, the parties reached a resolution whereby the arbitration and stay actions were dismissed. Unfortunately, the parties' efforts to reach a global settlement of their differences were ultimately unsuccessful. In March 2019, Trade Links commenced an action in the United States District Court for the District of Connecticut asserting claims for breach of contract; violation of the Connecticut Unfair Trade Practices Act (CUTPA); violation of the Connecticut Franchise Act; breach of the implied covenant of good faith and fair dealing; interference with business expectancy; violation of the Connecticut Sales Representatives Commission statute; violation of the Massachusetts Unfair Trade Practices Act; and vexatious litigation in violation of Connecticut law. BI-QEM moved to dismiss the complaint for lack of personal jurisdiction pursuant to Federal Rule of Civil Procedure 12(b)(2) and moved to dismiss various claims for failure to state a claim pursuant to Rule 12(b)(6).

Turning to the jurisdictional issue, the court noted that the plaintiff bears the burden of showing that the court has jurisdiction over the defendants and that the court conducts a two-part analysis to determine whether specific personal jurisdiction exists in a diversity case: first, it must look to the state's long-arm statute and then analyze whether jurisdiction comports with federal due process.

Connecticut's long-arm statute set forth four situations in which foreign corporations can be hailed into a Connecticut court. As relevant here,

section 33-929(f)(1) of the long-arm statute states that foreign corporations are subject to suit in Connecticut "on any cause of action arising . . . out of any contract . . . to be performed in this state." Whether a contract contemplates performance in Connecticut turns on its totality of contacts that a party to the contract obligates itself to have, or contemplates that it will have, in Connecticut on the basis of the agreed-upon performance in the contract. This determination requires a fact-specific, case-by-case examination of the obligations that the contract contemplates. The court concluded that the SRA contemplated that performance would occur in Connecticut, based on, *inter alia*, the presence of Trade Links' customers in Connecticut, Trade Links' offices and employees in Connecticut, and the Connecticut choice-of-law provision. As a result, the court concluded that Trade Links met its burden of establishing that the court's exercise of personal jurisdiction over the defendants was proper under Connecticut's long-arm statute.

The court then considered whether the exercise of personal jurisdiction over the defendants comported with due process. Summarizing well-settled law, the court noted that due process requires that a defendant be haled into court in a forum state based on his own affiliation with the state, not based on the random, fortuitous, or attenuated contacts that he makes by interacting with other person affiliated with that state. The due-process analysis proceeds in two steps. First, courts evaluate the quality and nature of the defendant's contacts with the forum state under the totality of the circumstances test. Where the claim arises out of, or relates to, the defendant's contacts within the forum—that is, specific jurisdiction is asserted—minimum contacts to support such jurisdiction exist where the defendant purposely availed itself of the privilege of doing business in the forum and could foresee being haled into court there. Second, once minimum contacts are established, a court considers those contacts in light of other factors to determine whether the assertion of personal jurisdiction would comport with fair play and substantial justice. Finally, a commercial actor need not have a physical presence in a state to establish the necessary minimum contacts, so long as the defendant's own actions have created a substantial connection with the forum state—for example, by deliberately engaging in significant activities within the forum state or creating continuing obligations between himself and a resident of the forum state.

The court concluded that the defendants had purposely availed themselves of the benefit of doing business in Connecticut in a variety of ways, including entering into the SRA and selling its products in Connecticut through Trade Links. The court was also persuaded that its exercise of personal jurisdiction over the defendants would not offend traditional notions of fair play and substantial justice. First, Connecticut is a neighboring state of Massachusetts, where the defendants were located. Second, the court was not persuaded that litigating in Connecticut would be unduly burdensome to the defendants, who have an international reach and anticipated doing business in Connecticut. Third, Connecticut had a strong interest in adjudicating this case since plaintiff was a Connecticut resident. And, finally, the

convenience of the plaintiff and the witnesses favored exercise of jurisdiction in Connecticut. As a result, the court denied the defendants' motion to dismiss for lack of personal jurisdiction.

Turning to the various motions to dismiss for failure to state a claim under Rule 12(b)(6), the court noted that in order to survive a motion under this rule, a complaint must contain sufficient factual matter, accepted as true, to state a claim to relief that is plausible on its fact.

The defendants moved to dismiss Trade Links' claim under the Connecticut Franchise Act, Con. Gen. Stat. ¶ 42-133e (Franchise Act) on the grounds that the SRA did not constitute a franchise as defined in the Franchise Act. Under the Franchise Act, a franchise is

> a written agreement . . . in which (i) a franchisee is granted the right to engage in the business of offering, selling or distributing goods . . . under a marketing plan or system prescribes in substantial part by a franchisor . . . and (ii) the operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logo type, advertising or other commercial symbol designating the franchisor or its affiliate. . . .

Conn. Gen. Stat. ¶ 42-1333(b). The court noted that this definition requires a two-step inquiry. First, the franchisee must have the right to offer, sell or distribute goods or services and, second, the franchisor must substantially prescribe a marketing plan for the offering, selling, or distributing of goods or services.

The court began its analysis by noting that the purpose of the Franchise Act is to protect independent businesspersons who have assumed an entrepreneurial role and who face the risk of the market. Thus, one who acts an agent for another in selling a product does not ordinarily qualify as a franchisee. Reviewing the parties' relationship and the SRA, the court concluded that, even construing the allegations liberally and in the plaintiff's favor, Trade Links had not plausibly alleged that its relationship with BI-QEM was one of franchisor-franchisee. Indeed, the SRA itself contradicted any such claim. Trade Links was not in the business of offering or selling goods, within the meaning of the Franchise Act, since Trade Links did not purchase BI-QEM's products and resell them to consumers. Rather, it merely served as BI-QEM's agent. BI-QEM had the sole discretion to accept and fulfill orders obtained by Trade Links, and BI-QEM had the exclusive right to set the price and terms for sale of its products. The court concluded that the parties' relationship was not a franchise and, as a result, dismissed Trade Links' claim under the Franchise Act.

The defendants also moved to dismiss the claims under the Connecticut Unfair Trade Practices |Act (CUTPA), Conn. Gen. Stat. ¶ 42-110a, and the Massachusetts Unfair Trade Practices Act (Chapter 93A), Mass. Gen. Laws. Ch. 93A, § 1 *et seq*. To successfully state a claim for a CUTPA violation, a plaintiff must allege that he (1) suffered an ascertainable loss of money or property, (2) that was caused by an unfair method of competition or an

unfair or deceptive act, and (3) that occurred in the conduct of trade or commerce. After discussing the factors to be considered to determine whether an "ascertainable loss" has been suffered and whether a practice is unfair, the court concluded that Trade Links pleaded a plausible CUTPA violation. The amended complaint outlined in detail how BI-QEM sought to marginalize Trade Links from their business arrangement in an effort to coerce Trade Links into renegotiating or terminating the SRA. BI-QEM is alleged to have issued a notice of termination to bolster its negotiating position with Trade Links and will full knowledge that such termination was not permitted under the SRA. When Trade Links attempted to arbitrate the dispute, BI-QEM filed petitions to stay both in New York and Massachusetts and was accused of knowingly submitting false affidavits in support of the Massachusetts stay action. Only after the arbitration proceeded to a hearing did BI-QEM withdraw the notice of termination and yet, thereafter, it increased its efforts to marginalize Trade Links. The court concluded that these allegations were more than sufficient to state a claim under CUTPA.

Similarly, the court denied the defendants' motion to dismiss the Chapter 93A claim. To state a cause of action under Chapter 93A, plaintiff must allege that he (i) suffered a loss of money or property (ii) as a result of an unfair method of competition or an unfair or deceptive act (iii) that was used or employed by someone who engages in trader commerce. Further, a plaintiff must establish that the actions or transactions constituting an alleged unfair method of competition or unfair deceptive act or practice occurred primarily and substantially within Massachusetts. BI-QEM first asserted that only competitors can assert claims under Chapter 93A, an argument that the court quickly dismissed based on the plain language of Chapter 93A and Massachusetts precedent. The defendants next argued that Trade Links did not allege that the unfair acts occurred principally or substantially in Massachusetts. However, the allegations in the amended complaint included a number of events and conduct on the part of BI-QEM which were alleged to have occurred, expressly or by implication, in Massachusetts. As a result, the court concluded that the amended complaint sufficiently plead a Chapter 93A claim.

BI-QEM next argued that Trade Links did not assert a claim for tortious interference with business expectancy based on its relationship with BI-QEM's customers. The court began its analysis by noting that in order to recover for a claim of tortious interference with business expectancies, the claimant must plead and prove that: (1) a business relationship existed between the plaintiff and another party; (2) the defendant intentionally interfered with the business relationship while knowing of the relationship; and (3) as a result of the interference, the plaintiff suffered actual loss. BI-QEM's sole argument was that Trade Links' business relationship with BI-QEM's customers cannot satisfy the first element—a business relationship between plaintiff and third party—as a matter of law. However, BI-QEM relied on a single precedent, which the court found inapplicable, and, absent controlling precedent that a sales representative cannot assert a claim for tortious

interference under Connecticut law based on its relationship with its principal's customers, the court was compelled to deny the motion on this ground.

Finally, the court denied the defendants' motion to dismiss the breach of the covenant of good faith and fair dealing, the Connecticut Commissions statute, and the Connecticut vexatious litigation statute in summary fashion.

In short, although the court concluded that the distribution relationship did not constitute a franchise, the plaintiff/representative had pleaded statutory and common-law claims sufficient to survive the motion to dismiss.

LABOR AND EMPLOYMENT

***Aguilera v. Matco Tools Corp.*, Bus. Franchise Guide (CCH) ¶ 16,617, 2020 LEXIS 43283 (S.D. Cal. Mar. 12, 2020)**

This case is discussed under the topic heading "Arbitration."

***Billie v. Coverall North America, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,619, 2020 WL 1185251 (D. Conn. Mar. 12, 2020)**

This case is discussed under the topic heading "Arbitration."

***Chavez v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 16,623, 2020 WL 1322864 (D. Colo. Mar. 20, 2020)**

This case is discussed under the topic heading "Discrimination."

***JTH Tax LLC v. McHugh*, Bus. Franchise Guide (CCH) ¶ 16,631, 2020 WL 1689731 (W.D. Wash. Apr 7, 2020)**

This case is discussed under the topic heading "Injunctive Relief."

***Turner v. McDonald's USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,641, 2020 WL 3044086 (N.D. Ill. Apr. 24, 2020)**

This case is discussed under the topic heading "Antitrust."

NON-COMPETE AGREEMENTS

***Real Estate Visionaries v. RE/MAX of New England*, Bus. Franchise Guide (CCH) ¶ 16,642, (Mass. Super. Ct. Apr. 16, 2020)**

This case is discussed under the topic heading "Contract Issues."

***Turner v. McDonald's USA, LLC*, Bus. Franchise Guide (CCH) ¶ 1,641, 2020 WL 3044086 (N.D. Ill. Apr. 24, 2020)**

This case is discussed under the topic heading "Antitrust."

RELEASES

***Aguilera v. Matco Tools Corp.*, Bus. Franchise Guide (CCH) ¶ 16,617, 2020 LEXIS 43283 (S.D. Cal. Mar. 12, 2020)**

This case is discussed under the topic heading "Arbitration."

STATE DISCLOSURE/REGISTRATION LAWS

***Fabius v. Medinexo USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,629, 2020 LEXIS 59029 (E.D. Mo. Apr. 3, 2020)**
This case is discussed under the topic heading "Contract Issues."

STATUTORY CLAIMS

***Aguilera v. Matco Tools Corp.*, Bus. Franchise Guide (CCH) ¶ 16,617, 2020 LEXIS 43283 (S.D. Cal. Mar. 12, 2020)**
This case is discussed under the topic heading "Arbitration."

***Fabius v. Medinexo USA, LLC*, Bus. Franchise Guide (CCH) ¶ 16,629, 2020 LEXIS 59029 (E.D. Mo. Apr. 3, 2020)**
This case is discussed under the topic heading "Contract Issues."

***N.J. Coalition v. Mazda Motor of America*, Bus. Franchise Guide ¶ 16,643, 957 F.3d 390 (3d Cir. Apr. 28, 2020)**
The Third Circuit Court of Appeals reversed the U.S. District Court for the District of New Jersey's dismissal of a complaint by an automobile dealers' association for lack of standing because it found that the district court construed the association's complaint too narrowly.

The New Jersey Coalition of Automobile Retailers (Association) filed a complaint against Mazda Motor of America, Inc. (Mazda) seeking to enjoin Mazda from an incentive program that the Association alleged violated the New Jersey Franchise Practices Act by creating unfair competitive advantages for dealers who qualified for incentives under the program. The district court applied the three-prong test established by the Supreme Court in *Hunt v. Washington State Apple Advertising Commission*, 432 U.S. 333, 343, (1977), which provides that an association has standing if "(a) its members would otherwise have standing to sue in their own right; (b) the interests it seeks to protect are germane to the organization's purpose; and (c) neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit." The district court dismissed the complaint for lack of standing after it determined that it did not seek to protect the interests of the Association's members because only five of the sixteen members who were Mazda dealers would benefit from the lawsuit.

Reversing the decision, the Third Circuit first noted that the complaint must be construed in favor of the complaining party. The court noted that the district court improperly confined the Association's complaint to a single zero-sum theory that could only favor the five dealers that did not qualify for the incentive program. The Third Circuit noted several reasons why the lawsuit might benefit more than just those dealers who did not qualify for incentives and ultimately determined that Mazda failed to show that any more than five dealers opposed filing the lawsuit. The court refused to infer

that other dealers who participated in the incentive program opposed the lawsuit because doing so would not be viewing the complaint in the light most favorable to the complainant. The Third Circuit did make clear, however, that it took no position on whether the complaint adequately pled a claim under the New Jersey Franchise Practices Act. Dismissal was reversed, and the case was remanded for further proceedings in the district court.

***Trade Links, LLC v. BI-QEM SA de CV*, Bus. Franchise Guide (CCH) ¶ 16,664, 2020 WL 1335688 (D. Conn. Mar. 23, 2020)**
This case is discussed under the topic heading "Jurisdiction."

TERMINATION AND NONRENEWAL

***Chong v. 7-Eleven, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,613, 2020 LEXIS 39402 (E.D. Pa. Mar. 4, 2020)**
This case is discussed under the topic heading "Attorneys Fees."

***Real Estate Visionaries v. RE/MAX of New England*, Bus. Franchise Guide (CCH) ¶ 16,642, Superior Court, Mass. (Apr. 16, 2020)**
This case is discussed under the topic heading "Contract Issues."

TORTIOUS INTERFERENCE

***Real Estate Visionaries v. RE/MAX of New England*, Bus. Franchise Guide (CCH) ¶ 16,642, Superior Court, Mass. (Apr. 16, 2020)**
This case is discussed under the topic heading "Contract Issues."

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES

***Real Estate Visionaries v. RE/MAX of New England*, Bus. Franchise Guide (CCH) ¶ 16,642, Superior Court, Mass. (Apr. 16 ,2020)**
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VICARIOUS LIABILITY

***A.B. v. Marriott International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,640, 2020 WL 1939678 (E.D. Pa. Apr. 22, 2020)**
This United States District Court for the Eastern District of Pennsylvania case deals with claims of a hotel franchisor's vicarious liability for sex trafficking. The defendant Marriott International (Marriott) is a franchisor of three Philadelphia airport hotels where plaintiff A.B. alleged she was sex trafficked between 2009 and 2014. As the Court stated, Marriott "sells its brand name and marketing power to third-party owners for use for building and operations run by a franchisee or third-party management company under Marriott's control." It is not expressly stated in the Court decision whether

the hotels in question were run by a franchisee or owned by a franchisee and run by a third-party management company under Marriott's control.

The plaintiff, A.B., structured her claim around Marriott's knowledge, through an actual agency relationship with the hotel franchisees, that they were benefitting from the proceeds of sex trafficking, thus entitling A.B. to a remedy under section 1595 of the William Wilberforce Trafficking Victims Protection Reauthorization Act of 2008, 18 U.S.C. § 1595 (Act). The plaintiff claimed that Marriott should have known she was being trafficked due to several obvious signs present over the course of her five-year ordeal. She claimed that her traffickers paid for rooms weeks in advance with prepaid credit cards; she never had a phone, identification, or personal possessions with her; she often had visible signs of abuse such as bruising; and there was significant foot traffic to and from the rooms and sex paraphernalia in the rooms where men were allegedly purchasing sex. A.B. further pleaded that Marriott "failed to adopt and enforce anti-trafficking policies from the corporate level," failed to establish effective reporting mechanisms at the hotels, and failed to take measures to prevent sex trafficking. Marriott has control over the three franchises through their brand name, marketing, and property maintenance and inspection. Marriott receives ten percent of each franchisee's total revenue.

Marriott brought a motion to dismiss, which was granted in part. However, the court found that A.B. adequately pleaded a claim under the Act, which entitles trafficking victims to a civil remedy against their traffickers and "whoever" knowingly profited from the trafficking. The court determined that A.B. plausibly alleged actual or constructive knowledge on the part of Marriott and an agency relationship between Marriott and the hotels. A.B.'s apparent agency claim was dismissed, as were the time-barred Pennsylvania human-trafficking statute claims.

The Act entitles a victim of sex trafficking to receive civil damages from both the trafficker and anyone who benefited from the trafficking. The elements of the civil remedy require A.B. to plead facts beyond mere conclusions, allowing the plausible inference that Marriott (1) knowingly benefitted financially or by receiving anything of value, (2) from participation in a venture, (3) it knew or should have known has engaged in sex trafficking under § 1591. Marriott sought to dismiss because it interpreted the legislation as requiring a "joint venture" between Marriott and the traffickers, which A.B. did not plead. However, the court disagreed with Marriott's interpretation and agreed with A.B. that the remedy Congress intended to give to victims of trafficking is against "whoever knowingly benefits" from participation in a venture that the person "knew or should have known engaged" in a violation of the Act. This does not impose any positive duties on hotels to end trafficking; rather, it allows victims to obtain a remedy from those parties who benefited financially from their trafficking. The court found that A.B. had sufficiently pleaded these facts and her claim for the remedy under the Act was permitted to move forward.

The court then analyzed each element of § 1595: "knowingly benefits financially," "participation in a venture," and "knew or should have known" of a sex trafficking venture. Regarding the first element, the allegations at this stage adequately suggested Marriott benefitted financially from the renting of the rooms through the ten percent paid to the company by each franchisee. The court also found that A.B.'s pleadings that Marriott "participated in a venture" were sufficient. Regarding the third element, Marriott argued that A.B.'s pleadings as to whether Marriott "knew or should have known" of a sex trafficking venture were too broad and relate to the hospitality industry generally and not their three franchises specifically. The court disagreed with this analysis, as A.B.'s pleadings pointed to several specificities, like loud altercations overhead by patrons and employees, and the constant stream of men coming and going from the rooms rented by the traffickers. The elements of § 1595 were sufficiently pleaded, and this portion of the claim was not dismissed.

Next, the court turned to the principal-agent relationship between the three franchised hotels and Marriott. Marriott's response was that Pennsylvania law does not necessarily imply a principal-agent relationship between franchisee and franchisor. Rather, the court noted, A.B. must sufficiently apply the facts to a test set by the Pennsylvania Supreme Court to determine the existence of a master-servant relationship: "whether such person is subject to the alleged employer's control or right to control with respect to his physical conduct in the performance of the services for which he was engaged. . . . The hallmark of an employee-employer relationship is that the employer not only controls the result of the work but has the right to direct the manner in which the work shall be accomplished; the hallmark of an independent contractee-contractor relationship is that the person engaged in the work has the exclusive control of the manner of performing it, being responsible only for the result." Marriott relied on *Myszkowski v. Penn Stroud Hotel, Inc.*, 634 A.2d 622, 625 (Pa. Super. 1993), a case where the Pennsylvania Superior Court decided that the franchisor did not have an agency relationship with the franchisee due to lack of sufficient day-to-day control. The court distinguished that case and found that A.B. properly pled Marriott's "ongoing and systematic right of control over its franchisee hotels." The following factors were cited by A.B. in determining an agency relationship: "hosting online bookings on Marriott's domain; requiring the three hotels to use Marriott's customer rewards program; setting employee wages; making employment decisions and advertising for employment; sharing profits; standardizing employee training; building and maintaining the facility as specified by Marriott; standardized rules of operation; regulation site inspections; fixing pricings, and other actions depriving the three hotels from any independence in their business operations." Ultimately, the court found A.B.'s pleadings regarding principal-agent liability sufficient.

However, the court granted Marriott's motion to dismiss A.B.'s apparent agency theory because A.B. was unable to show the necessary elements of a representation of agency and reliance by the plaintiff on that agency. The court also dismissed A.B.'s Pennsylvania claim, as it was time-barred and failed to state a claim.

***Chavez v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 16,623, 2020 WL 1322864 (D. Colo. Mar. 20, 2020)**

This case is discussed under the topic heading "Discrimination."