Franchise Law Journal

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Franchise Law Journal

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From the Editor-in-Chief

John M. Doroghazi*

Congratulations readers! You made it. You have survived my reign of terror over the *Franchise Law Journal*.

Mr. Doroghazi

In all seriousness, I am not one for lengthy goodbyes or self-indulgent victory laps. So instead, I will simply thank you for your having been a reader of this publication and a supporter of the Forum. The Forum is, in my opinion, the premier organization for franchise law education in the country. And the *Journal* is its flagship platform for the exchange of ideas about franchising. It offers franchise practitioners thoughtful articles on issues of importance to them. It also offers non-franchise practitioners a digestible access point to understanding the nuances of franchising. Indeed, courts routinely cite articles in the *Journal* on both franchise- and non-franchise–related matters[1] because, in my opinion, the *Journal* historically has published articles that are timely, easy to read, and substantive (or as the saying goes, All Killer, No Filler).[2]

1. A quick search by me on Westlaw revealed almost hundred citations to *Journal* articles by federal and state courts, including a variety of cases on issues of importance to the franchise community. *See, e.g.*, Mouanda v. Jani-King Int'l, 653 S.W.3d 65, 72 (Ky. 2022) (case determining whether franchisees and their employees were employees of franchisor and citing Journal article on same for background understanding of issue); Overstock.com, Inc. v. State *ex rel.* French, 234 A.3d 1175, 1179 (Del. 2020) (citing *Journal* article about issue of gift cards and whether leftover money must be escheated to state); Patterson v. Domino's Pizza, LLC, 333 P.3d 723 (Cal. 2014) (discussing multiple *FLJ* articles regarding control for purposes of vicarious liability of franchisee's acts); LJL Transp., Inc. v. Pilot Air Freight Corp., 962 A.2d 639, 651 (Pa. 2009) (relying on *Journal* article when making determination about notice necessary of termination when there is an incurable default); Casserlie v. Shell Oil Co., 902 N.E.2d 1, 6 (Ohio 2009) (how to determine good faith and bad faith).

2. For those who are not plugged into early 2000's pop-punk music, "All Killer, No Filler" is the debut album of Sum 41. They are famous for two things: (1) the absolute masterpiece song "Fat Lip"; and (2) their lead singer Deryck Whibley was Avril Lavigne's first husband.

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My sincere hope is that you will continue to read this *Journal* after I fade away into [pick your favorite movie or book reference][3] and, more importantly, that you will contribute content to the *Journal*. The *Journal* does not exist without contributions from Forum membership. Unlike many other scholarly publications, the content in the *Journal* comes almost exclusively from practicing attorneys, not from academia. That is both its curse and its superpower. You don't get to send an invoice at the end of the month for time spent working on *Journal* articles. And so it is often a heavy lift, complete with loving and persistent nagging from the *Journal* staff, to get most authors to turn articles in remotely in the time frame promised. But the perspective of practicing lawyers allows the *Journal* to offer something different. It means that the *Journal* has meaningful insight on how the law, or changes to it, will play out in the real world. It allows for authors to use their own experiences to flag potential risks that are not obvious until you have been in the trenches. It is also a platform for explaining how to avoid those risks. So get out your proverbial pens and write an article. It is not just shouting into the void.

My predecessor Dan Oates told me that part of the trick of being a good Editor-in-Chief is recommending a worthy successor to yourself to the Forum Chair. So I guess Dan whiffed on that one. But I, unlike Dan, have not whiffed. Your next Editor-in-Chief will be Aaron-Michael Sapp. He has all of the skills and characteristics necessary to succeed in this job. He is organized, persistent, careful, and a skilled editor. He is sure to uphold the high standards and quality of the *Journal*. Good luck, Aaron-Michael.[4]

3. W.P. Kinsella, Shoeless Joe (Houghton Mifflin 1982) (fade into Iowa cornfield); J.K. Rowling, Harry Potter and the Order of the Phoenix (Bloomsbury 2003) (fade into the magic veil); Star Wars: Return of Jedi (20th Century Fox 1983) (disappear in a bed or disappear in a space iron lung).

4. So next time you see me at the Forum, there is no longer need to run and hide. I will no longer try to pitch you on an article for the *Journal*.

Copyright Protection for the Franchised Business

*Valerie Brennan**

Ms. Brennan

For most franchisors, copyrights are less critical to the franchised business model than trademarks and trade secrets. This distinction leads many franchisors and their counsel to either overlook copyright rights and protection entirely when developing an overall intellectual property strategy, or not give copyright rights sufficient consideration.[1] However, most franchised businesses create and use original works in the form of brand manuals, promotional materials, and even software applications, and such works are entitled to copyright protection.[2] For some types of franchises known for their copyrighted works, such as their lesson plans or curriculum, copyright rights can be more important than even the brand. Moreover, copyright is often a faster, easier, more straightforward, and less expensive route to obtain rights and to enforce those rights. While copyright rights are different from other types of intellectual property—both in their purpose and manner of creation, acquisition, protection, and enforcement—often copyright rights can be used or can augment the ability to achieve desired outcomes.

This article will discuss copyright law and its applicability to franchising. Part I will provide an overview of copyright law in the United States. Part II addresses the reason and procedures for copyright registration, with a focus on how the process applies to franchisors. Part III focuses on types of copyrights that franchisors typically own. In Part IV, the article summarizes the applicability of copyright to franchise disclosure requirements and to franchise agreements. Part V addresses copyright ownership and common pitfalls. In Part VI, the article outlines issues arising when using copyrights of third parties, including licensing and fair use. Part VII summarizes the law on copyright infringement and examines infringement claims in the

1. *See* Mark S. VanderBroek & Jennifer M. D'Angelo, *Copyright Protection: The Forgotten Stepchild of a Franchise Intellectual Property Portfolio*, 28 Franchise L.J. 84 (2008).
2. *See id.*

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franchise contexts. In Part VIII, the article offers best practices for franchisors, and then concludes in Part IX with some final takeaways.

I. Overview of U.S. Copyright Law[3]

The role of copyrights is to protect and promote creative and original expression of ideas. This section will provide an overview of (1) the elements of a copyright and (2) copyright protection under United States and, briefly, international law.

In the United States, copyright law stems from the Constitution itself: "The Congress shall have Power . . . To promote the Progress of Science and useful Arts, by securing for limited Times to Authors and Inventors the exclusive Right to their respective Writings and Discoveries."[4] The law is codified in Title 17 of the United States Code, as amended (the "Copyright Act").[5]

A. *Basic Concepts*

Copyrights protect original, minimally creative authored works, such as writings, music, images, audio or audiovisual recordings, and architectural works[6] that are fixed in a tangible medium of expression.[7] Only the copyrighted expression is protected, not the underlying ideas, procedures, methods, discoveries, concepts, or "useful articles."[8] These are always in the public domain, unless protected under other intellectual property rights, like patent or trade secret protection.[9] Common items that are not protected under copyright include titles, names, slogans, basic designs, typography, blank forms, formulas, and recipes that are mere listings of ingredients or contents.[10] Only creative works are protectable under copyright. As further discussed in Part III, "scènes à faire" is a copyright doctrine that states that certain effort is not protectable if it is ordinary, mandated, or customary to a particular genre or "elements of a work that necessarily result from its subject matter or ideas."[11]

3. The following section is based on the copyright section of *Basics Track: Trademarks and Intellectual Property*, Int'l Franchise Ass'n, 53rd Annual Legal Symposium, at 23–26 (2021).

4. U.S. Const. art. 1, § 8.

5. Copyright Act of 1976, Pub. L. No. 94-553, 90 Stat. 2541. The original law governing copyrights was enacted in 1909. *See generally* Copyright Act of 1909, Pub. Law 60-349.

6. 17 U.S.C. § 102.

7. A "tangible medium of expression" is one now known or later developed, from which the work can be perceived, reproduced, or otherwise communicated, either directly or with the aid of a machine or device. 17 U.S.C. § 102(a).

8. "A 'useful article' is an article having an intrinsic utilitarian function that is not merely to portray the appearance of the article or to convey information." 17 U.S.C. § 101.

9. *See id*.

10. For more information on what is not protected under copyright, see U.S. Copyright Off., Circular 33: Works Not Protected by Copyright 1–4 (Mar. 2021), https://www.copyright.gov/circs/circ33.pdf.

11. Civility Experts Worldwide v. Molly Manners, LLC, 167 F. Supp. 3d 1179, 1187 (D. Colo. 2016)*;* DeBitetto v. Alpha Books, 7 F. Supp. 2d 330, 334 (S.D.N.Y. 1998) (defendant's

Copyright ownership, like other forms of intellectual property protection, includes a number of exclusive rights. A copyright provides the owner the exclusive right to copy, distribute, perform, display, and make modified versions known as derivative works of the copyrighted work,[12] or to authorize others to do so.[13]

Generally, the author (the creator) of the protected work owns the copyright. However, as detailed in Part VI, under the "works-made-for-hire" doctrine, ownership can instead be created in an employer or commissioning party. In that case, an employee's work automatically belongs to her or his employer if it was made within the scope of the employee's employment. In the case of a work commissioned from an independent contractor, a work that falls within certain statutory categories and is the subject of a written agreement between the parties is a work-made-for-hire and the property of the commissioning party.[14]

The term of copyright protection varies depending on the nature of the work and the date of publication.[15] For works published after 1978, copyright generally extends from creation and for 70 years following the death of the author. For works made for hire, the copyright extends for the lesser of either 95 years from first publication, or 120 years from creation.[16]

B. *Copyright Protection*

1. United States

Registration is not required for a copyright to attach—the property right is created as soon as the work is fixed in a "tangible medium of expression."[17] However, copyright registration *is* required to bring suit for copyright infringement in the United States.[18] Moreover, prompt registration enables the would-be infringement plaintiff to avoid the additional cost associated with expediting registration applications and can entitle the owner to statutory damages of up to of $150,000 per infringement and reasonable

motion for summary judgment granted in part and denied in part, referencing the "*scenes a faire*" doctrine in the denial where much of the allegedly infringement copied unprotectible elements, including facts, not protectible expression).

12. A derivative work is "a work based upon one or more preexisting works, such as a translation, musical arrangement, dramatization, fictionalization, motion picture version, sound recording, art reproduction, abridgement, condensation, or any other form in which a work may be recast, transformed, or adapted." 17 U.S.C. § 101.

13. 17 U.S.C. § 106.

14. *See* 17 U.S.C. § 101.

15. "Publication" is defined by the Copyright Act as the distribution or offer to publicly distribute copies of a work to the public. Mere performance or display of the protected work falls outside this definition. *Id.*

16. 17 U.S.C. § 302.

17. 17 U.S.C. § 411.

18. *See* Fourth Estate Pub. Ben. Corp. v. Wall-Street.com, LLC, 586 U.S. 296, 309 (2019) (holding that registration for purposes of 17 U.S.C. § 411 does not occur when "an application for registration is filed, but when the Register has registered a copyright after examining a properly filed application.").

attorney's fees.[19] In certain cases, attorney fees in copyright infringement cases can far outweigh actual damages.[20] The prospect of potential statutory damages can be a powerful deterrent to potential willful infringers.

To register a copyright with the Copyright Office, the owner must file an application form, pay a modest fee, and submit "deposit materials" representing the best edition of the copyrighted work.[21] Once the Copyright Office approves the application, it issues a registration certificate, enabling the holder to enforce the copyright through federal litigation, record assignments and transfers of the copyright, and record the copyright with U.S. Customs to prevent importation of infringing material.[22]

Copyright notice is another useful tool which, though not legally required,[23] is highly advisable for copyright protection. Including the year of publication, owner's name, and a © or other copyright designation on copyrighted material puts the public on notice that the work is protected and precludes defenses to infringement. The proper format is "CDC" or (© Year Owner), which is shorthand for (1) the symbol © (or the word Copyright or the abbreviation Copr.), (2) the year of first publication of the work, and (3) the name of the copyright owner.[24]

2. International

A number of treaties govern international cooperation for copyright protection, including the Berne Convention for the Protection of Literary and Artistic Works,[25] the related World Intellectual Property Organization (WIPO) Copyright Treaty (WCT),[26] and The Agreement on Trade-Related Aspects of Intellectual Property Rights (TRIPS),[27] among others. The majority of countries recognize automatic copyright protection for nationals of treaty member states without any registration requirements.

The Berne Convention, in fact, contains language prohibiting member states from conditioning copyright protection on "formalities"[28] (such as the need for use of proper copyright notice). However, many countries have

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19. 17 U.S.C. § 504.

20. *See* Rockford Map Publishers, Inc. v. Directory Serv. Co. of Colo., Inc., 768 F.2d 145, 150 (7th Cir. 1985) (successful plaintiff awarded only $250 in statutory damages but approximately $22,000 in attorney's fees).

21. *See generally* U.S. Copyright Off., CIRCULAR 2: Copyright Registration (May 2022), https://www.copyright.gov/circs/circ02.pdf. This process is discussed further in Part III, *infra*.

22. *Id.*

23. Except for works published prior to March 1, 1989. *See* 17 U.S.C. § 406(c).

24. 17 U.S.C. § 401(b).

25. 828 U.N.T.S. 221 (1886).

26. 2186 U.N.T.S. 121 (1996).

27. Marrakesh Agreement Establishing the World Trade Organization, Annex 1C, 1869 U.N.T.S. 3 (1994).

28. For this reason, the U.S. requirement that a copyright be registered before its owner can pursue copyright infringement litigation in U.S. federal courts is inapplicable to foreign nationals.

individual voluntary copyright registration mechanisms that can simplify copyright use and enforcement for U.S. copyright holders abroad.

II. Copyright Registration in the United States

To register a copyrighted work in the United States, the applicant must select the appropriate or primary category of the work so as to identify the appropriate application form. There are copyright application forms for individual copyrighted works, as well as several options for group registration (of multiple works in a single application).

The primary categories of copyrighted works are as follows:

(1) Literary works. The Copyright Act defines "literary works" as "works, other than audiovisual works, expressed in words, numbers, or other verbal or numerical symbols or indicia, regardless of the nature of the material objects, such as books, periodicals, manuscripts, phonorecords, film, tapes, disks, or cards, in which they are embodied."[29]

(2) Performing Arts. The Copyright Act states that performing a work "means to recite, render, play, dance, or act it, either directly or by means of any device or process or, in the case of a motion picture or other audiovisual work, to show its images in any sequence or to make the sounds accompanying it audible."[30]

(3) Pictorial, Graphic, and Sculptural Works. The Copyright Act states that "pictorial, graphic, and sculptural works include two-dimensional and three-dimensional works of fine, graphic, and applied art, photographs, prints and art reproductions, maps, globes, charts, diagrams, models, and technical drawings, including architectural plans."[31]

(4) Architectural Works. The Copyright Act defines "Architectural Works" as "the design of a building as embodied in any tangible medium of expression, including a building, architectural plans, or drawings. The work includes the overall form as well as the arrangement and composition of spaces and elements in the design but does not include individual standard features."[32]

(5) Photographs. The Copyright Act does not include a definition of "photograph" but the term includes photographs that are created with a camera and captured in a digital file or other visual medium such as film.[33]

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29. 17 U.S.C. § 101; *see also* U.S. Copyright Off., Literary Works, https://www.copyright.gov/registration/literary-works.

30. 17 U.S.C. § 101.

31. *Id.*

32. *Id.*

33. *See* U.S. Copyright Off., Circular 42: Copyright Registration of Photographs 1–2 (Mar. 2021), https://www.copyright.gov/circs/circ42.pdf.

(6) Computer Software and Apps. Copyright in software extends to source code, which is copyrightable expression, but does not protect anything functional, such as the program's logic or system design or algorithms.[34] HTML (hypertext markup language) is not considered to be a computer program and thus is not registrable as such, but might be registrable as a literary work if created by a human as opposed to generated by website design software (including artificial intelligence (AI) software).[35] Screen displays may be registered together with the software code that creates them or separately if the display and the code are owned by different parties.[36]

(7) Websites. Copyrights in websites can be protected in several ways, and often more than one type of application is relevant. Websites typically contain written content (text), as well as photographs, artwork/graphics/illustrations, and videos. One type of application does not cover all of these works, so one would choose the primary types of content and register based on that type of work. Written word-heavy websites such as blogs would be registered as Literary Works. Visual-rich websites would be registered as Pictorial Works, etc. Multiple applications might be needed to cover a website that contains multiple types of copyrighted content. Websites that have creative, nonfunctional creative expression in the way in which the content is arranged might also be protected as a compilation or collective work.[37]

(8) Audiovisual Works. The Copyright Act defines "audiovisual works" as "works that consist of a series of related images which are intrinsically intended to be shown by the use of machines or devices such as projectors, viewers, or electronic equipment, together with accompanying sounds, if any, regardless of the nature of the material objects, such as films or tapes, in which the works are embodied."[38]

The Copyright Office administratively divides copyrighted works into five classes of works,[39] namely: Class TX for Nondramatic Literary Works[40] (e.g., books and manuscripts); Class VA for Works of the Visual Arts[41] (e.g., movies and photographs); Class PA for Works of the Performing Arts[42] (e.g., dramatic scripts); Class SR for Sound Recordings[43] (e.g., records and

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34. *See* U.S. Copyright Off., Circular 61: Copyright Registration of Computer Programs 1 (Mar. 2021), https://www.copyright.gov/circs/circ61.pdf.

35. *Id.* at 5.

36. *Id.* at 4–5.

37. *See* U.S. Copyright Off., Circular 66: Copyright Registration of Websites and Website Content 1–3 (Mar. 2021); *see also* U.S. Copyright Off., Compendium of U.S. Copyright Office Practices § 101 (3d ed. 2021) (specifically, chapter 1000, "Websites and Website Content") [hereinafter Compendium].

38. 17 U.S.C. § 101.

39. U.S. Copyright Off., https://www.copyright.gov/forms.

40. U.S. Copyright Off., https://www.copyright.gov/forms/formtx.pdf.

41. U.S. Copyright Off., https://www.copyright.gov/forms/formva.pdf.

42. U.S. Copyright Off., https://www.copyright.gov/forms/formpa.pdf.

43. U.S. Copyright Off., https://www.copyright.gov/forms/formsr.pdf.

audiocassettes); and Class SE for Single Serials[44] (e.g., newspapers, magazines, and journals).

Within these classes, a franchisor is most likely to use to two primary application forms in connection with its franchise system:

- Within Class TX, the Standard Application for Literary Works is used to register a wide variety of works that are intended to be read, including books, textbooks, written manuals, reference works, directories, catalogs, advertising copy, computer programs and code, compilations of information, and databases.[45]
- Within Class VA, the Standard Application for Work of the Visual Arts is used to register pictorial, graphic, sculptural works of art, architectural works, photographs, technical drawings, and maps.[46]

Franchisors should obtain, or file applications for, copyright registration for all key content that will be provided to franchisees including, but not limited to, content that franchisees will use publicly. As discussed previously, to bring suit for copyright infringement, the copyright owner must have registered the copyrights.[47] Thus, registering copyrights in content before it is distributed both places the franchisor in a position to take action quickly in the event of infringement and creates a strong disincentive for unauthorized copying. Damages for infringement of copyrights that were registered prior to the commencement of infringement are typically significantly higher than those available for copyrights registered after the fact (for which the owner must prove actual damages) and can include attorney's fees.[48] Unless copyrights are registered early and kept up to date (by registering subsequent versions), enforcement might not be cost-effective. Franchisors should consider protecting both public content such as websites, and behind-the-scenes content such as operations and training manuals or proprietary software, through copyright registration.

Copyright protection is available for both published and unpublished works.[49] Publication is a tricky concept because the meaning of "publication" under the Copyright Act differs from conventional understanding of the word. For instance, launching a public website does not make that

44. U.S. Copyright Off., https://www.copyright.gov/forms/formse.pdf.

45. U.S. Copyright Off., Preview for the Standard Application for a Textual Work or Other Textual Content 3, https://www.copyright.gov/registration/docs/literary-standard.pdf.

46. U.S. Copyright Off., Preview for the Standard Application for a Work of the Visual Arts 3, https://www.copyright.gov/registration/docs/visual-arts-work-standard.pdf. With respect to group registration options, the Group Registration of Published Photographs is typically the one most relevant to franchising.

47. 17 U.S.C. § 411(a).

48. 17 U.S.C. § 504.

49. A work is deemed "published" when the copyright owner makes the original work (or copies thereof) available to the general public, whether it is sold, leased, loaned, or given away. *See* 1 Nimmer on Copyright § 4.04 (2007). Distribution of limited works or distribution only to a limited audience is typically not deemed publication.

website "published."[50] Most works used in franchised businesses would not be considered "published" because they are not provided to others broadly, such as a published book or software available for licensing by the general public. For that reason, most applications filed by franchisors would be filed as "unpublished" works.

It is important to ensure that all information included in a copyright application is accurate. For instance, if a work is based on a prior work, and therefore, a derivative work, the prior work must be disclosed in the application. Errors in factual information could give rise to an equitable defense when the claimant attempts to enforce the copyright.[51]

At present, the fee for a single application, filed electronically, varies from forty-five dollars for a single author, same claimant, one work, not a work made for hire to sixty-five dollars for a standard application.[52] The fees for other types of applications, such as group registrations, vary. The current time frame from filing to issuance of a copyright registration is approximately six weeks.[53] Expedited or "special handling" review is possible in certain circumstances upon payment of an additional $800 fee.[54] Special handling is available only with a compelling need, such as pending or prospective litigation, a need for customs enforcement, or other deadlines.[55]

There often is a hesitation to register copyrights in certain works due to concern that the submission to the Copyright Office makes the proprietary information public. Copyright deposits do not become public; only the fact of the registration and identifying information does.[56] Third parties may obtain copies only in the context of litigation relating to the copyright.[57] That said, the law as to whether submitting a deposit with a copyright application constitutes a disclosure that negated trade secret rights is not clearly established. For this reason, the Copyright Office created specific procedures, with respect to source code, that allows copyright registration of source code subject to trade secret protection.[58]

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50. *See* Compendium, *supra* note 37, § 101, ch. 1900 "Publication."

51. *See* Qad, Inc. v. ALN Assocs., 974 F.2d 834 (7th Cir. 1992).

52. *See* U.S. Copyright Off., Fees, https://www.copyright.gov/about/fees.html.

53. *See* U.S. Copyright Off., Registration Processing Times, https://copyright.gov/registration/docs/processing-times-faqs.pdf.

54. *See* U.S. Copyright Off., Circular 4, Copyright Office Fees 4 (Mar. 2021), https://www.copyright.gov/circs/circ04.pdf.

55. *Id.*

56. U.S. Copyright Off., Circular 18: Privacy: Copyright Public Records 1–2 (Jan. 2021), https://www.copyright.gov/circs/circ18.pdf.

57. U.S. Copyright Off., Circular 6, Obtaining Access to and Copies of Copyright Office Records and Deposits 3 (Jan. 2019), https://www.copyright.gov/circs/circ06.pdf.

58. *See* Compendium, *supra* note 37, § 1509.1(c)(4)(a) ("In the 1980s a concern was expressed that making computer programs available for public inspection could jeopardize a copyright owner's trade secret protection under state law. In response to these concerns, the Office established a specific procedure for submitting source code that contains trade secret material."). Special procedures also exist for registration of secure tests. U.S. Copyright Off., Circular 64: Secure Tests and Test Items (June 2023), https://www.copyright.gov/circs/circ64.pdf.

Therefore, the author does not recommend that franchisors include in a copyright application any information considered protected as a trade secret. As noted, software, however, may be registered with a claim of trade secret protection.[59] If any non-software deposits contain trade secrets, consider redacting the trade secrets from the deposit copy. In many cases, what a franchisor would claim as a trade secret, such as formulas or data, is not protectable under copyright law.[60]

III. Overview of Types of Copyrights Franchisors Might Own

Almost every business owns and uses copyrighted works, whether or not franchised. For instance, most businesses develop advertising materials, take photographs of their products for advertising, make social media posts, and launch websites.

Franchised businesses often have additional types of copyrighted works used throughout their system, such as operating manuals and training materials. Because of the desire for uniformity in franchised systems, franchisors also often own proprietary software, architectural drawings and works for uniform look and feel,[61] and content-rich forms to guide franchisees in operating. Franchisors might create mascots or characters, distinctive music, artistic logos, brand/style guides, and customer handouts (such as coloring sheets for kids). Franchisors sometimes use newsletters for their franchisees to send to customers. For franchises that use vehicles in providing services, those vehicles might incorporate artwork or vehicle wraps.

The artistic or creative elements of all of these works are protected by copyright. As discussed previously, "*scènes à faire*," however, are not protected by copyright.[62] This limitation on what can be protected under copyright often applies to operating manuals or training materials, which often follow a predicable order and convey functional information presented in an effective and efficient, but often not terribly creative, manner.

Logos are rarely protectable under copyright because the U.S. Copyright Office views most trademark logos as insufficiently creative to be protected under copyright.[63] According to the Copyright Office Compendium, "[t]he Office typically refuses to register trademarks, logos, or labels that consist of only the following content:

- Wording.

59. Circular 61, *supra* note 34, at 3.

60. Circular 33, *supra* note 10.

61. *See*, *e.g.*, Arthur Rutenberg Homes, Inc. v. Maloney, 891 F. Supp. 1560 (M.D. Fla. 1995) (franchisor successfully sued another homebuilder, among others, for infringement of the copyrights in its architectural designs).

62. Civility Experts Worldwide v. Molly Manners, LLC, 167 F. Supp. 3d 1179, 1187 (D. Colo. 2016); DeBitetto v. Alpha Books, 7 F. Supp. 2d 330, 334 (S.D.N.Y. 1998).

63. Compendium, *supra* note 37, § 101 (ch. 914 "Trademarks, Logos, and Labels.").

- Mere scripting or lettering, either with or without uncopyrightable ornamentation.
- Handwritten words or signatures, regardless of how fanciful they may be.
- Mere spatial placement or format of trademark, logo, or label elements.
- Uncopyrightable use of color, frames, borders, or differently sized font.
- Mere use of different fonts or colors, frames, or borders, either standing alone or in combination.[64]

The International Trademark Association (INTA) has published multiple versions of a chart that analyzes copyright protection for logos in dozens of countries worldwide. "[T]he chart covers how copyright protection is achieved in each country, the scope of such protection, whether law exists applying copyright protection to logos, how ownership is determined, whether registration is possible, and what the advantages and disadvantages are of using copyright law to protect and enforce rights in logos as compared with trademark law."[65] On September 12, 2017, the INTA Board passed a resolution supporting the position that copyrights and trademarks are separate disciplines, such that protection of a creative work of art, such as a logo, under one discipline should not hinder the ability of the artwork to receive protection under the other discipline.[66]

Despite these limitations, some logos have been deemed protectable. One franchisor, Wyndham Hotels and Resorts, LLC, registered the copyright in its logo as early as 1989.[67] This example suggests a brand owner may not have to rely solely on trademark rights when its logo may also qualify as an original work of art deserving of copyright protection."[68] Franchisors can review past decisions of the Review Board of the U.S. Copyright Office to evaluate whether their artwork/logo might be protectable as a copyright; a current listing of such decisions is available on the Copyright Office website.[69]

A search of "Labels and Logos" demonstrates the determinations made by the Review Board on appeals of Copyright Office refusal decisions. Most appealed refusals of registration of logos are affirmed; in other words, the Review Board agrees with the decision of the Copyright Office examiner to refuse registration of the logo at issue. In 2023 no refusals were reversed. In 2022, only one refusal was reversed.[70] The logo at issue, shown below, was a work titled "Hexagon Shaped Logo" for which an application was filed with Mazzella Lifting Technologies, Inc. as claimant.

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64. *Id.* ch. 914.2.

65. *See* Alicia Groos, *INTA Adds 11 New Countries to Report on Copyright Protections for Logos*, INTA News: Copyright Committee Update (Feb. 15, 2020).

66. Copyright Protection for Trademarked Material, INTA Board Resolution (Sept. 12, 2017).

67. Wyndham Logo, Registration. No. VA0001749578.

68. *Id.*

69. *See generally* www.copyight.gov.

70. Wyndham Logo, Registration. No. VA0001749578.

In this case, the logo in question is also registered as a U.S. federal trademark.[71]

Certain types of businesses rely even more heavily on copyright. Copyright-heavy franchise systems might include educational offerings that use works such as curriculum and other teaching materials. Registrations by educational companies include registration of workbooks by Sylvan Learning, Inc. and Sylvan Learning, LLC, and registration of tests, solution books and worksheets by Kumon Institute of Education Company, Ltd.[72]

Children-focused businesses such as indoor play spaces might include standard artwork for party themes. Ivybrook Academy, a pre-school franchise, owns registrations in its curricula, such as “Ivybrook Academy Creative Expression Curriculum”[73] and “Ivybrook Academy Literacy Connection Curriculum.”[74] Another child-focused, licensed business, Music Together LLC, has registered hundreds of its songs, teacher materials, and activity workbooks, including as texts, sound recordings, and performances, such as “Music Together in School (Purple) Song Activities,”[75] “Rhythm Kids Alligator Family Songbook,”[76] and “Music Together Fiddle Song Collection Teacher Edition.”[77]

Restaurant franchises might create menu artwork or menu boards that would be protected under copyright. As examples, Starbucks Corporation has obtained over 500 copyright registrations, protecting primarily artwork. Registrations covering coffee bag art include “Tribute Blend coffee bag art” and “Anniversary Blend Bag Art.” Starbucks Corporation also registered the artwork in many of its NFT “stamps,” such as the “Oleato Journey Stamp.” Similar to the steps taken by Starbucks, Taco Bell IP Holder, LLC has registered the artwork/design in its sauce packets. McDonald’s Corporation has obtained numerous copyright registrations (but seems to have ceased doing

71. Hexagon Shaped Logo, Registration No. 6119883 (Aug. 4, 2020).

72. Sylvan Learning Reading Comprehension Success 3rd Grade, Registration No. TX0006937289 (Mar. 6, 2009).

73. Ivybrook Academy Creative Expression Curriculum, Registration No. TXu002125710 (Nov. 29, 2018).

74. Ivybrook Academy Literacy Connection Curriculum, Registration No. TXu002125722 (Nov. 29, 2018).

75. Music Together in School (Purple) Song Activities, Registration No. PAu004194038 (Aug. 9, 2023).

76. Rhythm Kids Alligator Family Songbook, Registration. No. VA0002392766 (Mar. 7, 2024).

77. Music Together Fiddle Song Collection Teacher Edition, Registration No. TX0009302898 (Jan. 12, 2023).

so a decade ago) for marketing videos, broker-related information materials, kids' coloring handouts, and the like.[78]

Copyright portfolios are not limited to famous or multinational brands. Painting with a Twist, L.L.C., a franchised night-out painting concept, has registered the copyrights in many of the works that are used as inspiration for its events, such as "Happy Hydrangeas"[79] and "Cosmic Reflections."[80] In addition, franchises that teach coding likely would have significant software copyrights and software-focused teaching materials such as videos and games.

Most of these works would be licensed to franchisees through the franchise agreement. Certain works, such as franchise sales brochures, might be used only by the franchisor, or other works, such as architectural plans, might be used in developing the franchise but then not used in the operation of the franchised business.

IV. Overview of Copyright Matters in Franchise Disclosure Documents (FDDs) and Franchise Agreements

A. *FDDs—Item 14*

Item 14 requires a franchisor to describe all other types of intellectual property licensed with the franchise, namely, patents and patent applications, copyrights, trade secrets, rights of publicity (unless more appropriately disclosed in Item 18), and other proprietary information.[81] This listing generally includes the operations manual but, depending on the type of system, also might include some of the copyrighted works discussed in the prior section. Registered copyrights must be disclosed with specificity (registration date and number), including whether renewal is available and will be sought.[82]

As with Item 13, here with respect to patents, copyrights, and proprietary information, the franchisor must disclose all legal proceedings, settlements, and restrictions that affect these proprietary rights or limit a franchisee's ability to use the intellectual property.[83] Item 14 must explain how the determination affects the franchised business.[84] The disclosure may, in some circumstances, include an attorney's opinion with the issuing attorney's permission regarding disclosed litigation or administrative proceeding or determination or a summary thereof, with the full opinion then attached to Item 22.[85]

78. *See* U.S. Copyright Office Public Catalog for examples of registrations, such as, by Starbucks Corp., Tribute Blend coffee bag art, Registration No. VA0002386700 (Jan. 3, 2024); Anniversary Blend Bag Art, Registration No. VA0002343585 (Mar. 9, 2023); Oleato Journey Stamp, Registration No. VAu001522679 (Jan. 23, 2024); NFTs available for sale at: https://www.niftygateway.com/collections/starbucks-odyssey-2024-explore-oleato-journey; by Taco Bell IP Holder, LLC, Taco Bell Sauce Packet, Registration No. VA0002243237.

79. Happy Hydrangeas, Registration No. VA0002057828 (Feb. 6, 2017).

80. Cosmic Reflections, Registration No. VA0002023586 (Nov. 30, 2016).

81. *See* 16 CFR § 436.5(n).

82. *Id.* § 436.5(n)(3).

83. *Id.* § 436.5(n)(6).

84. *Id.* § 436.5(n)(2).

85. *Id.* § 436.5(n)(3).

The franchisor also must disclose what obligations it has to protect the intellectual property of the system, specifically how infringements will be addressed in the following contexts: (i) whether a franchisee would need to cease use of copyrighted material if there is a claim (or determination) that that material infringes the intellectual property of a third party; (ii) what action a franchisor must take, if any, if notified of an infringement claim and whether a franchisee is obligated to notify the franchisor of such claims; (iii) who, as between the franchisor and a franchisee, has the right to control infringement-related litigation; (iv) whether the franchisor must indemnify or defend a franchisee for expenses or damages in the case of a claim that material licensed to the franchisee infringes the intellectual property of a third party.[86]

Notably, the franchisor must disclose any "copyright infringement that could materially affect the franchisee."[87] Specifically, the FTC Franchise Rule requires the franchisor to disclose "(i) the nature of the infringement; (ii) the locations where the infringement is occurring; (iii) the length of time of the infringement to the extent known; and (iv) any action taken or anticipated by the franchisor."[88] The resulting situation is that many works that are created by employees or commissioned are not in fact owned by the employer or commissioning party.

B. *Addressing Intellectual Property in the Franchise Agreement*

The primary intellectual property-related issues that must be addressed in the franchise agreement are definitions, ownership, use, sublicensing restrictions, restrictive covenants, and confidentiality.

1. Definitions of Intellectual Property

Franchisors should clearly define the intellectual property that they are licensing to franchisees in the franchise agreement so that it is clear as to what the franchisor claims as proprietary and how each element of intellectual property fits within the system that is licensed to the franchisee. Definitions might need to be both general—to ensure continued applicability as the franchised system evolves—and specific—to include elements of trade dress, particularly those that are not inherently distinctive. Definitions also need to be consistent throughout various documentation, such as the operations manual.

2. Ownership

The franchise agreement should make clear that, as between the franchisor and franchisee, the franchisor owns all rights to the intellectual property. This claim of ownership should include goodwill that is created through use of the marks and to any intellectual property created by the franchisee itself,

86. *Id.* § 436.5(n)(5).
87. *Id.* § 436.5(n)(6).
88. *Id.*

or its owners, employees or agents, such as new menu items. A franchisor might choose to restrict the right of a franchisee to insert franchisee-created elements into the operation of the franchise; however, if it does not, or if a franchisee creates protectable rights contrary to a restriction, the franchisor should own them. Franchisees conceivably could create a new way of accomplishing a task or making a product that could be protected as a patent or trade secret, or create new artwork or take photographs which may be copyrightable, and used by the franchisor for the benefit of the system.

The franchise agreement should have all such creations assigned automatically to the franchisor, with the franchisee agreeing to cooperate in the assignment and protection, which typically would be at franchisor's expense. Works made for hire, a copyright concept, is often misunderstood and applies to only limited types of creations;[89] thus, there is a need for an express assignment in the franchise agreement. The franchisor's ownership of new developments enables exploitation of creativity for the benefit of the entire franchise system. While data obtained through operation of a franchised business by a franchisee might not always be protectable as intellectual property,[90] ownership and use of the data should be addressed contractually if the data has value to the franchisor, bearing in mind any data security or privacy laws that may be implicated.

3. Use and Sublicensing Requirements and Restrictions

The franchise agreement needs to identify what the franchisee may and may not do with each element of intellectual property. Franchise agreements typically grant the franchisee the non-exclusive right and obligation to use the trademarks and the brand's operating system to operate the franchised business only in accordance with the franchisor's quality standards and specifications. The specifications typically are contained in the franchisor's operations manuals, which franchisors generally retain the right to update and change unilaterally.

Some or all of the intellectual property to be used by the franchisee will not be sublicensable by the franchisee. The franchisor's trademarks are one example. However, other intellectual property will be licensed to the franchisee with the intent that the franchisee will sublicense it to its customers, such as software in certain types of businesses. Some intellectual property will be used publicly (e.g., the marks) and some will be back-office only (e.g., operations manuals and training materials).

In addition to clearly specifying the rights granted, the franchise agreement should specify rights not granted to the franchisee such as the right to open additional franchised businesses or to sublicense or to use the licensed intellectual property for any purpose other than operating the franchised

89. *See* Copyright Act, 17 U.S.C. § 101; U.S. Copyright Off., Circular 30: Works Made for Hire 2 (Mar. 2021), https://www.copyright.gov/circs/circ30.pdf.

90. Compilations of data can be protectable as copyrights or trade secrets in certain circumstances.

business. Rights reserved by the franchisor—such as the right to license the marks and system to others that may compete directly with the franchisee, in any channel of distribution or in any geographic region not specifically excluded—should likewise be stated.

V. Ensuring Ownership of Copyrights

In addition to issues relating to ownership of copyrights between franchisors and franchisees, it is important to consider ownership of works created by the franchisor to ensure that such works are owned as intended. Because franchisors typically license content to franchisees, a dispute with respect to ownership or limitations on use can be problematic due to the use of the work not only by the franchisor but by its licensees/franchisees.

The "author" of the work describes the "first owner." This first owner is typically the individual creator of the work, but in two situations the first owner or author is someone else, either an individual or a company. In these "works made for hire" situations, when a work is created by an employee or commissioned, then the author is the employer or the commissioning party. Authors must be human (not monkeys or AI software): "the copyright law only protects 'the fruits of intellectual labor' that 'are founded in the creative powers of the mind.'"[91]

The categories of works that qualify as "works made for hire" tends to be much narrower than typically understood. The resulting situation is that many works that are created by employees or commissioned are not in fact owned by the employer or commissioning party.

Works created by employees are "authored" by the employer only when the work is created as part of the employee's regular duties or within the scope of the employee's employment. For instance, if a company has a staff photographer or photography is part of a marketing employee's established duties, then photographs taken by the employee related to the business likely are owned by the employer. But if a company has a contest and many people including employees submit photos, those photos created by employees would not be authored or owned by the company automatically because they do not qualify as "works made for hire."

Works that are commissioned qualify as "works made for hire" owned by the commissioning party only when an express written agreement is in place and when the work is specially ordered or commissioned for use as one of nine types of works: (i) a compilation; (ii) a contribution to a collective work; (iii) a part of a motion picture or other audiovisual work; (iv) a translation; (v) a supplementary work; (vi) an instructional text; (vii) a test; (viii) answer

91. *See* Compendium, *supra* note 37, § 306; Trade-Mark Cases, 100 U.S. 82, 94 (1879); *see also* Thaler v. Perlmutter (BAH), 2023 WL 5333236 (D.D.C. Aug. 18, 2023) (Copyright Office denied registration of a work of visual art created by the claimant's AI program; denial affirmed on the basis that author of a copyrighted work must be human).

material for a test; and (ix) an atlas.[92] This narrow listing of categories does not include many if not most of the types of works that a franchisor might commission, such as the design of a logo or advertisements or photographs. These works, as well as any other type of work that does not qualify as a "work made for hire," must be assigned, in writing, for ownership to transfer from the author.[93]

In copyright parlance, the owner of the work (whether the same as the author or a new owner pursuant to assignment) is called the "claimant." A work that is not a work made for hire is therefore "authored" by the original creator and owned by that same creator (meaning the author and the claimant are the same) unless assigned in writing. Once a work is assigned, the author (which remains the same) and the claimant (the new owner) are different. In a work made for hire, the author and claimant will, initially, be the same. If a work is assigned after a copyright is registered, the assignment may be recorded at the U.S. Copyright Office.[94]

The doctrine of "work made for hire" and ownership of works as between employee/employer and creator/client varies by country. In 2021, the INTA published a helpful report that details the handling of copyrighted works and how and whether this doctrine applies.[95]

One wrinkle relevant to the design of trademark artwork is that, when an individual is hired to create such a work (as opposed to a company, like a design firm), that individual will, thirty-five years after the execution date of the assignment or license, have the right to terminate that grant.[96] If the right granted included the right of publication, then the period is either thirty-five years from the date of publication, or forty years from the execution date of the grant, whichever ends earlier.[97] The author (or their heirs) must comply with certain recordation requirements in order to do so.[98]

This not widely known rule came into play in a dispute between the Philadelphia Phillies baseball team and a mascot, the creation of which the team had commissioned through a design firm. In the original agreement, the design firm retained copyright ownership and granted license rights to the team. That arrangement led to a dispute in 1979 over the scope of rights included within the license. The earlier dispute was resolved by way

92. 17 U.S.C. § 101.

93. *See Works Made for Hire: Review of Legislation and Practice, prepared by a Cross-Subcommittee Task Force under the direction of the International & Legislative Subcommittee of the Copyright Committee of the International Trademark Association*, INTA (July 2021), https://www.inta.org/wp-content/uploads/member-only/advocacy/committee-reports/20210802_Work-for-Hire-Report-July-2021-FINAL.pdf.

94. *See* U.S. Copyright Off., Circular 12: Recordation of Transfers and Other Documents 1–2 (Sept. 2016), https://www.copyright.gov/circs/circ12.pdf.

95. *Copyright Office Survey*, INTA (Feb. 2023), https://www.inta.org/wp-content/uploads/public-files/advocacy/committee-reports/Report_Copyright-Office-Survey_v10052023.pdf

96. 17 U.S.C. § 203.

97. *Id.* § 203(a)(3).

98. *Id.* § 203(a)(5).

of payments and a broader, exclusive license.[99] In 2018, however, the design firm issued a notice to terminate the agreement in compliance with Section 203 of the 1976 U.S. Copyright Act.[100] The case was eventually settled after the filing of multiple pleadings raising a myriad of issues, and, thus, no opinion was issued. The dispute itself, however, makes clear the potential scope of an unaddressed right to terminate a copyright grant.

Acquirors cannot avoid this termination right by including a waiver in the original assignment. "Termination of the grant may be effected notwithstanding any agreement to the contrary, including an agreement to make a will or to make any future grant."[101] Thus, if any work that the future owner might still need to use after thirty-five years is to be commissioned, it is important to ensure that that work is created either by an employee within the scope of their employment or by a design company not an individual.[102]

VI. Use of Copyrights of Third Parties

A. *Licensing*

As with any business, use of copyrighted works of third parties must either be licensed or otherwise used with permission or fall within an exception or defense such as the fair-use doctrine.[103] In the franchise context, ensuring that one has the necessary rights in third-party works is critical for a variety of reasons. From the perspective of the franchisor, when licensing works to franchisees, the franchisor might be taking on liability from the use or misuse of those works by the franchisees.[104]

In addition, a work that becomes part of a franchise system will be used more broadly in a multiunit franchised concept as compared to a non-franchised single location. Expanded use through a franchised concept means that, from a practical perspective, a rights owner whose rights are infringed by the use is more likely to discover the use. In addition, the damages available to the rights owner through broad misuse would be greater than from a limited use.

Because copyright rights include multiple types of rights, a use of a work that is licensed for one specific type of use, such as "display" to cover the use of in-licensed artwork on the walls of a franchised business, might not

99. *See* Michael McCann, *Will Philles Have to Ditch Philly Phanatic Mascot*, Sports Illustrated (Aug. 6, 2019), https://www.si.com/mlb/2019/08/06/philadelphia-phillies-mascot-lawsuit-phanatic.

100. *See* Blake Brittain, *MLB's Phillies, Muppet designer Settle Spat over "Phanatic" Mascot*, Reuters (Oct. 8, 2021) https://www.reuters.com/legal/transactional/mlbs-phillies-muppet-designer-settle-spat-over-phanatic-mascot-2021-10-08.

101. 17 U.S.C. § 203(a)(5).

102. Deborah L. Shapiro & Erica B. E. Rogers, *Unintended Consequences of Copyright and Trademark Protection in Design*, INTA Bull. (Dec. 2, 2020); Jaime Angeles, Alejandra Aoun & Michael Lovitz, *Unintended Consequences Part 2: What the Phillie Phanatic Litigation Teaches About Copyright and Trademark Rights in Mascots*, INTA Bull. (Feb. 8, 2023).

103. 17 U.S.C. § 107.

104. *See* Part IV.A, *supra*, for discussion of Item 14 of the FDD.

extend to other uses. For instance, a video shot in a franchised business that clearly displays the same artwork in the background and then becomes part of an advertisement might be outside the scope of a simple "display" license and therefore infringe the rights of the copyright owner. Similarly, framed or finished artwork that is purchased and displayed, as opposed to buying rights and then replicating the artwork, may be displayed without a license under the "first sale doctrine,"[105] but incorporation of that same artwork in the advertisement similarly does not fall within the first sale doctrine and therefore can be infringing.

Even when one obtains a license, disputes can arise over the scope of the licensed use authorized. For example, in *Civility Experts Worldwide v. Molly Manners, LLC*,[106] a licensor of a curriculum for teaching manners to children (Molly Manners) was sued for alleged misuse of copyrights of Civility Training Worldwide (Civility Training). Civility Training's proprietor registered copyrights in three of its lessons.[107] According to court documents, Molly Manners licensed the registered copyrights from Civility Training, with some dispute over whether that license included the right for Molly Manners to sublicense the works (as incorporated into Molly Manners' own materials) to its licensees.[108] The parties settled the first dispute without litigation and entered into a settlement agreement.[109] When a further dispute arose a few years later, including whether Molly Manners had complied with the settlement agreement, Civility Training brought suit for a variety of claims, including copyright infringement. Moreover, Civility Training named as defendants not only Molly Manners but two of Molly Manners' licensees. In granting Molly Manners' motion for partial summary judgment, the court dismissed the copyright infringement claims based on the insufficient protectible nature of what was copied by Molly Manners and as the lack of substantial similarity between the protectible elements and the allegedly infringing works;[110] however, the district court noted that Molly Manners also had obligations to Civility Training under the settlement agreement.[111]

B. *Fair Use*

The fair-use doctrine allows certain uses of copyrighted works of others without needing permission of the copyright owner. Fair use is a more limited concept than one would expect. Under the fair-use doctrine, copyrighted

105. *See* 17 U.S.C. § 109 ("[T]he owner of a particular copy or phonorecord lawfully made . . . , or any person authorized by such owner, is entitled, without the authority of the copyright owner, to sell or otherwise dispose of the possession of that copy or phonorecord.").

106. Civility Experts Worldwide v. Molly Manners, LLC, 167 F. Supp. 3d 1179 (D. Colo. 2016).

107. Confidence Is Cool, Registration No. TX0007724994 (Apr. 13, 2013); Macaroni and Please, Registration No. TX0007724985 (Apr. 13, 2013); Proud to Be Polite, Registration No. TX0007724991 (Apr. 13, 2013). All have Lewena L. Bayer as claimant.

108. *Civility Experts*, 167 F. Supp. 3d at 1188.

109. *Id.*

110. *Id.* at 1215.

111. *Id.* at 1216.

works may be generally used "for purposes such as criticism, comment, news reporting, teaching (including multiple copies for classroom use), scholarship, and research."[112] Specific statutory rules exist for certain types of uses, such as by libraries, that are not broadly applicable but could come into play with an educational franchise system.

The Copyright Act provides the following factors for courts to examine in determining whether the unauthorized use made of a copyrighted work constitutes a "fair" use:

> (1) the purpose and character of the use, including whether [the] use is of a commercial nature or is for nonprofit educational purposes; (2) the nature of the copyrighted work; (3) the amount and substantiality of the portion used in relation to the copyrighted work as a whole; and (4) the effect of the use upon the potential market for or value of the copyrighted work.[113]

If a work that a business desires to use has been "commercialized," meaning the copyright owner has created a license scheme for the work, then attempting to use the work without a license is less likely to be fair; the user has avoided and therefore eliminated the potential/copyright owner-created market for the work.[114] Under this doctrine, therefore, use of works for which there is a licensing scheme or for which the copyright owner is typically paid is riskier. As an example, the copyright owner of a photograph that is licensed through Getty Images has created a "reasonable license fee" applicable to use of that photograph, or sometimes a series of fees depending on the type and scope of use.

C. *Demand Letters*

With the technological ease in image searching and reverse image searching, many copyright users are finding themselves on the receiving end of demand letters regarding the use of photographs in ads or through social media platforms like YouTube and Facebook. Copyright-protected font software is another common subject matter of these demand letters.[115] As examples, a franchisor or franchisee might receive such a demand based on the typeface

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112. 17 U.S.C. § 107.

113. *Id*.

114. *See* Am. Geophysical Union v. Texaco, Inc., 802 F. Supp. 1 (S.D.N.Y. 1992), *aff'd*, 37 F.3d 881, *order amended & superseded*, 60 F.3d 913, *aff'd*, 60 F.3d 913 (2d Cir. 1994).

115. Typefaces themselves are rarely protected under copyright law, but the software that makes fonts scalable typically is. *See* Circular 33, *supra* note 10 ("Copyright law does not protect typeface or mere variations of typographical ornamentation or lettering. A typeface is a set of letters, numbers, or other characters with repeating design elements that is intended to be used in composing text or other combinations of characters, including calligraphy. Generally, typeface, fonts, and lettering are building blocks of expression that are used to create works of authorship. The Office cannot register a claim to copyright in typeface or mere variations of typographic ornamentation or lettering, regardless of whether the typeface is commonly used or unique. There are some very limited cases where the Office may register some types of typeface, typefont, lettering, or calligraphy. For more information, see chapter 900, section 906.4 of the Compendium. To register copyrightable content, you should describe the surface decoration or other ornamentation and should explain how it is separable from the typeface characters.").

used in the franchised system's logo or website or based on graphics or artwork used on a website.

The first step typically is for a plaintiff's law firm that specializes in this area to send an email or demand letter asking for confirmation that the use was licensed, sometimes including a demand and settlement offer in the initial correspondence.[116] Depending on the response to the initial missive, the forcefulness of the follow-up often increases quickly. Recipients of such demands and their counsel often refer to this practice as "copyright trolling."[117]

Determining a strategy in responding to such demand letters is a fact-specific situation to be discussed with the franchisor's counsel. A few factors to consider include (i) whether the claim is legitimate (i.e., whether the use of the copyrighted work in fact occurred as alleged); (ii) whether the copyright at issue was at the time of use, or is now, registered; (iii) whether the demand has provided a connection between the sender of the letter and the copyright owner; (iv) the stage and background of the demand, meaning have there been multiple prior reach-outs to the recipient; and (v) whether the demand is from the rights-owner or a law firm or rights company whose business is obtaining significant licensing fees from users through aggressive behavior such as increasing demand amounts, threats of lawsuits and attorney's fees (even in situations where the rights owners would not be entitled to those remedies).

Responses to such demands can include the following: 1) offering to pay the initially proposed license fee, if reasonable and the alleged use occurred; 2) refusing any payment, which may be appropriate when the claim has been insufficiently substantiated or when the recipient chooses to call the sender's bluff; 3) shutting down discussions with a strong response such as seeking a declaratory judgment or filing a Rule 68 Offer of Judgment.[118]

VII. Copyright Infringement

A. *Elements of an Infringement Claim*

The elements of a copyright infringement claim are (1) ownership of a valid copyright; and (2) violation of one of the exclusive copyright rights

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116. Sometimes the initial communication will come directly from the copyright owner, with the next escalation from a plaintiff law firm.

117. *See, e.g.*, Alex Jones, *Threats from a Copyright Troll? Here's What to Do* JDSupra (Oct. 12, 2023), https://www.jdsupra.com/legalnews/threats-from-a-copyright-troll-here-s-2617140; David Perry & Heidi G. Crikelair, *Beware of the Trolls: Recent Uptick in Copyright Trolling and What You Should Do*, JDSupra (Aug. 4, 2020), https://www.jdsupra.com/legalnews/beware-of-the-trolls-recent-uptick-in-63839.

118. As set forth in Federal Rule of Civil Procedure 68, a Rule 68 Offer of Judgment is a mechanism that allows a defendant to make an offer of settlement to resolve a case. The offer may be accepted, ending the case, but if rejected, and the plaintiff either loses or receives less than the amount of the offer, then the plaintiff must pay the defendant's "costs" incurred after the offer is made. And though courts are split, in the context of a copyright case, "costs" can include the defendant's attorney's fees. *See, e.g.*, Energy Intel. Grp., Inc. v. Kayne Anderson Cap. Advisors, LP, 326 F.R.D. 453, 459 (S.D. Tex. 2018) (discussing split). Courts encourage such offers because "the very purpose of Rule 68 is to encourage the termination of litigation." *See, e.g.*, Latshaw v. Trainer Wortham & Co., 452 F.3d 1097, 1103 (9th Cir. 2006).

(copying/reproduction, distribution, performance, public display, or creation of a derivative work) by defendant of constituent elements of the work that are original.[119] Ownership of a registered copyright constitutes *prima facie* evidence that the registrant owns a valid copyright.[120]

To prove that a violation has occurred, the plaintiff must show (1) that the defendant had access to the plaintiff's work, and (2) that the defendant's work is substantially similar to protected aspects of the plaintiff's work.[121] There are circuit-specific variants on how similarity is judged. In the Second Circuit, for instance, courts first separate out unprotectable elements of the work, then look at the remaining protectable elements in comparison with the allegedly infringing work to determine whether the similarities are "substantial."[122] In the Ninth Circuit, courts apply two separate tests—"extrinsic" and "intrinsic"—in their analysis. The "extrinsic" test is similar to the Second Circuit test, whereas the "intrinsic" test is more holistic, focusing on the "ordinary person's subjective impression of the similarities between the works."[123]

In the absence of direct evidence of copying or other violation, an infringement plaintiff can show evidence that the defendant had access to the protected work and that the infringing work is substantially similar.[124] Access can be established if a plaintiff's work has been widely disseminated, such as a hit song, or some contact between the plaintiff and defendant, such as the plaintiff's submission of her book to a movie studio. Writing software code in a "clean room" (i.e., without access to other code) is one approach often taken to minimize the risk of a successful copyright infringement claim.[125]

Copyright infringement litigants must contend with a number of copyright-specific affirmative defenses including the fair-use doctrine, discussed in Part VI.B. Recall that a plaintiff/copyright owner must have registered the copyright at (or attempted to register the copyright and had the application refused by) the Copyright Office prior to bringing a copyright infringement suit. Before the U.S. Supreme Court decided the question of whether registration is a prerequisite to bringing such an action, in its ruling in *Fourth Estate Public Benefit Corp. v. Wall-Street.com LLC*[126] in 2019, a long-standing circuit split had existed as to whether one could bring an infringement suit upon the filing of a copyright application. In its unanimous ruling, the Supreme Court determined that the plaintiff must wait until the registration is issued or refused.

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119. 17 U.S.C. § 501; Feist Publ'ns, Inc. v. Rural Tel. Serv. Co. Inc., 499 U.S. 340, 361 (1991).

120. 17 U.S.C. § 410(c); Donald Frederick Evans & Assocs., Inc. v. Cont'l Homes, Inc., 785 F.2d 897, 903 (11th Cir. 1986).

121. *Feist*, 499 U.S. at 361.

122. Williams v. Crichton, 84 F.3d 581, 588 (2d Cir. 1996).

123. Funky Films, Inc. v. Time Warner Ent. Co., 462 F.3d 1072, 1077 (9th Cir. 2006).

124. *See* Arthur Rutenberg Homes, Inc. v. Maloney, 891 F. Supp. 1560, 1566–67 (M.D. Fla. 1995).

125. See *How to Develop an IP "Clean Room" Policy*, Chip Law Group, Lexology (Aug. 23, 2023), https://www.lexology.com/library/detail.aspx?g=57ce5c16-717f-4fe0-9925-30628c54085c.

126. Fourth Estate Public Benefit Corp. v. Wall-Street.com LLC, 586 U.S. 296 (2019).

Copyright infringement suits must brought "within three years after the claim accrued."[127] The U.S. Supreme Court has not opined on the "discovery rule," namely whether claims accrue when they are "discovered" or at some other point in time.

B. *Infringement Awards*

A variety of remedies are available in a successful copyright infringement claim including injunctions[128] and impoundment of infringing articles;[129] however, damages are the most familiar. The damages awarded in a successful copyright infringement claim depend on a variety of factors.[130] For example, if the copyright at issue was registered prior to the infringement, statutory damages,[131] which can be up to $150,000, and attorney's fees[132] are a possibility. Whereas if the copyright registered after the infringement occurred, monetary damages are limited to actual damages and profits,[133] such as a reasonable royalty. Provided that the suit is brought within the three-year "accrual" window, copyright damages are not time-limited.[134] In the franchise context, actual damages can be based on a franchise fee that the infringer did not pay, but which paying and becoming a franchisee would have then authorized the infringing use of the franchisor's copyright.[135] In *Flying J, Inc. v. Central CA Kenworth*, discussed in the next section, a franchisor alleged infringement of copyrighted architectural plans in a case where the infringer did not become a franchisee but copied the franchise floor plans so as to create a competing business; the court affirmed the jury award of actual damages based on the franchise fee.[136] In addition to civil damages, certain types of infringement can be criminal offenses.[137]

C. *Situations in Which a Franchisor Might Claim Infringement*

Many of the situations in which a franchised business might bring an infringement suit are the same as with any business. For instance, if a business copies a work such as photos used on the website of the franchised

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127. 17 U.S.C. § 507(b).

128. 17 U.S.C. § 502; *see also* Int'l Trademark Ass'n, *Preliminary Relief in Copyright Cases: A Brief Report by the Enforcement Subcommittee of the Copyright Committee* (Nov. 2023).

129. 17 U.S.C. § 503.

130. 17 U.S.C. § 504.

131. 17 U.S.C. § 504(c).

132. 17 U.S.C. § 505; *see also* Fogerty v. Fantasy, Inc., 510 U.S. 517 (1994) (setting the standard by which attorney's fees can be awarded, whether to a defendant or a plaintiff, in a copyright infringement suit, and eliminating a circuit split whereby various circuits applied different standards to attorney's fees awards depending on whether such fees were being considered for the prevailing plaintiff or the prevailing defendant).

133. 17 U.S.C. § 504(b).

134. *See* Warner Chappell Music, Inc. v. Nealy, 144 S. Ct. 1135 (2024) (A six to three majority held that there is no three-year period for recovering damages, namely that the three-year post-accrual filing window does not apply to damages awards for a timely brought suit.).

135. Flying J, Inc. v. Cent. CA Kenworth, 45 F. App'x 763, 765 (9th Cir. 2002).

136. *Id.* at 765–66.

137. 17 U.S.C. § 506.

business and posts those same photos on the defendant's website, the copying business has violated the exclusive rights both of copying and of public display.

However, because many franchisors provide copyright content to franchisees, and therefore are licensors, one situation in which a copyright claim may arise is in a holdover franchisee situation in which all licenses granted to the former franchisee have been terminated. In this scenario, a terminated franchisee who continues to use a franchisor's brand and operating system might also continue to display, copy, or create derivative works of materials provided by a franchisor. These activities create an additional claim for the franchisor's arsenal. Note that "use" of materials is not an exclusive copyright right. In other words, if a terminated franchisee continues to use an operating manual, that is in itself is not a copyright violation. If, however, a terminated franchisee makes a copy of the operating manual or continues to display copyrighted works publicly, such as on its website or in its store location, those activities could constitute a copyright violation.

In another example, a franchisor of residential building companies successfully brought an infringement claim based on copying of copyrighted architectural designs based on the substantial similarity of those designs and homes built by the infringer.[138] In another suit where infringement of copyrighted architectural plans was alleged, the infringer did not become a franchisee but copied the franchise floor plans so as to create a competing business.[139]

D. *Alternate Enforcement Mechanisms*

1. DMCA—The Digital Millennium Copyright Act

While enforcing one's rights when a trademark is infringed online can be costly and slow, taking action against online infringement of a copyright often is simpler and more straightforward. In 1998, as a way of balancing the various rights and liabilities of online service providers and copyright owners while addressing online infringement, the U.S. Congress enacted the Digital Millenium Copyright Act (DMCA). The DMCA, codified at 17 U.S.C. § 512, created, among other provisions, a safe harbor for online service providers and website hosts that follow certain procedures. Specifically, provided that online-service providers cooperate with copyright owners to remove infringing content from websites that they host expeditiously, Section 512 shields website hosts from monetary liability for copyright infringement of their users.

To obtain safe-harbor protection, online service providers must register an agent who may be contacted with the DMCA Designated Agent Directory. The DMCA Designated Agent Directory[140] is an online searchable

138. Arthur Rutenberg Homes, Inc. v. Maloney, 891 F. Supp. 1560, 1561 (M.D. Fla. 1995).

139. Flying J, Inc. v. Cent. CA Kenworth, 45 F. App'x 763, 766 (9th Cir. 2002).

140. The DMCA Designated Agent Directory is available on the U.S. Copyright Office website at https://www.copyright.gov/dmca-directory.

directory that allows copyright owners to determine whom to contact when infringing content is found on a website.

When a copyright owner locates infringing material on a website, it can send a written notification of claimed infringement (or a "takedown notice") to the service provider's designated agent. The takedown notice must comply with specific requirements, namely providing information that allows the service provider both to identify the infringing work and its location, contact information of the complaining party, and declarations that the complainant has a good-faith belief that the use is not authorized, and that the complainant has the authority to object.[141] Often the takedown notice is submitted via a form on the designated agent's website. The service provider then must remove or disable access to the material, which often leads to the website being taken down entirely. The system does not necessarily work to remove copyrighted content in all instances. There is a "counter-notice" procedure that allows the user to object to the takedown notice as well as the right to claim that the copyright owner misrepresented its rights.[142] However, using the DMCA is often a quick and effective means of having infringing material removed from the Internet.

For a franchisor, the DMCA is useful in taking action against holdover franchisees who continue to use a franchisor's copyrighted works on a website. Similarly, the DMCA could be used to have a competing website taken down if that website copied the website, copyrighted photos, or other materials of a franchisor.

Practically speaking, it often is more straightforward to identify an online service provider's DMCA policy by reviewing the legal notices on the provider's website, rather than searching the DMCA Designated Agent Directory. Most online service providers/website hosts have online forms to enable copyright owners or their agents to submit takedown notices.[143]

Many such forms allow the submission of trademark complaints as well; however, while the DMCA provides a clear incentive to service providers to remove content that infringes on copyrights, in the form of a safe harbor from liability, there is not the same incentive with respect to trademark infringement. Accordingly, while there is little harm in submitting trademark takedown notices, they often are not as successful as copyright takedown notices.

141. *See* 17 U.S.C. § 512(c)(3)(A).

142. *See* Automattic Inc. v. Steiner, 2014 U.S. Dist. LEXIS 182295, at *47 (N.D. Cal. Oct. 6, 2014) (court awarded money damages to a party that received a DMCA takedown notice with material misrepresentations).

143. As an example, the GoDaddy.com legal terms includes a detailed explanation of their procedures for handling copyright claims. *See* GoDaddy, *GoDaddy—TRADEMARK/COPYRIGHT INFRINGEMENT*, https://www.godaddy.com/legal/agreements/trademark-copyright-infringement (last revised Apr. 4, 2024).

2. Copyright Claims Board

In 2020, through the Copyright Alternative in Small-Claims Enforcement (CASE) Act of 2020,[144] Congress created the Copyright Claims Board (CCB). The CCB was designed as a simpler and less costly alternative to court litigation. The CCB is made of up three officers, with monetary damages capped at $30,000. Participation in the CCB process is voluntary, meaning that both the claimant and the respondent can decide whether to participate in CCB proceedings. A party with a copyright claim (including one with damages under $30,000) can choose instead to bring suit in federal court; a respondent against whom a complaint is filed with the CCB can opt out (in which case the claimant may bring suit in federal court). The jurisdiction of the CCB is limited to three types of copyright claims: 1) claims of infringement of a copyright; 2) claims seeking a declaration that certain behavior does not constitute copyright infringement; and 3) claims of misrepresentation in DMCA takedown notices.

Complaints at the CCB can be brought without the use of an attorney; the Copyright Office has created detailed "how-to" materials, available on a website dedicated to the Copyright Claims Board,[145] including a "Copyright Claims Board Handbook." The determinations of the CCB are available and viewable online on the CCB website, through the "Electronic Filing and Case Management System." Because the CCB is fairly new (having gone live in June 2022), with the first decision issued in 2023, fewer than two dozen decisions have been issued at the time of this writing.

Several cases have been brought against operators of the types of businesses that often are franchised, such as restaurants, bars, and spas. Examples include *Hursey v. The Little Door*[146] (dismissed without prejudice due to lack of service); *Sedlik v. Culinary Investments*[147] (settled and dismissed without prejudice); *Schirmacher v. Bellisimo Euro. Day Spa*[148] (dismissed without prejudice due to respondent Bellissimo's opt-out); *Schirmacher v. Allora Medical Spa*[149] (final determination issued February 16, 2024, awarding photographer Tom Schirmacher $7,000 in statutory damages for copyright infringement of the work "Salt Facial Photograph"); *Joe Hand Promotions v. Arif Skyline Cafe*[150] (final determination issued September 22, 2023, dismissing the case against respondent Kassa, which was based on vicarious liability, and finding

144. Copyright Alternative in Small-Claims Enforcement Act, 17 U.S.C. §§ 1501–1511 (2020).

145. Copyright Claims Bd., https://ccb.gov.

146. Copyright Claims Bd. No. 22-CCB-0221, https://dockets.ccb.gov/case/detail/22-CCB-0221.

147. Copyright Claims Bd. No. 22-CCB-0004, https://dockets.ccb.gov/case/detail/22-CCB-0004.

148. Copyright Claims Bd. No. 22-CCB-0182, https://dockets.ccb.gov/case/detail/22-CCB-0182.

149. Copyright Claims Bd. No. 22-CCB-0183, https://dockets.ccb.gov/case/detail/22-CCB-0183.

150. Copyright Claims Bd. No. 22-CCB-0098, https://dockets.ccb.gov/case/detail/22-CCB-0098.

Arif Skyline Café LLC liable for copyright infringing for unauthorized public display of a boxing event and awarding Joe Hand Promotion, Inc. $3,000 in statutory damages); and *Joe Hand Promotions v. Fusion Groups*[151] (dismissed without prejudice after claimant withdrew the claims).[152]

Due to the high cost of standard court litigation, and the relatively lower cost of using the CCB, it seems likely that cases will be brought against users of copyrighted materials that, without the CCB, would not have resulted in litigation. Accordingly, franchised businesses should be prepared to respond if such cases are brought and should consider using CCB proceedings in determining an appropriate strategy for addressing copyright infringement offensively.

VIII. Best Practices for Franchisors[153]

The best practices for franchised businesses do not vary significantly from best practices for other businesses.

- Ensuring Clear Use Rights—One difference from the perspective of franchisors is that the business model contemplates that content developed by the franchisor will be licensed to franchisees. Because the licensor/franchisor often takes on liability for content that it provides to its licensee/franchisees, it is important to 1) ensure that copyrighted works intended to be owned or freely licensable are in fact owned or freely licensable becomes paramount; and 2) establish clear guidelines for the use of third-party works.
- Protection—Because copyrights often are easier to enforce than trademark rights (particularly online), registering the copyrights in materials that will be licensed out to franchisees is important to allow franchisors additional recourse in holdover franchisee situations. In addition to the ability to use the DMCA to force the takedown of rogue holdover websites that use franchisor-provided photographs, for instance, franchisor-provided copyright-protected art that is displayed in a franchised business constitutes a violation of the exclusive "display" right of the copyright owner.
- Originality—Given the challenges in creating enforceable trade dress, creating original copyrighted works can be an alternative way to create a distinctive look and feel.

151. Copyright Claims Bd. No. 22-CCB-0067, https://dockets.ccb.gov/case/detail/22-CCB-0067.

152. For details on the collection of CCB cases discussed in this section, see Marc Lieberstein & Anna Antonova, *Franchising and the New Copyright Claims Board*, N.Y.L.J. (Feb. 14, 2023), https://www.law.com/newyorklawjournal/2023/02/14/franchising-and-the-new-copyright-claims-board.

153. Because franchisees often obtain their copyrighted works through a license from a franchisor and, in some cases, have rights they create through operation of a franchised business assigned back to the franchisor, these best practices are focused on franchisors.

- Value—Franchised businesses are often looking for investors, financing, or exit strategies through sale opportunities. Sophisticated investors and buyers of franchised businesses are more likely (than purchasers of a single-unit, non-franchised business) to look for copyright portfolios in addition to trademark portfolios.

IX. Conclusion

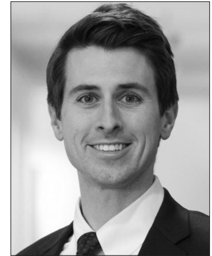
Copyright law remains one of the simplest, most cost-effective, and least utilized means of protecting one's franchised system from holdover franchisees and copycat competitors. Adding enforceable copyright protection to an intellectual property portfolio is an uncomplicated way to strengthen rights in a franchised brand affordably.

Personal Liability for Franchise Sellers

*Robert M. Einhorn & Benjamin W. Clements**

I. Introduction

Mr. Einhorn



Mr. Clements

Franchising is regulated by the Federal Trade Commission (FTC), which aims to protect prospective franchisees from deceptive practices. The FTC Act[1] explicitly prohibits material misrepresentations about any business investment, and the FTC's Franchise Rule (Franchise Rule) requires franchisors offering or selling a franchise in the United States to provide all prospective franchisees with a disclosure document containing twenty-three items of information about the offered franchise, its officers, and other franchisees.[2] The FTC Act also prohibits a franchisor from making financial representations about the potential performance or profitability of the franchise unit outside the disclosure document.[3]

Despite these regulations, franchisors sometimes engage in unlawful conduct or fraudulent activities in the sale of franchises. This conduct may lead to significant financial losses for franchisees. Because no private cause of action exists under the Franchise Rule, franchisees must rely on state statutes that

1. 15 U.S.C. §§ 41–58. The FTC Act empowers the FTC, inter alia, to (a) prevent unfair methods of competition and unfair or deceptive acts or practices in or affecting commerce; (b) seek monetary redress and other relief for conduct injurious to consumers; (c) prescribe rules defining with specificity acts or practices that are unfair or deceptive, and establishing requirements designed to prevent such acts or practices; (d) gather and compile information and conduct investigations relating to the organization, business, practices, and management of entities engaged in commerce; and (e) make reports and legislative recommendations to Congress and the public. *Id.* §§ 45(1)(2), 46(a), 46(f), 57a, 57b.

2. 16 C.F.R. § 436.1–436.10; *see also* Samuel Levine, *Holding Franchisors Accountable for Illegal Practices*, Fed. Trade Comm'n (Aug. 3, 2022), https://www.ftc.gov/business-guidance/blog/2022/08/holding-franchisors-accountable-illegal-practices.

3. 16 C.F.R § 436.9(c) (prohibiting franchisors from disseminating "any financial performance representations to prospective franchisees unless . . . the representation is included in Item 19 of the franchisor's disclosure document").

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prohibit unfair or deceptive practices to bring claims against franchisors. When franchise disclosure documents contain false or misleading information or when franchisors make material misrepresentations during the sale of a franchise, franchisees can also assert state common law fraud claims.

However, franchisees in these situations may have little practical recourse to obtain compensation for their losses against a franchisor lacking cash flow or assets. Indeed, franchisors engaged in illegal franchise sales and related fraud are often not long for this world. Such franchisor entities may end up financially defunct or bankrupt under the weight of regulatory action, franchisee closures, and litigation.

This paper examines potential solutions to these circumstances by looking a step beyond a franchisor's potential liability and exploring the potential personal liability of the franchisor's principals or agents involved in illegal franchise sales. It examines the extent to which these individuals can be held personally accountable for their involvement in fraudulent activities. As this paper will illustrate, the personal liability of a principal involved in conducting a franchise sale will vary based on applicable state law, but in any event will likely turn on the nature and egregiousness of the fraud or statutory violation and the degree of participation by the individual.

II. The FTC's Pursuit of Civil Penalties Against Principals

The FTC has occasionally pursued individuals involved in illegal franchise sales as part of its regulatory oversight of franchising. In 2016, the FTC sued LearningRx Franchise Corp. and its CEO and sole director, Ken Gibson, for "making a range of false and unsubstantiated claims" to franchisees and consumers.[4] The FTC alleged Gibson disseminated advertising and marketing materials containing false or unsubstantiated claims that LearningRx's "brain training" programs were "clinically proven to permanently improve serious health conditions," such as attention deficit hyperactivity disorder and dementia,[5] and to significantly increase IQ scores.[6] The FTC detailed the extent of Gibson's control over nearly every aspect of Learning Rx's operations as follows:

> Defendant Ken Gibson is the CEO, secretary, and sole director of LFC. He is the department manager of LFC's "executive department," which is responsible for overseeing all aspects of LFC. Mr. Gibson signs LearningRx franchise agreements, conducts training for franchisees as part of LFC's Training Program, which includes training on marketing and sales, reviews and approves advertising,

4. Press Release, Fed. Trade Comm'n, Marketers of One-on-One 'Brain Training' Programs Settle FTC Charges That Claims About Ability to Treat Severe Cognitive Impairments Are Unsupported (May 18, 2016), https://www.ftc.gov/news-events/news/press-releases/2016/05/marketers-one-one-brain-training-programs-settle-ftc-charges-claims-about-ability-treat-severe.

5. *Id.*

6. Complaint for Permanent Injunction and Other Equitable Relief at 5, Fed. Trade Comm'n v. LearningRx Franchise Corp., No. 1:16-cv-1159 (D. Colo. May 18, 2016).

> and is responsible for LearningRx advertising claim substantiation issues. He has the authority to review and approve all advertising and marketing materials for LearningRx programs, including the materials disseminated to franchisees. At all times material to this Complaint, acting alone or in concert with others, he has formulated, directed, controlled, had the authority to control, or participated in the acts and practices of LFC, including the acts and practices set forth in this Complaint.[7]

The FTC alleged that LearningRX's deceptive acts were squarely in violation of Sections 5(a) and 12 of the FTC Act.[8] The FTC sought "such relief as the Court finds necessary to redress injury to consumers resulting from Defendants' violation of the FTC Act, including but not limited to, recission or reformation of contracts, restitution, the refund of monies paid, and the disgorgement of ill-gotten monies."[9] Despite the FTC's decision to name Gibson as a defendant in his individual capacity, the FTC's proposed settlement did not hold him jointly and severally liable for the stipulated $4 million judgment against LearningRx,[10] which ultimately settled for $200,000.[11]

In *LearningRX*, the FTC sought relief under Section 13 of the FTC Act, which provides for injunctive relief.[12] However, the FTC could have also sought relief under Section 5 of the Act, which imposes civil liabilities of up to $10,000 per violation on a "person, partnership or corporation" who violates an FTC rule "with actual knowledge or knowledge fairly implied on the basis of objective circumstances that such act is unfair or deceptive and is prohibited by such rule."[13] The FTC in that particular instance chose to limit its focus to equitable relief under Section 13 of FTC Act.[14]

More recently, the FTC has taken a firmer approach in holding individual principals liable for violations of the FTC Act. In 2022, the FTC sued fast food burger restaurant franchisor, BurgerIM Group USA, Inc., along with its affiliate company tasked with managing the franchisees, BurgerIM Group, Inc., and its CEO Oren Loni. There, the FTC specifically sought "monetary civil penalties from *each* Defendant for every violation of the Franchise Rule."[15] In contrast to the *LearningRX* complaint, the *BurgerIM*

7. *Id.* ¶ 7.

8. *Id.* ¶¶ 12–16.

9. *Id.* ¶ 21.

10. Stipulated Order for Permanent Injunction and Other Equitable Relief Against Defendants LearningRX Franchise Corp. and Ken Gibson at 9, Fed. Trade Comm'n v. LearningRx Franchise Corp., No. 1:16-cv-1159-RM (D. Colo. May 24, 2016).

11. Press Release, *supra* note 4.

12. 15 U.S.C. § 53.

13. 15 U.S.C § 45(m)(1)(A).

14. *See also In re* Carrot Neurotechnology, Inc., 2016 WL 807980, at *37 (F.T.C. Feb. 22, 2016) (ordering Carrot Neurotechnology and its owners to pay $150,000); Stipulated Final Judgment and Order for Permanent Injunction and Other Equitable Relief at 9, Fed. Trade Comm'n v. Lumos Labs, Inc., 3:16-cv-00001-sk (N.D. Cal. Jan. 8, 2016) (ordering Lumos Labs, but not any individuals, to pay $2,000,000.00 in consumer redress).

15. Complaint for Permanent Injunction and Monetary Judgments for Civil Penalties and Consumer Redress, and Other Relief at 16, United States v. BurgerIM Group USA, No. 2:22-CV-825 (C.D. Cal. Feb. 7, 2022) (emphasis added).

complaint expressly sought to hold Loni jointly and severally liable for damages resulting from the violations that he and the entities under his control committed.[16] The FTC alleged that the fast-food chain "lure[d] would-be entrepreneurs into paying tens of thousands of dollars" by "making representations in their disclosure document that contradicted other statements they made to the prospective franchises."[17] The FTC alleged BurgerIM and Loni not only induced potential franchisees through false promises, but also withheld material information as required by the Franchise Rule.[18] According to the *BurgerIM* complaint,

> Defendant Oren Loni ("Loni") was at all relevant times the chief executive officer of BIMGUSA and BIMG (collectively, "Corporate Defendants"). Acting alone or in concert with others, he has formulated, directed, controlled, had the authority to control, or participated in the acts and practices of Corporate Defendants, including the acts and practices set forth in this Complaint. Loni has advertised, marketed, distributed or sold BurgerIM franchises to consumers throughout the United States. At all times material to this Complaint, Loni formulated, directed, controlled, had the authority to control, or participated in the acts and practices of Corporate Defendants. Loni has been a signatory on BIMGUSA and BIMG bank accounts, communicated with prospective and existing franchisees about the BurgerIM franchise opportunity, entered into agreements, and negotiated contracts with franchisees.[19]

On January 19, 2024, the U.S. District Court for the Central District of California entered a default judgment against BurgerIM and Loni, in his individual capacity, awarding the FTC $7,750,000 in civil penalties and $48,476,689 in consumer redress.[20] The *BurgerIM* case therefore appears to represent a more aggressive approach by the FTC in its use of its enforcement action powers and its willingness to pursue individual liability against franchise sellers under Section 5 of the FTC Act. While the FTC's more aggressive actions may give wronged franchisees another opportunity at redress, the FTC does not have unlimited resources and must prioritize individual actions like these with larger regulatory and enforcement authority. Further, the FTC is subject to the oftentimes shifting policy priorities of each Presidential administration.

III. Personal Liability Under State Law

Because no private cause of action exists under the Franchise Rule, a franchisee seeking redress for a violation of the Rule must look to applicable

16. *Id.*
17. *Id.* ¶¶ 2, 4.
18. *Id.* ¶ 36.
19. *Id.* ¶ 18.
20. Default Judgment and Final Order for Permanent Injunction and Monetary Judgments for Civil Penalty and Consumer Redress at 4, United States v. BurgerIM Grp. USA, No. 2:22-CV-825-DMG (C.D. Cal. Jan. 19, 2024).

state law.[21] Before its 2007 amendments, the Franchise Rule had remained unchanged since its promulgation in 1979. As a result, states enacted their own franchise statutes to accord greater protection to franchisees. Significantly, these state laws vary. Some states regulate franchising under franchise-specific statutes, business opportunity statutes, or both. Twenty-three states, the District of Columbia, the U.S. Virgin Islands, and Puerto Rico have enacted franchisor-franchisee relationship laws, but only fourteen of these states expressly recognize the potential personal liability of franchisor principals who make misrepresentations in connection with the offer, sale, or purchase of a franchise.[22] Notably, despite the existence of these statutory provisions, a franchisee's success in holding a principal personally liable still largely depends upon the language of the applicable statute and the court's interpretation of that statutory language, as well as the nature and extent of the principal's participation in the unlawful conduct.

A. *State Franchise Laws*

As others have commented, state franchise laws imposing joint and several liability on principals share a few common features.[23] First, they require a predicate statutory violation by the franchisor. Second, they typically categorize individuals who are subject to joint and several liability either as persons who directly or indirectly control the franchisor (control persons); executive officers, directors, or persons occupying a similar status or performing similar functions; or employees. Third, for some or all of these categories, they require proof that the individual "materially aids" the act or transaction constituting the statutory violation.

To the extent that courts have addressed these statutory provisions, most of the analysis has concerned the "materially aids" limitation. There is some variability in how state legislatures have structured their statutes to apply this limitation. On one end of the spectrum, Indiana requires the individual defendant to "materially aid[] or abet[]" the underlying violation, regardless

21. *See* Arruda v. Curves Int'l, Inc., 861 F. App'x 831, 835 (5th Cir. 2021) ("Even if the Franchise Rule would cover such omissions, Plaintiffs concede the Federal Trade Commission Act ('FTCA') provides no private right of action.") (collecting cases).

22. Megan B. Center, *Is It Possible To Fully Insulate Yourself from Personal Liability?*, 37 Franchise L.J. 379, 380 & n.8 (2018). These states are the following: California (Cal. Corp. Code § 31302); Hawaii (Haw. Rev. Stat. § 482E-9(b)); Illinois (815 Ill. Comp. Stat. 705/26); Indiana (Ind. Code § 23-2-2.5-29); Maryland (Md. Code Ann., Bus. Reg. § 14-227(d)); Michigan (Mich. Comp. Laws § 445.1532); Minnesota (Minn. Stat. § 80C.17(2)); New York (N.Y. Gen. Bus. Law § 691); North Dakota (N.D. Cent. Code § 51-19-12(2)); Oregon (Or. Rev. Stat. § 650.020); Rhode Island (19 R.I. Gen. Laws § 19-28.1-21(b)); South Dakota (S.D. Codified Laws § 37-5B-49); Washington (Wash. Rev. Code § 19.100.190); and Wisconsin (Wis. Stat. § 553.51). In addition, Iowa's statute includes similar language that expressly recognizes the potential personal liability of principals under its business opportunity law. Iowa Code § 551A.8.

23. Cynthia M. Klaus, *Personal Liability of Franchisor Executives & Employees Under State Franchise Laws*, 29 Franchise L.J. 99, 100 (2009); Center, *supra* note 22, at 380–81.

of whether he or she is a control person, an executive officer, or a mere employee.[24] Indiana's statute reads:

> Every person who materially aids or abets in an act or transaction constituting a violation of this chapter is also liable jointly and severally to the same extent as the person whom he aided and abetted, unless the person who aided and abetted had no knowledge of or reasonable grounds to believe in the existence of the facts by reason of which the liability is alleged to exist.[25]

That is, there is only one category of defendant: "person[s] who materially aid[] or abet[] in an act or transaction constituting a violation."[26]

On the other end of the spectrum, Maryland expressly applies the "materially aids" limitation solely to "employee[s]."[27] Under the Maryland Franchise Registration and Disclosure Law, joint and several liability extends to:

> (i) each person who directly or indirectly controls a person liable under this section;
> (ii) each partner in a partnership liable under this section;
> (iii) each principal officer or director of a corporation liable under this section;
> (iv) each other person that has a similar status or performs similar functions as a person liable under this section; and
> (v) each employee of a person liable under this section, if the employee materially aids in the act or transaction that is a violation under this subtitle.[28]

Using a clear structure that other states might learn from, Maryland lists each separate category of defendant and employs the "materially aids" limitation only in the final category for employees, imposing joint and several liability on "each employee of a person liable under this section, if the employee materially aids in the act or transaction that is a violation."[29]

For most other states, whether an individual defendant must "materially aid" the underlying violation to be jointly and severally liable remains somewhat murky. At least to an extent, the ambiguity in applying these state statutes derives from their structure.

As other commentators have noted, the placement of a single comma may be responsible for different outcomes in the case law.[30] Four states—Illinois, New York, Rhode Island, and South Dakota—employ a comma before the phrase "who materially aids in the act or transaction constituting the violation."[31] For example, Illinois's statute reads:

> Every person who directly or indirectly controls a person liable under this Section 26, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every manager of a limited liability company

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24. Ind. Code § 23-2-2.5-29. Indiana is also unique in employing the "materially *aids or abets*" formulation. *Id.* (emphasis added).
25. *Id.*
26. *See id.*
27. Md. Code Ann., Bus. Reg. § 14-227(d)(1).
28. *Id.*
29. *Id.*
30. Klaus, *supra* note 23, at 100–01.
31. 815 Ill. Comp. Stat. 705/26; N.Y. Gen. Bus. Law § 691; 19 R.I. Gen. Laws § 19-28.1-21(b); S.D. Codified Laws § 37-5B-49.

> so liable, every person occupying a similar status or performing similar functions, and every employee of a person so liable, *who materially aids in the act or transaction constituting the violation*, is also liable jointly and severally[.][32]

By contrast, five states—California, Michigan, Minnesota, North Dakota, and Wisconsin—do not employ a comma before that same phrase.[33] For example, California's statute reads:

> Every person who directly or indirectly controls a person liable under Section 31300 or 31301, every partner in a firm so liable, every principal executive officer or director of a corporation so liable, every person occupying a similar status or performing similar functions, every employee of a person so liable *who materially aids in the act or transaction constituting the violation*, are also liable jointly and severally . . . .[34]

Four states—Minnesota, North Dakota, Oregon, and Wisconsin—go a step further. These states do not just remove the comma; they also add the conjunction "and" before the final category concerning "employees."[35] For example, Oregon's statute reads:

> Every person who directly or indirectly controls a franchisor liable under subsection (1) of this section, every partner, officer or director of the franchisor, every person occupying a similar status or performing similar functions, *and every person who participates or materially aids in the sale of a franchise is also liable jointly and severally to the same extent as the franchisor*, unless the nonseller did not know, and, in the exercise of reasonable care, could not have known, of the existence of the facts on which the liability is based.[36]

Principles of statutory interpretation suggest that the varying structures of these statutes should dictate differing meanings. Grammatically, the placement of the comma immediately before the "materially aids" limitation, as in the laws of Illinois, New York, Rhode Island and South Dakota, suggests that the limitation should apply to all preceding categories.[37] By contrast, the absence of the comma, not to mention the addition of "and," in the laws of Minnesota, North Dakota, Oregon,[38] and Wisconsin, strengthens the grammatical argument that "materially aids" applies to only the immediately preceding category concerning "employees." Under the last-antecedent rule, "a limiting clause or phrase . . . should ordinarily be read as modifying only the noun or phrase that it immediately follows."[39]

32. 815 Ill. Comp. Stat. 705/26 (emphasis added).

33. Cal. Corp. Code § 31302; Mich. Comp. Laws § 445.1532; Minn. Stat. § 80C.17(2); N.D. Cent. Code § 51-19-12(2); Wis. Stat. § 553.51(3).

34. Cal. Corp. Code § 31302 (emphasis added).

35. Minn. Stat. § 80C.17(2); N.D. Cent. Code § 51-19-12 (2); Or. Rev. Stat. § 650.020; Wis. Stat. § 553.51(3).

36. Or. Rev. Stat. § 650.020 (emphasis added).

37. *See* Jama v. Immigr. & Customs Enf't, 543 U.S. 335, 344 n.4 (2005) (noting that the last-antecedent rule may not apply where "[t]he modifying clause appear[s] not in a structurally discrete statutory provision, but at the end of a single, integrated list").

38. Oregon extends liability to those who *participate* or materially aid in the sale of a franchise. Or. Rev. Stat. § 650.020.

39. Lockhart v. United States, 577 U.S. 347, 351 (2016).

To date, however, courts have mostly declined to address these statutory nuances. To the extent that courts have addressed them at all, they have done so in a manner that is not easily reconcilable. For example, a federal district court in Michigan purported to apply the last-antecedent rule in construing the Michigan Franchise Investment Law.[40] Noting the absence of the comma in Michigan's law, the court held that "[t]he proper grammatical reading is that the clause 'materially aids in the act or transaction constituting the violation' modifies only the last antecedent, 'an employee of a person so liable.'"[41] The upshot was that the plaintiffs did not need to prove that the franchisor's control persons "materially aided" the violation.[42] But in reaching this conclusion, the Michigan court cited the opinion of an Illinois federal district court that construed the Illinois Franchise Disclosure Act.[43] As discussed earlier, Illinois's law does contain the comma.[44] The Michigan court was apparently unconcerned by that distinction, but the court's failure to address the distinction could limit its persuasive value in the future.

Similarly, a few recent New York cases eschewed a nuanced statutory analysis in favor of a pragmatic distinction between "control persons" on the one hand and executive officers and employees on the other. In one case, a New York state court held that the two owners of the corporate franchisor were "control persons" who were jointly and severally liable without any discussion of whether they "materially aided" the statutory violation.[45] Likewise, the U.S. District Court for the Eastern District of New York suggested that control persons may be held liable "merely by virtue of their position."[46] By contrast, another decision from the U.S. District Court for the Eastern District of New York recently applied the "materially aids" limitation to the general counsel and an officer of the corporate franchisor, suggesting that these high-ranking employees were different from control persons.[47] The

40. Tankersley v. Lynch, No. 11-12847, 2012 WL 683384, at *10 (E.D. Mich. Mar. 2, 2012).

41. *Id.*

42. *Id.*

43. *Id.* (citing Shipman v. Case Handyman Servs., L.L.C., 446 F. Supp. 2d 812, 814 (N.D. Ill. 2006)).

44. In *Shipman*, the federal district court held that, notwithstanding the comma, Illinois's law distinguished between control persons on the one hand, who do not need to "materially aid" the violation to be liable, and employees on the other hand, who do need to "materially aid" the violation to be liable. *Shipman*, 446 F. Supp. 2d at 814.

45. S. Shore D'Lites LLC v. First Class Prods. Grp., LLC, 187 N.Y.S.3d 185 (App. Div. 2023) ("Furthermore, plaintiffs are entitled to a summary judgment ruling that defendants Todd Coven and Magda Abt, the individual owners of defendant First Class, are control persons jointly and severally liable for any Franchise Act violations pursuant to General Business Law § 691 (1) and (3).").

46. Schwartzco Enters. LLC v. TMH Mgmt., LLC, 60 F. Supp. 3d 331, 358 (E.D.N.Y. 2014) (considering whether "group pleading" was permissible "given the statute's provision for 'control person' liability under § 691(3) for an individual merely by virtue of their position").

47. Sea Tow Servs. Int'l, Inc. v. Tampa Bay Marine Recovery, Inc., 632 F. Supp. 3d 91, 113 (E.D.N.Y. 2022) ("Stein, as Sea Tow's General Counsel, and Frohnhoefer, an Officer of Sea Tow, are each 'persons' within the meaning of the NYFSA, and the allegations in the Third-Party Complaint extensively detail their direct participation in facilitating the Management Agreement with the Jaeger Defendants.") (citing A. J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc., 663 N.E.2d 890, 895 (N.Y. 1996)).

U.S. District Court for the Eastern District of Wisconsin has also rejected the argument that chief executive officers are automatically liable because they "should know everything about their companies."[48]

Although there is still plenty of room for practitioners to maneuver when litigating these issues, there appears to be a growing consensus that, regardless of statutory structure or interpretive rules, control persons need not "materially aid" the underlying violation to be jointly and severally liable. Given this apparent consensus, franchisees likely will have an easier time establishing joint and several liability against a control person—that is, someone like Ken Gibson in the *LearningRx* case or Oren Loni in the *BurgerIM* case—than other officers or other employees of the corporate franchisor.[49]

The significance of control person liability was illustrated by a United States Bankruptcy Court that refused to discharge a franchisee's claims against control persons under New York's franchise law. In *In re Butler*,[50] a franchisee filed an action against the franchisor's principals, the Butlers, to recover franchise payments from the unlawful sale of twelve franchises.[51] The franchisee initially sought to recover $714,000 in franchise payments from

48. Cousin Subs Sys. Inc. v. Better Subs Dev. Inc., No. 09-C-0336, 2011 WL 4585541, at *14 (E.D. Wis. Sept. 30, 2011) (granting summary judgment on claim against president and CEO under Indiana Franchise Disclosure Act where "there is no evidence to show that Specht violated 23–2–2.5–29 other than, in his role as president, he should know everything," thereby rejecting "the inference that CEOs should know everything about their companies").

49. Although the focus of this paper is personal liability of principals, franchise brokers have become common in the industry and may act as an intermediary between a franchisor and prospective franchisee. Recently, courts have imposed liability on brokers as "sellers" of a franchise under state franchise laws. *See, e.g.*, Xiaolin Li v. FranChoice, Inc., No. 19-cv-1267, 2019 WL 7598656, at *4–5, *8 (D. Minn. Dec. 19, 2019), *report and recommendation adopted*, 2020 WL 264273 (D. Minn. Jan. 17, 2020) (holding that a franchise broker and its individual agent could be liable under the Illinois Franchise Disclosure Act and the New York Franchise Sales Act for alleged misrepresentations relied on by a prospective franchisee because they were engaged in "solicitation" and thus an "offer to sell"); Hanley v. Doctors Express Franchising, LLC, No. CIV.A. ELH-12-795, 2013 WL 690521, at *35 (D. Md. Feb. 25, 2013) ("The word 'sells' expands the scope of liability beyond the franchisor; any other interpretation would not make sense of the legislature's inclusion of both 'sell[ing]' and 'grant[ing]' a franchise as predicates for liability. The legislature's intent to establish a broad scope of liability under the statute is further confirmed by the provisions for joint and several liability under B.R. § 14–227(d)(1), which make liable, *inter alia*, 'each other person that has a similar status *or performs similar junctions* as a person liable under [B.R. § 14–227],' and 'each employee of a person liable under [B.R. § 14–227], if the employee *materially aids in the act or transaction* that is a violation under [the Maryland Franchise Law].' This language is sufficiently broad to include an agent who participates in making the sale of a franchise. [The contrary] interpretation is further undercut by the interpretive regulations promulgated by the Commissioner, which delineate and proscribe particular fraudulent and misleading activities when performed by any 'person authorizing, aiding in, or causing to be made an offer or sale of a franchise.'" (citations omitted)); Johnson v. FranChoice, Inc., No. 19-cv-1417, 2019 WL 7598623 (D. Minn. Dec. 19, 2019) (finding franchise broker liability under Michigan's Franchise Investment law).

50. *In re* Butler, No. 10-32030, 2012 WL 6106586, at *1 (Bankr. W.D.N.C. Dec. 10, 2012).

51. *Id.* The circumstances of the illegal sales are as follows. The franchisor's permit to sell franchises in New York was still pending. The law requires that a franchisor with a pending permit must escrow the franchise fees paid in a separate trust pending approval of its application. Once approved, the franchisor must provide the franchisee the most recent franchise disclosure document and give the franchisee an opportunity to rescind the franchise agreement and have the fees returned. In this case, the franchisor failed to escrow the initial fees, provide

the franchisor entity in New York State court; however, the Butlers filed for personal bankruptcy.[52] Applying a New York appellate court's "directly participates" requirement, the Bankruptcy Court held that the franchisor's owners were personally liable to the franchisee because they "were personally involved in [his] solicitation," having sold him the franchises "by promoting [themselves] as the key members of the franchisor in the advertising materials."[53] The owners also "active[ly] control[led]" the franchisor, were "the primary decision-makers" in how the franchisee's fees were used, and allocated those fees "to fund their [own] salaries."[54] In addition to finding the owners personally liable, the Bankruptcy Court held that the franchisee's claims were not dischargeable because the claims arose from the owners' fraud and defalcation.[55] As this case demonstrates, control persons may be unable to discharge personal liability in bankruptcy proceedings.

In contrast to the states discussed above, three states—Arkansas, Florida, and Virginia—do not expressly refer to joint and several liability for principals. Instead, the Arkansas Franchise Practices Act and the Florida Franchise Act more broadly declare it unlawful for "any person," which includes an "individual" in Florida, or "natural person" in Arkansas, to make certain misrepresentations in connection with the offer or sale of a franchise.[56] Similarly, Virginia's Retail Franchise Act makes it unlawful for "any person" to engage in fraud in the sale of a franchise.[57] Although none of these three statutes requires that a person "materially aids" in the act or transaction constituting the statutory violation, the Florida statute requires that a person "intentionally . . . misrepresent";[58] Arkansas finds liability whether a person "directly or indirectly" commits fraudulent acts, provided these acts were performed "knowingly";[59] and Virginia mirrors Arkansas except that it omits the "knowingly" requirement.[60] In these states, personal liability likely depends on the court's interpretation of the statutes and the extent of an individual's participation in the alleged fraud. Florida courts, for example, have held that individual defendants *may* be personally liable for violating the Florida Franchise Act where they themselves participated in the prohibited misrepresentations in the sale of a franchise.[61]

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the franchisee with a registered disclosure document, or offer recission. Instead, the franchisor distributed the franchise fee payments to its principals. *Id.* at *7–12.

52. *Id.* at *1.

53. *Id.* at *7 (noting that under *A.J. Temple Marble & Tile, Inc. v. Union Carbide Marble Care, Inc.*, 663 N.E.2d 890 (N.Y.1996) "[i]f one of the individuals or entities defined as a person directly participates in an unlawful offer or sale, there is civil liability for the purchaser's resulting damages").

54. *Id.* at *8.

55. *Id.* at *9–12.

56. Ark. Code Ann. § 4-72-202, -207; Fla. Stat. § 817.416.

57. Va. Code Ann. § 13.1-563.

58. Fla. Stat. § 817.416.

59. Ark. Code Ann. § 4-72-207.

60. Va. Code Ann. § 13.1-563.

61. *E.g.*, KC Leisure, Inc. v. Haber, 972 So. 2d 1069, 1075 (Fla. Dist. Ct. App. 2008); *see also* SIG, Inc. v. AT & T Digit. Life, Inc., 971 F. Supp. 2d 1178, 1193 (S.D. Fla. 2013) (granting

B. *Imposing Liability Using State Business Opportunity Statutes, Consumer Protection Statutes, and Common Law*

In addition to franchise-specific laws, franchisees may seek redress under state business opportunity or consumer protection laws as well as state common law. Many state franchise laws expressly note that "[t]he rights and remedies provided . . . shall be in addition to any and all other rights and remedies that may exist at law or in equity."[62] It is therefore common for injured franchisees to seek additional remedies through other state statutes and common law claims.

For example, in Florida, injured franchisees may seek additional damages through Florida's Deceptive and Unfair Trade Practices Act (FDUTPA)[63] and Florida's Sale of Business Opportunities Act.[64] In *KC Leisure, Inc. v. Haber*,[65] a Florida appellate court explained that the "actively participated" standard that governs an individual's personal liability under the FTC Act is similar to the "direct participant" standard that governs individual liability under FDUTPA.[66] Applying Florida law and citing *KC Leisure*, a Michigan federal district court recently found a franchisor's president and area developer jointly and severally liable for false statements and fraudulent omissions in connection with the sale of a spa franchise.[67] The franchisee was awarded

individual defendants' motion to dismiss claim for alleged violations of Florida's Franchise Act where "Plaintiffs' Complaint is completely devoid of any facts with respect to James and Robert Diamond's personal participation in anything").

62. Va. Code Ann. § 13.1-563(d); *see also* Cal. Corp. Code § 31306 ("Nothing in this chapter shall limit any liability which may exist by virtue of any other statute or under common law if this law were not in effect."); 815 Ill. Comp. Stat. 705/28 ("Nothing in this Act shall limit any liability which may exist by virtue of any other statute or under common law if this Act were not in effect."); Md. Code Ann., Bus. Reg. § 14-204 ("The powers, remedies, procedures, and penalties of this subtitle are in addition to and not in limitation of any other powers, remedies, procedures, and penalties provided by law."); Mich. Comp. Laws § 445.1534 ("Nothing in this act shall limit a liability which may exist by virtue of any other statute or under common law if this act were not in effect."); Minn. Stat. § 80C.17(2) ("Nothing herein shall limit any liability which may exist by virtue of any other statute or under common law if sections 80C.01 to 80C.22 were not in effect."); N.Y. Gen. Bus. Law § 691(5) ("Nothing in this article shall limit a liability which may exist by virtue of any other statute or under common law if this article were not in effect."); N.D. Cent. Code § 51-19-12(6) ("Nothing herein limits any liability which may exist by virtue of any other statute or under common law if this chapter were not in effect."); Or. Rev. Stat. § 650.085 ("Nothing in ORS 650.005 to 650.100 limits any statutory or common-law rights of a person to bring an action in any court for an act involved in the sale of franchises . . . ."); 19 R.I. Gen. Laws § 19-28.1-23 ("Nothing in the act limits liability that may exist under another statute or at common law."); S.D. Codified Laws § 37-5B-49 ("Nothing in this section limits any liability which would exist by virtue of any other statute or under common law if this chapter were not in effect."); Wash. Rev. Code § 19.100.910 ("The provisions of this chapter shall be cumulative and nonexclusive and shall not affect any other remedy available at law."); Wis. Stat. § 553.51(5) ("The rights and remedies under this chapter are in addition to any other rights or remedies that may exist at law or in equity.").

63. Fla. Stat. § 501.203.

64. *Id.* § 559.80 *et seq.*

65. *KC Leisure, Inc.*, 972 So. 2d 1069.

66. *Id.* at 1074–75.

67. MTR Cap., LLC v. Lavida Massage Franchise Dev., Inc., No. 2:17-CV-13552-TGB-EAS, 2021 WL 1626353, at *1, *4–5 (E.D. Mich. Apr. 27, 2021).

damages for its FDUTPA claim in the amount of the initial franchise fee.[68] Thus, an individual who is liable for violating the FTC Act and Florida's Franchise Act may also be held liable for violating FDUTPA. Other states' unfair trade practices laws similarly align with liability under the FTC Act.[69]

As *KC Leisure* illustrates,[70] the existence of an applicable franchise-specific statute does not necessarily preclude a franchisee from seeking relief under a state's business opportunity laws. Twenty-six states have laws that regulate the sale of opportunities to engage in new business ventures.[71] Therefore, businesses opportunity laws may provide an additional or alternative avenue for franchisees to hold principals individually liable for their fraudulent acts.[72] However, franchisees will need to assess whether such a law applies to their particular situation. Although a franchise may often be a new business venture, whether a franchise opportunity is covered by a particular state's business opportunity law will vary by state.

For example, Florida's Sale of Business Opportunities Act applies to transactions that enable the purchaser "to *start* a business" under certain defined circumstances.[73] It does not apply to the sale of "an ongoing business."[74] For that reason, the court in *Batlemento v. Dove Fountain, Inc.*[75] reversed a judgment based on an alleged violation of the law in connection with the sale of an existing restaurant business.[76] The court also noted that "[t]he prohibitions of the act apply to the *seller* of the opportunity, not the shareholders of the seller or individuals who act for the seller."[77]

Similarly, courts have held that the Oklahoma Business Opportunity Sales Act does not apply to certain franchises. In *Tallyho Enterprises, LLC v. PremierGarage Systems, LLC*,[78] the court held that the plaintiff's franchise fell outside the definition of "business opportunity" because Oklahoma's statute expressly excludes certain business opportunities that involve sellers with a minimum net worth of $1 million.[79] Some states go even further and expressly exclude any franchise from their business opportunity laws. Alaska's Sale of Business Opportunities law, for example, "does not apply to a sale of or an offer to sell . . . a franchise under [the Franchise Rule]."[80]

68. *Id.*

69. *See, e.g.*, Conn. Gen. Stat. § 42-110b.

70. *KC Leisure*, 972 So. 2d at 1074.

71. David J. Kaufmann, *An Overview of Federal and State Franchise Laws, Rules, and Regulations*, N.Y. L.J. (Oct. 17, 2023, 12:00 PM), https://www.law.com/newyorklawjournal/2023/10/17/an-overview-of-federal-and-state-franchise-laws-rules-and-regulations.

72. As discussed earlier, Iowa's business opportunity law expressly recognizes the potential personal liability of corporate principals. Iowa Code § 551A.8.

73. Fla. Stat. § 559.801(1)(a) (emphasis added).

74. Batlemento v. Dove Fountain, Inc., 593 So. 2d 234, 239 (Fla. Dist. Ct. App. 1991).

75. *Id.*

76. *Id.*

77. *Id.*

78. Tallyho Enters., LLC v. PremierGarage Sys., LLC, No. CV-07-01791-PHX-SRB, 2008 WL 11338891, at *7 (D. Ariz. Apr. 29, 2008).

79. *Id.*

80. Alaska Stat. § 45.66.220(2).

In the absence of an applicable franchise-specific or business opportunity law, franchisees may consider state consumer protection laws. Here, a recurring question is whether a franchisee is a "consumer" within the meaning of the statute. Again, the answer will likely vary by state.

For instance, in *Carlock v. Pillsbury Co.*,[81] which involved a dispute about an ice cream franchise, a Minnesota court found that Idaho-based franchisees could proceed under the Idaho Consumer Protection Act.[82] The franchisees sought to hold the franchisor's president liable for claims of fraudulent inducement to enter the franchise agreement, and for claims of fraud in the distribution of the ice cream and the operation of the franchise system.[83] In interpreting Idaho's consumer protection statute, the Minnesota court declined to narrow the definition of "consumer" within the act to preclude franchisees.[84] The court held that the plaintiffs stated a claim against *all* named defendants to proceed under the Idaho Consumer Protection Act.[85]

By contrast, in *Tallyho Enterprises*, the court narrowly interpreted "consumer transaction" under Kansas's Consumer Protection Act to exclude transactions involving franchisees who purchased branded goods from a franchisor for resale.[86] The court there held that the Kansas Consumer Protection Act covered the purchase of goods "to be used or consumed in the course of one's business" but not "for the purpose of resale to customers for profit."[87]

Common law fraud claims can also be a source of personal liability against a franchise seller, either exclusively or in conjunction with alleged statutory violations. For example, in *Bans Pasta, LLC v. Mirko Franchising, LLC*, a franchisee sued a franchise and its principals for written misrepresentations regarding the financial viability of an Italian restaurant franchise.[88] Although the franchisee's claim under the Virginia Retail Franchising Act was dismissed on procedural grounds, the franchisees were able to proceed with their common law claims against the franchisor and its principals.[89]

In some cases, common law claims may provide franchisees the only viable path to relief. For example, in *Upshaw v. Lacado*,[90] the president of a franchise was found personally liable for breach of contract and common law fraud claims relating to omissions and misrepresentations in the franchisor's franchise disclosure document and franchise agreements.[91] The franchisee

81. Carlock v. Pillsbury Co., 719 F. Supp. 791, 798 (D. Minn. 1989).
82. *Id.* at 850–52.
83. *Id.* at 827.
84. *Id.* at 851.
85. *Id.*
86. Tallyho Enters., LLC v. PremierGarage Sys., LLC, No. CV-07-01791-PHX-SRB, 2008 WL 11338891, at *4 (D. Ariz. Apr. 29, 2008).
87. *Id.* at *6 (citing Wayman v. Amoco Oil Co., 923 F. Supp. 1322, 1364–65 (D. Kan. 1996)).
88. Bans Pasta, LLC v. Mirko Fran., LLC, No. 7:13-CV-00360-JCT, 2014 WL 637762, at *1 (W.D. Va. Feb. 12, 2014).
89. *Id.* at *14.
90. Upshaw v. Lacado, 650 S.W.3d 61 (Tex. App. 2021).
91. *Id.* at 71.

prevailed in Texas state court on its common law claims, and a jury found the franchisor's president jointly and severally liable for damages exceeding $1 million.[92]

In federal court, and in most jurisdictions around the country, allegations of fraud or mistake are subject to a heightened pleading standard.[93] One important consideration for common law claims sounding in fraud is that they require franchisees to clearly detail and assert that the principal actively engaged in the misconduct or fraud.

Conclusion

Principals of franchisors who actively participate in fraudulent or illegal franchises are not immune from personal liability. However, such personal liability is usually challenging to establish by franchisees. Ultimately, establishing liability for a fraudulent franchise offer or sale through business opportunity statutes, consumer protection laws, or common law claims requires more than just asserting that someone holds a principal role in a franchise. Franchisees who are induced to purchase franchises due to fraudulent or illegal actions on the part of the franchise sellers will likely need to specifically allege and prove the principal's direct involvement in the wrongful conduct.

92. *Id.*
93. *See generally* Fed. R. Civ. P. 9(b).

Managing Franchisor Risk Through the Enforcement of Contractual Terms and Provisions: An Analysis of Recent Case Law and Court Decisions

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Even during periods of economic and regulatory uncertainties, the franchise industry has consistently demonstrated robust growth and resilience. In 2023, the franchise industry grew by 2.2% and is projected to increase further by an additional 1.9% in 2024.[1] This steady expansion of franchisees and franchise systems alike not only signifies the increased strength of the franchise model, but also introduces an amplified risk for disputes between the two parties. Independently, the considerable changes to franchise laws that have occurred over the last few years[2] are creating a higher frequency of disputes, necessitating a more comprehensive approach to risk management in franchise agreements.

Each claim, whether raised by a single franchisee or several within the franchisor's system, brings its own unique risk profile that requires careful evaluation by the stakeholders involved in the business's legal decisions. The franchise agreement, which serves as the legal cornerstone of the franchisor-franchisee relationship, is a critical tool in managing franchisor risk.[3] While the specific risks and mitigations can vary depending on industry, location, and other factors, this article examines several key clauses and provisions that

1. *2024 Franchising Economic Outlook*, Int'l Franchise Ass'n (2024), https://www.franchise.org/sites/default/files/2024-02/2024%20Franchising%20Economic%20Report.pdf.

2. Joe Halpern, *Franchise Regulations Change, but No 'Existential Threat*,' Franchise Times (Mar. 27, 2024), https://www.franchisetimes.com/franchise_legal/franchise-regulations-change-but-no-existential-threat/article_008cb03a-e6d9-11ee-a39c-5342257e4e9d.html.

3. Edward Wood Dunham, *Enforcing Contract Terms Designed to Manage Franchisor Risk*, 19 Franchise L.J. 91 (2000).

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franchisors should contemplate incorporating or strengthening in their franchise agreement, depending upon the applicable jurisdiction, to better help them effectively navigate and mitigate the risk of litigation or other disputes raised by a franchisee in the franchisor's system.

Mandatory Mediation Clauses

As an initial matter, franchisors should anticipate potential disputes with franchisees and detail the dispute resolution mechanisms available to the parties. Including a mandatory mediation clause in a franchise agreement can serve as a very valuable "pre-litigation" tool in a franchisor's and franchisee's toolbox.[4] Mediation is a procedure in which the parties to an emerging dispute make a good-faith effort to resolve their disagreement under the supervision of a third-party mediator who has no vested interest in the outcome of the merits of the dispute.[5] A mandatory mediation clause is a contractual provision that requires that the parties engage in the mediation process before either party may advance their claims in a court of law or other applicable forum.[6]

Mandatory early mediation can offer several benefits to both the franchisor and franchisee. Among other advantages, mandatory mediation, when successful, offers a cost-effective path to resolving a dispute. It allows both parties to save on legal fees, court costs, and other expenses associated with traditional dispute resolution methods. It also is an opportunity for parties to reach a faster resolution to their dispute. Mediation typically takes less time than court proceedings or arbitration, enabling the franchisor and franchisee to resolve their issue more quickly, reducing disruption to their business and allowing them to continue to focus on their core operations rather than immediately deploying valuable resources in pursuit of litigation.[7] An additional benefit is the greater control over the outcome that it provides the parties. In mediation, the parties actively participate in crafting a mutually agreeable solution, and that solution is unbounded by what remedies are available by a particular cause of action. For example, the parties can decide that the transfer of a franchise or a restructuring of fees is best. In litigation or arbitration, the outcome is in the hands of the judge/jury or arbitrator, and they are constrained to award only the relief that is available for a particular cause of action. Further, by engaging in mediation, the parties have a

4. W. Michael Garner, *Dispute Resolution in the Twenty-First Century: The Challenge to Get ADR Right*, 40 Franchise L.J. 25 (2020).

5. JAMS, *Mediation Defined: What Is Mediation?*, https://www.jamsadr.com/mediation-defined.

6. DeValk Lincoln Mercury, Inc. v. Ford Motor Co., 811 F.2d 326, 336 (7th Cir. 1987) (holding that mandatory mediation provision was a condition precedent to litigation).

7. Roy Weinstein et al., *Efficiency and Economic Benefits of Dispute Resolution Through Arbitration Compared with U.S. Dis. Court Proceedings*, Micronomics Consulting (Mar. 2017), https://static1.squarespace.com/static/61b53e492ea58d13b806ccb3/t/61bb8320fa9ba06e1700a3bc/1639678753466/Efficiency_Economic_Benefits_Dispute_Resolution_through_Arbitration_Compared_with_US_District_Court_Proceedings.pdf.

chance to preserve the franchisor-franchisee relationship. They equally have an opportunity to address their concerns and find common ground. This can be particularly valuable when there is a desire to maintain a long-term business partnership. Another added benefit of mediation is confidentiality. Mediation proceedings are generally confidential, allowing the parties to openly discuss their concerns without the risk of negative publicity or harm to their respective reputations.[8] Unlike rules of evidence regarding settlement discussions, many jurisdictions have mediation statutes that provide stronger rights to confidentiality, especially pre-litigation.[9] In short, it is largely to the franchisor's benefit to include a mediation provision that the parties must engage in before proceeding with a claim. The key is to craft language that preemptively addresses any roadblocks that may be encountered in pursuit of mediation, such as in selection of a mediator if the parties cannot mutually agree and a carve-out allowing either party to pursue immediate injunctive relief.

Courts across the United States have routinely acknowledged the validity and enforceability of mandatory mediation clauses.[10] And those holdings have extended to franchisor-franchisee disputes as well.

Jumping Jack Retail II, Inc. v. 7-Eleven, Inc.[11] concerned a franchise dispute between Jumping Jack Retail II, Inc. (JJ)—a franchisee of 7-Eleven that operated multiple 7-Eleven locations in south Florida—and the franchisor 7-Eleven, Inc. (7-Eleven).[12] JJ filed a lawsuit against 7-Eleven in Florida state court and alleged that 7-Eleven breached two separate franchise agreements between the parties.[13] After 7-Eleven removed the lawsuit to federal court, it moved to dismiss the lawsuit on the basis that JJ was required to mediate any and all disputes with 7-Eleven before commencing litigation.[14] JJ argued that the mediation clause contained in the franchise agreements was optional, not mandatory. However, the court concluded otherwise after examining the language of the mediation clause, which read in relevant part:

8. Stuart Michael Widman, *Confidentiality and Its Exceptions in Mediation*, Am. Bar Ass'n Litig. (Nov. 20, 2020), https://www.americanbar.org/groups/litigation/resources/newsletters/alternative-dispute-resolution/confidentiality-its-exceptions-mediation.

9. The Uniform Mediation Act has been enacted in multiple jurisdictions. *See, e.g.*, Fla. Stat. § 44.405; 710 Ill. Comp. Stat. 35/1; Ohio Rev. Code Ann. §§ 2710.01–2710.10.

10. *See, e.g.*, Xanitos, LLC v. Am. Healthcare Sys. Ill., LLC, No. 23-cv-2339-DWD, 2024 U.S. Dist. LEXIS 28900 (S.D. Ill. Feb. 20, 2024); Jumping Jack Retail II, Inc. v. 7-Eleven, Inc., No. 22-cv-6144-BLOOM/Valle, 2022 U.S. Dist. LEXIS 173701 (S.D. Fla. Sept. 25, 2022); Hydration Station U.S. Franchise Sys., LLC v. Seaverns, No. 19-cv-05192-LMM, 2021 U.S. Dist. LEXIS 269461 (N.D. Ga. Jan. 13, 2021); R&F, LLC v. Brooke Corp., No. 07-2175-JWL, 2008 U.S. Dist. LEXIS 7452 (D. Kan. Jan. 31, 2008) (enforcing mandatory mediation provision contained in parties' franchise agreement); Primov v. Serco, Inc., 96 Va. Cir. 121, 128 (2017) ("Virginia courts have enforced mandatory mediation provisions . . . as conditions precedent to filing suit.").

11. Jumping Jack Retail II, Inc. v. 7-Eleven, Inc., No. 22-cv-6144-BLOOM/Valle, 2022 U.S. Dist. LEXIS 173701, at *1 (S.D. Fla. Sept. 25, 2022).

12. *Id.*.

13. *Id.* at *1–2.

14. *Id.* at *2.

> To facilitate such resolution, we and you agree that, except as otherwise specified below, if any dispute between you and us cannot be settled through negotiation, then before commencing litigation to resolve the dispute, you and we will first attempt in good faith to settle the dispute by non-binding mediation.[15]

The court in *Jumping Jack Retail* found that the term "will" as it was used in the franchise agreements made the condition of mediation *mandatory* rather than permissive.[16] On that basis, the court granted 7-Eleven's motion to dismiss and dismissed JJ's complaint without prejudice.[17]

Franchisors should be mindful, however, that mandatory mediation clauses likely apply both ways, and franchisees can use them to prevent the franchisor from immediately advancing to litigation against a franchisee. In *Hydration Station United States Franchise Systems, LLC v. Seaverns*,[18] the franchisor brought a lawsuit in federal court against former franchisees and their affiliates for various claims under federal and state statutes, as well as Georgia common law claims, asserting that the franchisees took various steps to steal the franchisor's confidential information and then compete against them following termination.[19] The franchise agreement that governed the parties' business relationship, stated in relevant part:

> The parties agree to submit any claim, dispute or disagreement, including any matter pertaining to the interpretation of this Agreement or issues relating to the offer and sale of the franchise or the relationship between the parties (a "Dispute") to mediation before a mutually-agreeable mediator prior to arbitration. If the Dispute is not resolved by mediation within 30 days after either party makes a demand for mediation, the parties will submit the dispute to mandatory and binding arbitration conducted pursuant to the Commercial Arbitration Rules of the American Arbitration Association . . . . Notwithstanding the foregoing, any Dispute that involves an alleged breach of Section 14 or Section 17 will not be subject to mediation or arbitration unless otherwise agreed to by both parties, and either party may immediately file a lawsuit in accordance with this Section with respect to any alleged breach of Section 14 or Section 17.[20]

In this case, the defendant-franchisees moved to dismiss franchisor's complaint and argued that the franchise agreement mandated the mediation of the franchisor's claims before it could advance any litigation against the franchisees.[21] The court agreed that the parties were required to mediate claims first and stayed the federal court proceeding pending the parties' completion of the necessary conditions in their franchise agreement and further found that the disputed issues did not arise under the sections of the agreement that were excepted from mediation.[22]

15. *Id.* at *4–5.
16. *Id.* at *5.
17. *Id.*
18. Hydration Station U.S. Franchise Sys., LLC v. Seaverns, No. 19-cv-05192-LMM, 2021 U.S. Dist. LEXIS 269461 (N.D. Ga. Jan. 13, 2021).
19. *Id.*
20. *Id.* at *5.
21. *Id.* at *7.
22. *Id.* at *19.

Mandatory Arbitration Clauses

If mediation is unsuccessful and the parties' disagreement remains, the logical next step for the parties involves litigation of the dispute in court, unless the franchise agreement that governs contains an arbitration provision that applies to the claims that are at issue. Arbitration is an alternative dispute resolution method that has become commonplace in franchise agreements, with the parties agreeing to present their case to an impartial third party instead of going to court, with the arbitrator's decision binding upon the parties, and with limited right to appeal the outcome.[23] Although now a routine part of franchise agreements, as Peter Silverman, an arbitrator with over thirty-six years of experience, warned, franchise agreement arbitration provisions "may be up to twenty years old and outdated."[24] This longevity is a particularly salient point when considering the considerable changes to the law on franchise arbitration clauses over the past thirty years and a clause that was "state of the art" in 1994 is a relic in 2024.[25]

From the franchisor's perspective, incorporating a clear and detailed arbitration process in the franchise agreement offers several advantages. It allows the parties to contractually set terms and parameters outlining exactly how disputes will be adjudicated, including but not limited to setting conditions such as: (1) the number of arbitrators that would decide the dispute; (2) the qualifications that an arbitrator must possess; (3) the issues that are reserved for the arbitrator to decide; (4) the entity that must administer the arbitration; (5) the rules that must govern the arbitration; (6) the scope of discovery and other fact-gathering measures that the parties are permitted to take; (7) the speed in which the dispute must be resolved; (8) the ability to proceed in court under limited circumstances for certain forms of relief, such as for a temporary restraining order or preliminary injunction; (9) the parties' obligation to maintain confidentiality of the arbitration beyond that provided in the arbitral forum rules; (10) the ability to bring dispositive motions; and (11) the manner in which the final arbitration hearing will occur (e.g., in person or by video conferencing).[26] By specifying these and other processes and procedures to be followed, the parties have more control over how their disputes are resolved, reducing uncertainties, and ensuring that both parties have a clear understanding of the steps involved. This certainty, in turn, can aid the franchisor in maintaining a healthier relationship

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23. *Arbitration Defined: What Is Arbitration?*, JAMS, https://www.jamsadr.com/arbitration-defined; *Arbitration*, Cornell L. Sch., Legal Info. Inst., https://www.law.cornell.edu/wex/arbitration; *Arbitration*, Duke Law, Goodson Law Libr., https://law.duke.edu/lib/research-guides/arbitration.

24. Peter Silverman, *Franchise Arbitrations, Selected Best Practices*, Franchise Law., Fall 2019, at 13.

25. Jonathan Solish & David Harford, *Stradivarius Revisited: Re-Tuning Your Franchise Arbitration Instrument*, 40 Franchise L.J. 69 (2020).

26. Am. Arb. Ass'n, *Drafting Dispute Resolution Clauses* (2013), https://www.adr.org/sites/default/files/document_repository/Drafting_Dispute_Resolution_Clauses-A_Practical_Guide.pdf.

with its franchisees by mitigating potential conflicts and fostering a sense of fairness and transparency. Additionally, predetermined procedures enhance predictability and protect the franchisor's interest by minimizing the risk of unpredictable legal rulings by creating a framework within which the outcome will be determined.

Arbitration clauses that detail the processes and procedures to be followed are generally enforceable under the Federal Arbitration Act (FAA). The U.S. Supreme Court recognized in *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior University* that "[a]rbitration under the [Federal Arbitration] Act is a matter of consent, not coercion, and parties are generally free to structure their arbitration agreements as they see fit."[27] The Supreme Court has continually reinforced this fundamental tenant again and again since then.[28] Given a franchise agreement may stay in place for many years while arbitration administrators continuously update their rules and procedures, a franchisor might prefer to specify certain arbitral processes and procedures while leaving others for determination at the time a dispute arises between it and its franchisee. Based on recent court rulings and the current rules in place with the two leading arbitral administrators in the United States—JAMS and the American Arbitration Association (AAA)—franchisors should carefully consider adding an arbitration clause or revising its existing arbitration clause to address one or more of the following terms:

Arbitrator Authority. Beyond specifying how many arbitrators the parties desire to decide their disputes and what qualifications they must possess (e.g., former judge, experience with franchise agreements, etc.), the franchise agreement should carefully define that the question of who decides gateway issues such as what is arbitrable. Conflicting state and federal court decisions abound, but the U.S. Supreme Court provided clarity in 2010 and then again in 2019, ruling that "[u]nder the Federal Arbitration Act, parties to a contract may agree that an arbitrator rather than a court will resolve disputes arising out of the contract."[29] To delegate threshold arbitrability questions to the arbitrator, however, the parties' agreement must do so by clear and unmistakable evidence.[30] So far, every circuit to rule on the point has found that incorporation of the AAA or JAMS rules of arbitration procedure is a delegation of authority to the arbitrator.[31]

Permissible Discovery. Although each franchisor-franchisee dispute contains its own unique set of facts and varies with respect to exposure or potential liability, litigation costs considerations remain constant. Whether

27. Volt Info. Scis., Inc. v. Bd. of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 479 (1989).

28. Henry Schein, Inc. v. Archer & White Sales, Inc., 586 U.S. 63, 65 (2019); *see also* Rent-A-Center W., Inc. v. Jackson, 561 U.S. 63, 77 (2010).

29. *Henry Schein*, 586 U.S. at 69.

30. *Id.*

31. John Doroghazi, Caroline Fichter & Aaron-Michael Sapp, *Recent Topics in Arbitration: What Litigators and Drafters Should Know*, W–1 Am. Bar Ass'n 45th Annual Forum on Franchising at 33–34 (2022) (collecting authority).

in federal or state court, broad discovery rules will almost certainly ensure that parties will have to expend a significant amount of time, effort, and resources preparing and responding to document requests, interrogatories, and requests for admission. Yet, discovery obligations do not end there. Federal and state court rules often permit party depositions and nonparty depositions and document subpoenas, further expanding the ultimate cost of litigation.[32] Arbitration's inherent discovery limitations, which frequently reserve discretion to the arbitrator, promote a more efficient and less costly adjudicatory proceeding. One such limitation is the ability of an arbitrator to compel pre-hearing nonparty discovery. The majority view is that Section 7 of the FAA[33] only authorizes arbitrators to issue subpoenas for attendance at a hearing and not for pre-hearing discovery.[34] The Fourth Circuit is an outlier; it holds that an arbitrator has the power to issue a subpoena to a nonparty for pre-hearing discovery "under unusual circumstances" and "upon a showing of special need or hardship."[35] The franchisor should carefully consider whether nonparty discovery is important to the types of disputes anticipated under the franchise agreement. If so, an important consideration is whether to invoke the much broader authority arbitrators have under the Revised Uniform Arbitration Act, adopted by over eighteen states, including Arizona, Colorado, Nevada, New Mexico, Oregon, Washington, and Utah, to issue subpoenas "to the extent a court could if the controversy were the subject of a civil action in this state."[36] As a general rule, where state law contradicts the FAA, the contradicting law "is displaced by the FAA."[37] But this rule does not automatically mean that the FAA prohibits the parties from contracting for a particular state's arbitration laws to apply for the limited purpose of nonparty discovery. This conclusion is consistent with U.S. Supreme Court precedent recognizing the parties' freedom "to arbitrate under different rules than those set forth in the Act itself" and their right to structure their arbitration agreement "as they see fit."[38]

Confidentiality Obligations. In the United States, courts have historically held that the First Amendment guarantees a qualified right of access to civil trials and to their related proceedings and records.[39] That presumptive First

32. *See, e.g.*, Fed. R. Civ. P. 45.

33. 9 U.S.C. § 7.

34. CVS Health Corp. v. Vividus, LLC, 878 F.3d 703, 706 (9th Cir. 2017); Managed Care Advisory Grp., LLC v. CIGNA Healthcare, Inc., 939 F.3d 1145 (11th Cir. 2019); Life Receivables Tr. v. Syndicate 102 at Lloyd's London, 549 F.3d 210 (2d Cir. 2008); Hay Grp., Inc. v. E.B.S. Acquisition Corp., 360 F.3d 404 (3d Cir. 2004).

35. COMSAT Corp. v. Nat'l Sci. Found., 190 F.3d 269, 275–76 (4th Cir. 1999).

36. Ariz. Rev. Stat. § 12-3017(D); *see also* Colo. Rev. Stat. § 13-22-217; Nev. Rev. Stat. § 38.233; N.M. Stat. Ann. § 44-7A-18; Or. Rev. Stat. § 36.675; Utah Code Ann. § 78B-11-118; Wash. Rev. Code § 7.04A.170.

37. AT&T Mobility LLC v. Concepcion, 563 U.S. 333, 341 (2011).

38. Volt Info. Scis., Inc. v. Bd. of Trustees of Leland Stanford Junior Univ., 489 U.S. 468, 479 (1989); *see also* Henry Schein, Inc. v. Archer & White Sales, Inc., 586 U.S. 63, 65 (2019).

39. N.Y. Civ. Liberties Union v. N.Y. City Transit Auth., 684 F.3d 286, 298 (2d Cir. 2012) (citing Westmoreland v. Columbia Broad. Sys., Inc., 752 F.2d 16, 22 (2d Cir. 1984)); Rushford v. New Yorker Mag., Inc., 846 F.2d 249, 253–54 (4th Cir. 1988); *In re* Cont'l Ill. Secs. Litig.,

Amendment right of access can create issues when a franchisor-franchisee dispute reaches the public consciousness or raises potential reputational and other public relations issues. Under the rules of the primary arbitration administrators, JAMS and AAA, non-parties generally lack the right to access proceedings and parties' filings, and the arbitral staff and arbitrators are obligated to keep information confidential.[40] Critically though, neither the AAA Commercial Rules nor JAMS Rules require the parties themselves to maintain confidentiality.[41] Indeed, the AAA provides in its Statement of Ethical Principles that "[t]he parties always have a right to disclose details of the proceeding, unless they have a separate confidentiality agreement."[42] Franchisors seeking to maintain confidentiality of the arbitration proceeding should include a specific provision in their franchise agreement arbitration clause that requires both parties to keep the arbitration materials confidential, except when legal obligations (such as disclosures requirements under the Federal Trade Commission's Franchise Disclosure Rule[43]) mandate disclosure. Courts generally uphold the agreement of parties to limit the use of certain materials unless compelled by legal duty, such as a subpoena or court order.[44] Typically, such clauses are challenged on the grounds that they are

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732 F.2d 1302, 1308 (7th Cir. 1984); Publicker Indus., Inc. v. Cohen, 733 F.2d 1059, 1070 (3d Cir. 1984); *In re* Iowa Freedom of Info. Council, 724 F.2d 658, 661 (8th Cir. 1983); Newman v. Graddick, 696 F.2d 796, 801 (11th Cir. 1983); *see also* Associated Press v. Dist. Court, 705 F.2d 1143, 1145 (9th Cir. 1983).

40. Am. Arb. Ass'n, Statement of Ethical Principles, https://www.adr.org/StatementofEthicalPrinciples (last visited July 19, 2024) [*hereinafter* Ethical Principles]; Am. Arb. Ass'n, Com. Arbitration Rules and Mediation Procedure, R-45 (Sept. 1, 2022)) [*hereinafter* AAA Commercial Rules]; JAMS, Comprehensive Arbitration Rules & Procedures, Rule 26(a) (June 1, 2021) [*hereinafter* JAMS Rules]. JAMS, however, does provide the arbitrator with discretion to allow "any person having a direct interest in the Arbitration" to attend the arbitration hearing. JAMS Rules, Rule 26(c).

41. *See generally id.* Both the AAA Commercial Rules and JAMS Rules, however, do authorize the arbitrator to enter a confidentiality order. AAA Com. Rules R-24(a), R-45(b); Am. Arb. Ass'n, Com. Rules Preliminary Hearing Procs, P-2(x); JAMS Rules 26(b).

42. Ethical Principles, *supra* note 40. Unlike the AAA and JAMS, Rule 20 of the International Institute for Conflict Prevention and Resolution (CPR) Administered Arbitration Rule, the parties, arbitrators, and CPR must keep the arbitration proceedings confidential. Int'l Institute for Conflict Prevention & Resolution, 2019 CPR Rules for Administered Arbitration of Int'l Disputes, Rule 20, https://drs.cpradr.org/rules/arbitration. Going a step further, Article 40 of the International Centre for Dispute Resolution (ICDR) International Dispute Resolution Procedures has an expansive requirement that witnesses, parties, arbitrators and ICDR keep confidential all information about the arbitration and the award. Int'l Centre for Dispute Resol., Int'l Dispute Resol. Procs. (Including Mediation and Arbitration Rules), Art. 40, https://www.adr.org/sites/default/files/ICDR_Rules_1.pdf. However, absent an objection by a party within six months of the award, Article 40.4 of the ICDR's rules allows that the ICDR may publish selected awards, orders, decisions and rulings, which are edited to conceal party names and other identifying details. *Id.*

43. 16 C.F.R. § 436.

44. *See, e.g.*, *In re* Int'l Bus. Machs. Corp. Arbitration Agreement Litig., 76 F.4th 74, 85–86 (2d Cir. 2023), *cert. denied sub nom*. Abelar v. Int'l Bus. Machs. Corp., 144 S. Ct. 827 (2024); Petrobas Am., Inc. v. Samsung Heavy Indus. Co., Ltd., No. CV-h-19-1410, 2019 WL 3759840, at *3 (S.D. Tex. Aug. 9, 2019). When it comes to third parties, a confidentiality agreement between the franchisor and franchisee may not be sufficient to preclude that third party from obtaining confidential arbitration materials through a subpoena. As one court explained, "Contracts bind only the parties. No one can 'agree' with someone else that a stranger's resort to discovery

unconscionable. Courts have largely ruled that a determination of whether a clause is unconscionable is a decision for the arbitrator.[45] But a few courts have elected to decide this issue themselves, with some rejecting the argument where the confidentiality clause had exceptions when disclosure is required by law or the parties otherwise consent,[46] and others finding clauses overbroad and substantively unconscionable where, for example, they prohibit a party from mentioning to anyone the existence of the controversy or the arbitration proceeding.[47] Accordingly, care should be taken when drafting the confidentiality provision to narrowly tailor it to the needs of the parties. It should be sufficiently broad to cover the arbitration award itself. The arbitration provision should obligate the parties in any post-arbitration court proceedings to seek to file the arbitration award and any other arbitration matters under seal to the extent allowed in the applicable jurisdiction.[48]

Distilled down, a detailed arbitration clause is not a procedural footnote; it is a strategic tool that can save time, protect assets, and maintain relationships. Unlike federal and state court proceedings, where the losing party almost always has an appellate right based on an issue with the trial court proceeding, the law that was applied, or how the law was applied, in arbitration a losing party has very limited rights to challenge or attempt to overturn an arbitrator's decision. The U.S. Supreme Court has stressed that judicial review of an arbitration award is very limited in scope and that a party seeking relief bears a heavy burden.[49] Indeed, under the FAA and most state arbitration statutes, a district court can vacate an arbitration award only if the award was obtained through fraud, corruption, or undue means, or if the arbitrators were guilty of some type of misconduct.[50] As such, a party is

under the Federal Rules of Civil Procedure will be cut-off." Gotham Holdings, LP v. Health Grades, Inc., 580 F.3d 664, 665 (7th Cir. 2009).

45. *See, e.g.*, Kilgore v. KeyBank Nat'l Ass'n, 718 F.3d 1052, 1059 n.9 (9th Cir. 2013) ("In any event, the enforceability of the confidentiality clause is a matter distinct from the enforceability of the arbitration clause in general. Plaintiffs are free to argue during arbitration that the confidentiality clause is not enforceable."); CarMax Auto Superstore Cal. LLC v. Hernandez, 94 F. Supp. 3d 1078, 1121–22 (C.D. Cal. 2015) ("Unless the arbitration clause itself is unenforceable, the question whether a particular provision of the contract, like the confidentiality clause, is unenforceable is thus left to the arbitrator.").

46. Chin v. Advanced Fresh Concepts Franchise Corp., 123 Cal. Rptr. 3d 547, 556–57 (Ct. App. 2011) (finding the following confidentiality provision in arbitration agreement not unconscionable where exceptions were present when disclosure is required by law or when the parties have provided prior written consent: "Except as may be required by law, no party or arbitrator(s) may disclose the existence, content or results of any arbitration hereunder without the prior written consent of both parties.").

47. Davis v. O'Melveny & Myers, 485 F.3d 1066, 1078 (9th Cir. 2007), *overruled on other grounds by* Kilgore v. KeyBank, Nat'l Ass'n, 673 F.3d 947 (9th Cir. 2013) (invalidating entire arbitration agreement after finding unconscionable confidentiality clause was not severable); Ting v. AT&T, 319 F.3d 1126, 1151 (9th Cir. 2003).

48. *In re Int'l Bus. Machs. Corp. Arbitration Agreement Litig.*, 76 F.4th at 86 (rejecting plaintiff's attempt to "end-run" the parties' confidentiality agreement by attaching protected materials to court filings and then invoking access to judicial documents doctrine).

49. Oxford Health Plans, LLC v. Sutter, 569 U.S. 564, 568 (2013).

50. *See, e.g.*, 9 U.S.C. § 10; Conn. Gen. Stat. §§ 52-408, -409; Va. Code Ann. § 8.01-581.010; Wash. Rev. Code § 7.04A.230.

more likely to achieve more certain finality of decision in arbitration rather than in state or federal court. This finality is a strong benefit when the franchisor is the prevailing party; however, in circumstances where the franchisor does not prevail, its options to limit or otherwise set aside judgment is significantly narrowed. It also militates in favor of having a well-defined arbitration clause that foresees potential pitfalls and addresses them by erecting legal safeguards to ensure consistent results are achieved through a streamlined, time-efficient, and cost-effective dispute resolution mechanism compared to traditional litigation. Fortunately for franchisors and franchisees alike, the U.S. Supreme Court has consistently demonstrated that arbitration remains an appropriate and enforceable approach to resolution of the parties' disputes if the parties have agreed to resolve their claims that way. That said, the Supreme Court in the past few years has shown itself to only enforce arbitration clause as writtens and to not go farther.[51] In the franchise context, the case law largely reflects the same: if the franchise agreement contains an agreement to arbitrate, then courts will not interfere and will enforce that arbitration agreement as written.[52]

Class and Collective Action Waivers

Much like the broader subject of arbitration, franchisors often use class and collective action waivers to help minimize franchisor litigation risk. Indeed, the two in some ways go hand in hand with one another. A class and collective action waiver is a contractual provision that, in the context of a franchise agreement, prevents franchisees from participating in class action and collective action legal proceedings in court or arbitration against the franchisor.[53] A waiver of a right to bring such an action is generally built into an arbitration clause, requiring the contracting parties to submit disputes to arbitration on an individual basis. The widescale acceptance of such provisions can be traced back to the 2011 decision *AT&T Mobility Services v. Concepcion*, where the U.S. Supreme Court upheld the enforceability of an arbitration contract that prohibited individual consumers from bringing or participating

51. *See, e.g.*, Morgan v. Sundance, 596 U.S. 411, 418 (2022) ("Accordingly, a court must hold a party to its arbitration contract just as the court would to any other kind. But a court may not devise novel rules to favor arbitration over litigation.").

52. Ice Rak, LLC v. Rita's Franchise Co., LLC, No. 8:23-cv-2659-WFJ-TGW, 2024 U.S. Dist. LEXIS 44917, at *27 (M.D. Fla. Mar. 14, 2024); Anthony v. Van Over, No. 3:22-cv-416, 2023 U.S. Dist. LEXIS 176604, at *6 (E.D. Tenn. Sept. 27, 2023); Doctor's Assocs., LLC v. Reino, No. 3:22-CV-00786 (JCH), 2023 U.S. Dist. LEXIS 53631, at *22 (D. Conn. Mar. 28, 2023).

53. John B. Lewis & Dustin D. Dow, *Arbitration Agreement and Class Action Waiver Enforcement in Employment Litigation and the Impact of the Supreme Court's Decision in* Epic Systems, Prac. Guidance J. (2024), https://www.lexisnexis.com/community/insights/legal/practical-guidance-journal/b/pa/posts/arbitration-agreement-and-class-action-waiver-enforcement-in-employment-litigation-and-the-impact-of-the-supreme-court-s-decision-in-epic-systems.

in class action litigation.[54] In the years since *Concepcion*, this type of waiver has become more ubiquitous in contracts, including franchise agreements.[55] Faced with this growing trend, courts continue to affirm the enforceability of class action waivers built into arbitration clauses, requiring would-be-plaintiffs to arbitrate their claims on an individual basis.[56]

Franchisors that have not yet added a class action waiver provision to their franchise agreements should consider doing so as it can markedly aid the franchisor's effort to mitigate litigation risks. By requiring individual arbitration instead of collective litigation, a franchisor may reduce the potential financial impact of large-scale lawsuits on its franchise system and can prevent a dispute involving a multitude of potential claimants potentially reaching the entirety of its franchise system with unknown exposure, instead limiting itself to straightforward bilateral disputes. This approach mitigates the potential financial exposure that a class action lawsuit might entail, as class actions can often result in significant settlements to avoid even larger potential runaway verdicts.[57] A class action waiver also ensures that the franchisor obtains the benefit of its bargain that the parties resolve their disputes in arbitration instead of in a traditional court case, reducing time and resources spent on litigation. As discussed above, arbitration provides a greater degree of control over the dispute resolution process, allowing the franchisor and franchisees to select a knowledgeable and experienced arbitrator. Moreover, by including a class action waiver, franchisors can manage potential conflicts case-by-case, promoting a more direct and tailored approach to dispute resolution that considers the individualized facts relevant to the specific dispute with that franchisee.

Federal and state courts have generally upheld class action waivers in franchise agreements. For example, in *Jai Sai Baba LLC v. Choice Hotels International Inc.*,[58] ninety franchisees filed a lawsuit in federal court asserting twenty-one separate counts against Choice Hotels (Choice) relating to conduct arising under the parties' franchise relationship.[59] Choice moved to compel arbitration based on the arbitration provision contained in the parties' franchise agreements.[60] Choice also argued that each arbitration should proceed on an individual basis given the existence of a class action waiver in

54. AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011); *see also Michael* McCarthy, Jeff Scott & Robert Herrington, *Stemming the Tide of Mass Arbitration*, GreenbergTraurig (June 7, 2021), https://www.gtlaw.com/en/insights/2021/6/stemming-the-tide-of-mass-arbitration.

55. *E.g.*, Jai Sai Baba LLC v. Choice Hotels Int'l Inc., No. 5:20-cv-02823, 2021 U.S. Dist. LEXIS 51943, at *9 (E.D. Pa. Mar. 19, 2021) ("The parties also agree that a majority of the Franchise Agreements contain a class action waiver provision.").

56. *See, e.g.*, Epic Sys. Corp. v. Lewis, 584 U.S. 497 (2018); Lamps Plus, Inc. v. Varela, 587 U.S. 176, 188–89 (2019) (holding that courts may not compel classwide arbitration based on an arbitration agreement that is ambiguous whether the parties agreed to arbitrate on a class basis).

57. Bateman v. Am. Multi-Cinema, Inc., 623 F.3d 708 (9th Cir. 2010) ("It is widely accepted that class certification may force a defendant to settle rather than incur the costs of defending a class action and run the risk of potentially ruinous liability.") (internal quotations omitted).

58. *Jai Sai Baba LLC*, 2021 U.S. Dist. LEXIS 51943, at *9.

59. *Id.* at *33.

60. *Id.*

the parties' agreements.[61] Following the court's review of the relevant information, it concluded that arbitration on an individual—and not collective—basis was appropriate.[62]

The *Jai Sai Baba* court started its analysis by looking to the language of the relevant provisions in the franchise agreements.[63] The arbitration provision, which was found in Paragraph 21 of the franchise agreements, stated, among other things:

> [A]ny controversy or claim arising out of or relating to this Agreement or any other related agreements, or the breach of this Agreement or any other related agreements, including any claim that this Agreement or any part of this Agreement or any related agreements is invalid, illegal, or otherwise voidable or void, as well as any claim that we violated any laws in connection with the execution or enforcement of this Agreement or any related agreements and any claims for declaratory relief, will be sent to final and binding arbitration in the state of Maryland before either the American Arbitration Association, J.A.M.S., or National Arbitration Forum . . . .[64]

The franchise agreement's class action waiver, which was contained in Paragraph 22, stated:

> NO CLASS ACTIONS. Neither you nor we shall seek to litigate or arbitrate against the other party to this Agreement or such party's affiliates, either as a representative of, or on behalf of, any other person, class, or entity, any dispute, controversy, or claim of any kind arising out of, or relating to, this Agreement, the rights and obligations of the parties, the sale of the franchise, or other claims or causes of action relating to the performance of either party to this Agreement. No arbitration or other action or proceeding under this Agreement shall add as a party, by consolidation, joinder, or in any other manner, any person or party other than us and you and any person in privity with, or claiming through, in the right of, or on behalf of, us or you, unless both we and you consent in writing. We have the absolute right to refuse such consent. You agree and acknowledge that any proceeding directly or indirectly arising from or relating to this Agreement, the relationship between the parties, or any Agreement or relationship between you and us or any affiliate of ours will be considered unique on its facts and may not be brought as a class or group action.[65]

The franchisees argued this language forced them to participate in individual arbitrations, thereby preventing them from effectively vindicating their claims. The court rejected this argument.[66] Instead, the court determined that the franchisees had not met their burden of showing that individual arbitrations would hurt their rights or that any part of either the arbitration provision or the class action waiver provision was unconscionable.[67] In so ruling, the court reasoned that "[t]he stream-lined discovery process and efficiencies in the arbitration system, especially when compared to the

61. *Id.*
62. *Id.* at *33–34.
63. *Id.* at *34.
64. *Id.* at *6–7.
65. *Id.* at *9–10.
66. *Id.* at *33–34.
67. *Id.* at *34.

extended litigation a class-action lawsuit in federal court entails, will likely enable [franchisees] to resolve their claims more quickly."[68] For similar reasons, among others, the court also declined to find that the arbitration provision containing the class action waiver was unconscionable.[69] The court found specifically that the class action waiver in the arbitration provision did not exculpate the franchisor from liability so as to show a lack of mutuality, noting there need not be "an exactly even exchange of identical rights and obligations between the two contracting parties before a contract will be deemed valid."[70] Finally, the court agreed that "a court may not compel arbitration on a class-wide basis when an agreement is 'silent' on the availability of such arbitration."[71]

Choice of Law Clauses

A choice of law clause is a contractual term specifying that any dispute arising under the contract will be determined in accordance with the law of a specific jurisdiction that is agreed to by the parties.[72] In the context of a franchisor-franchisee relationship, a choice of law provision can have a substantial impact on how an issue is adjudicated. For example, it could be the difference between whether a state franchise act is applied.[73] For purposes of uniformity and predictability in legal interpretations, a franchisor may prefer to tailor the legal principles governing the franchise relationship by determining, upfront, the jurisdiction and laws that will govern the franchise relationship for all franchisees. In the United States, with a few exceptions, contract interpretation principles are governed by state law.[74] By specifying a particular state's laws that will apply to the franchise agreement's interpretation, franchisors can ensure a better chance of consistency in legal outcomes across jurisdictions. This consistency can be particularly beneficial for franchisors operating in multiple states, as it enables them to limit the expense and burden of navigating the complexities associated with varying contract interpretation principles. Such a clause also prevents uncertainty by providing both the franchisor and franchisee with advance knowledge of the jurisdiction's laws that will govern the terms of their agreement. This enhanced legal predictability can save franchisors and franchisees time and financial resources by reducing the risk of litigation, as disputes can be avoided or resolved based on the clarity that having the laws of a predetermined jurisdiction provide the legal framework for the franchise relationship.

68. *Id.* at *22.
69. *Id.* at *25–30.
70. *Id.* at *30 (quotation and citation omitted).
71. *Id.*
72. *Choice of Law Clause*, Black's Law Dictionary (9th ed. 2009).
73. Hagstrom v. Am. Cir. Breaker Corp., 518 N.W.2d 46, 49 (N.C. Ct. App. 1994) (enforcing North Carolina choice of law provision that provide for shorter termination window compared to Minnesota law).
74. Donaldson Co. v. Burroughs Diesel, Inc., 581 F.3d 726, 731 (8th Cir. 2009).

Enforcement of choice-of-law provisions in franchise agreements is not absolute, and their enforceability depends on several factors and potential limitations. Courts across most state jurisdictions will uphold a choice of law provision if the contract is valid and the selected law does not violate the state's public policy.[75] However, a franchisor must be mindful of the impact that a franchise relationship law may have on its ability to enforce a choice of law provision, depending on where the franchisee is located.[76] For example, franchisees in California, Wisconsin, New York, Arkansas, Indiana, and many other "relationship law" states, have successfully relied upon their state franchise disclosure or relationship statute to avoid the application of a choice of law clause on the basis that the clause would waive certain statutory rights that the franchisee is entitled to under law.[77] Franchisors should therefore confirm whether any of their franchisees are located in states with specific franchise relationship laws and be mindful of their ability to invoke and rely upon the choice of law clauses included in their franchise agreement.[78]

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75. Chi. Franchise Sys. v. Dominique, No. 22-cv-3296, 2024 U.S. Dist. LEXIS 31266, at *8 (N.D. Ill. Feb. 23, 2024) ("Illinois law upholds a choice-of-law provision if the contract is valid, and the law opted does not violate Illinois' public policy."); CajunLand Pizza, LLC v. Marco's Franchising, LLC, 513 F. Supp. 3d 801, 805 (N.D. Ohio 2021) ("Under Ohio law, contractual choice-of-law provisions are valid and enforceable."); Howard Bank v. Compu-Link Corp., 472 F. Supp. 3d 267, 273 (D. Md. 2020) ("[A] contract's choice of law provision is unenforceable under Maryland if the choice of law jurisdiction has no substantial relationship to the transaction, or there is a fundamental policy difference in the laws of another jurisdiction with a more substantial interest in the parties or the transaction.") (internal quotations omitted); Goosehead Ins. Agency, LLC v. Williams Ins. & Consulting, Inc., 533 F. Supp. 3d 367, 384 (N.D. Tex. 2020) ("Texas law dictates, like Michigan law, that choice-of-law provisions do not constitute an impermissible waiver of rights in violation of public policy . . . .") (internal quotations omitted); LaGuardia Assocs. v. Holiday Hosp. Franchising, Inc., 92 F. Supp. 2d 119, 127 (E.D.N.Y. 2000) ("New York courts will, however, decline to enforce a contractual choice of law selection if (1) the law of the state selected does not have a reasonable relationship to the economic activity . . . or (2) the state law chosen violates a fundamental public policy of New York . . . .").

76. *See* Kerry L. Bundy & Joshua N. Turner, *The Wisconsin Fair Dealership Law: Understanding the Interplay Between Forum-Selection and Choice-of-Law Clauses*, 42 Franchise L.J. 123 (2022).

77. Cottman Transmission Sys. v. Kershner, 492 F. Supp. 2d 461, 469 (E.D. Pa. 2007) (finding that application of the choice-of-law provision specifying Pennsylvania law would be contrary to the policies of California, Wisconsin, and New York); Volvo Constr. Equip. N. Am., Inc. v. CLM Equip. Co., 386 F.3d 581, 607–10 (4th Cir. 2004) (holding that anti-waiver provision of Arkansas Franchise Act evinced fundamental public policy which overrode choice-of-law agreement, while Louisiana Dealer Act did not); Cromeens, Holloman, Sibert, Inc. v. AB Volvo, 349 F.3d 376, 391 (7th Cir. 2003) (holding that Maine franchise law expresses strong public policy against enforcement of countervailing choice-of-law provisions); Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 132 (7th Cir. 1990) (holding Indiana franchisee could not waive statutory rights through agreement to apply New York law, because Indiana franchise statutes prohibited waiver of its protections).

78. The enforceability of these forum selection provisions are very complicated and fact-specific, and must be analyzed on a case by case basis. *See* Stephanie J. Blumstein & John M. Doroghazi, *The Litigation Before the Litigation*, Am. Bar Ass'n, 46th Annual Forum on Franchising W-9 at 16-25 (Nov. 1–3, 2023); Bryan W. Dillon & Ann H. MacDonald, *The Long Arm of the Law: The Extraterritorial Scope of State Franchise Registration and Disclosure and Relationship Laws in Litigation*, Am. Bar Ass'n, 45th Ann. Forum on Franchising W-5 at 1–2 (Nov. 2–4, 2022).

Limitation on Liability Provision

In addition to the various procedural-based contract provisions that this article has discussed that can be incorporated in franchise agreements to minimize a franchisor's litigation risks, liability clauses can help define the boundaries of responsibility and protect both the franchisor and franchisees by narrowing the pool of potential exposure should a breach of the franchise agreement occur. A limitation on liability provision is a contractual clause that outlines the extent of a party's responsibility or liability by restricting or limiting the type or amount of damages that one party may recover from the other.[79] Besides reducing financial exposure, the cap on liability provides a franchisor a degree of predictability and certainty that allows the franchisor to better manage and anticipate their potential legal expenses. Such clauses also strike a balance between protecting a franchisor's brand and ensuring franchisees and franchisors can operate without excessive risk. Without this limitation, a substantial claim could potentially put the entire franchise system at risk.

One common type of limitation of liability clause authorizes a party to recover only the actual damages sustained, prohibiting all other types of damages that might otherwise be available at law or equity. For example, in *Pizza Hut LLC v. Ronak Foods, LLC*,[80] a franchise relationship soured between the franchisor and a franchisee when the franchisee defendants defaulted on their obligations to Pizza Hut.[81] One of the parties' contractual agreements contained a limitation on liability provision that provided that the franchisees "irrevocably waive . . . any right to or claim for . . . special . . . damages in any action or proceeding whatsoever between the parties."[82] When the franchisees attempted to assert a business disparagement claim against the franchisee, the court enforced this provision, holding that "[u]nder our strongly held principles of freedom to contract, . . . limitation-of-liability clauses are valid limited warranties that were the basis of the parties' bargain."[83]

Franchisors should also evaluate whether it is in their interest to include a limitation on liability through the use of limiting the time to bring claims, i.e. a contractual limitations period. The U.S. Supreme Court has held that, "[i]n the absence of a controlling statute to the contrary, a provision in a contract may validly limit, between the parties, the time for bringing an action on such contract to a period less than that prescribed in the general

79. Alexandra J. Gage & Sara E. Potts, *Ten Ways Your Limitation of Liability Provision Is Actually Ineffectual*, *Association of Corporate Counsel*, Ass'n of Corp. Counsel (Apr. 20, 2023), https://www.acc.com/resource-library/ten-ways-your-limitation-liability-provision-actually-ineffectual.

80. Pizza Hut, LLC v. Ronak Foods, LLC, No. 5:21-CV-00089-RWS, 2022 U.S. Dist. LEXIS 244497, at *7 (E.D. Tex. Feb. 10, 2022).

81. *Id.* at *35–36.

82. *Id.* at *33.

83. *Id.* at *36.

statute of limitations, provided that the shorter period itself shall be a reasonable period."[84]

In *Bigelow Corp. v. Hounds Town USA, LLC*,[85] plaintiffs were a franchisee of Hounds Town and filed suit against Hounds Town alleging that defendant made certain misrepresentations to plaintiffs during the franchise information disclosure phase, causing plaintiffs to rely on those representations and execute a franchise agreement.[86] Hounds Town moved to dismiss plaintiffs' breach of contract, unjust enrichment, fraud, negligent misrepresentation, negligence, and negligent infliction of emotional distress claims on the grounds that they were barred by the contractually agreed upon one-year statute of limitation contained in the agreement. The court agreed with the franchisor's position.[87]

Specifically, the court held that the limitation clause in the parties' franchise agreement was enforceable for two reasons.[88] First, the court found that no statutory prohibition stopped the parties from agreeing to a shorter limitations period.[89] It found that six of the seven claims were governed by a three-year statute of limitations period, and the seventh claim was governed by a four-year statute of limitations period.[90] However, the relevant statutes "neither explicitly nor implicitly prohibits contractual limitations shorter than the statutory period."[91] Second, the court found that the limitations clause contained in the franchise agreement was reasonable under North Carolina law and cited a series of holdings from North Carolina courts confirming this position contractually agreed upon limitations period of one year was reasonable.[92]

Based on these two findings, the court determined that the facts supporting plaintiffs' claims "clearly stem[med] from the Franchise Agreement and the parties' conduct and obligations flowing therefrom" and accordingly dismissed the various claims that were subject to the one-year statute of limitations with prejudice.[93]

Franchisors can employ other limitation on liability clauses that go beyond simply limiting damages or the time period to sue. In *Dance Fitness Michigan, LLC v. AKT Franchise, LLC*, a group of franchisees filed a lawsuit against the defendant-franchisor asserting a number of causes of action in connection with the central allegation that defendant AKT and a number of its employees made oral and written misstatements and omissions that

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84. Heimeshoff v. Hartford Life & Accident Ins. Co., 571 U.S. 99, 107 (2013) (citing Ord. of United Com. Travelers of Am. v. Wolfe, 331 U.S. 586, 608 (1947)).
85. Bigelow Corp. v. Hounds Town USA, LLC, No 3:23-CV-00134-FDW-SCR, 2023 U.S. Dist. LEXIS 134352 (W.D.N.C. Aug. 2, 2023).
86. *Id.* at *1–3.
87. *Id.* at *13–14.
88. *Id.* at *23.
89. *Id.*
90. *Id.*
91. *Id.*
92. *Id.* at *24.
93. *Id.* at *25.

caused plaintiffs to agree to become AKT franchisees.[94] As a component of the parties' arguments concerning whether the lawsuit should be remanded to state court or not, the court undertook the analysis of whether certain claims against the defendant's employees were proper. AKT argued that it was not because the operative franchise agreements expressly severed liability from any of AKT's agents, representatives, or individuals associated with the franchise company.[95] Plaintiffs tried to invoke the California Franchise Investment Law's anti-waiver provision[96] to invalidate the limitation of liability clause.[97] However, the court rejected plaintiffs' argument, concluding that

> [t]he plain language of the agreement does not seek to release or avoid liability. Rather, the language shifts liability to AKT and away from its "agents, representatives" or "individuals associated with" it." Such contractual limitations on individual liability are valid under California law when "the injured party retains his right to seek redress from the" parent entity."[98]

In summary, there are various forms of limitations on liability that a franchisor can include in a franchise agreement to better control the risks and uncertainty of litigation. It is crucial to recognize though that the enforceability of these clauses may vary by jurisdiction. State-specific laws and court interpretations play a significant role in determining their validity.

Contractual Indemnification Clauses

Franchisors' litigation risks are not limited to disputes with franchisees. Franchisors often face claims brought by third parties due to the alleged actions of one of their franchisees. One such scenario is where a franchisee's customer claims that it suffered an injury at the franchisee's location or the franchisee's conduct in some way gives rise to a cause of action that is brought by an injured party. Although the franchisor had no direct involvement in any of the circumstances giving rise to the customer's claim, often the franchisor finds itself in the customer's crosshairs, by way of being named as a co-defendant in the lawsuit with the franchisee, or simply named by itself. Other scenarios include employment disputes; misrepresentations by the franchisee concerning the franchisor's brand, products, or services; a franchisee's non-compliance with local, state, or federal laws or regulations; or a franchisee's infringement of a third party's intellectual property. While the appropriate gateway step under any of these scenarios can and should be to seek dismissal of the franchisor as a party (based on several potential theories depending on the facts of the case), there is no guarantee that the court views the landscape the same way. Accordingly, the franchisor should

94. Dance Fitness Mich., LLC v. AKT Franchise, LLC, No. 8:23-cv-01643-JVS(JDEx), 2023 U.S. Dist. LEXIS 203683, at *1 (C.D. Cal. Nov. 13, 2023).
95. *Id.* at *22.
96. Cal. Corp. Code § 31512.
97. *Dance Fitness*, 2023 U.S. Dist. LEXIS 203683, at *23.
98. *Id.* at *25.

include an indemnification clause to protect the franchisor from legal claims and losses that might occur due to the actions of its franchisee.[99]

A contractual indemnity provision is a contractual clause that provides that one party (referred to as the indemnifying party) will compensate or otherwise cover the costs, losses, or damages that the other party (the indemnified party) incurs due to the alleged conduct of the indemnifying party.[100] In the franchise context, these provisions are routinely utilized to effectively reduce franchisor risk when third parties set their sights on the franchisor (and its presumed deep pockets) by shifting the legal liability risks and associated defense costs to the franchisee.

A well-drafted indemnification clause will provide broad coverage that encompasses the wide range of potential claims and damages that might arise under its franchise system. An indemnification clause should also address insurance requirements, obligating the franchisee to maintain certain types of insurance to cover the anticipated third-party claims that may arise and provide consequences for failing to maintain adequate coverage.

A recent case out of the U.S. District Court for the District of Maryland involved a dispute between a daycare franchisor and franchisee and their respective insurance companies.[101] The franchisor and its insurer filed a lawsuit against the franchisee and its insurer, alleging that the franchisee was contractually obligated to indemnify franchisor and provide additional funds to it as part of franchisor's settlement of claims brought by a third party against franchisor (the *Lewis* litigation) based on the franchisee's alleged conduct.[102] The indemnification provision in the franchise agreement stated in relevant part:

> Franchisee will indemnify and hold Franchisor and Franchisor's members, managers, officers, directors and employees harmless against and from any and all claims arising either directly or indirectly from, as a result of, or in connection with the operation of the Franchised Business, as well as the costs, including attorneys' fees, of defending against them . . . .[103]

After reviewing the record on summary judgment, the court found in the franchisor's favor and concluded, among other things, that there was no dispute "(1) that the parties entered into a Franchise Agreement with an indemnification provision; or (2) that the *Lewis* litigation claims, and resulting liabilities, arose from operation of the daycare."[104] In enforcing the

99. Aaron's Inc. v. MKW Invs., Inc., 786 F. App'x 190, 195 (11th Cir. 2019) (franchise agreement's indemnification provision unambiguously required franchisee to indemnify franchisor for expenses incurred in underlying litigation).

100. *Indemnification Clauses in Contracts*, Bloomberg L. (Aug. 9, 2023), https://pro.bloomberglaw.com/insights/contracts/indemnification-clauses-in-contracts.

101. Phila. Indem. Ins. Co. v. Markel Ins. Co., 649 F. Supp. 3d 84 (D. Md. 2023).

102. *Id.* at 90–91.

103. *Id.* at 100.

104. *Id.* at 101.

provision, the court looked at the plain language of the franchisee agreement as part of its analysis and found that the language was unambiguous.[105]

The franchisor should also take care to specify that its attorneys' fees, litigation costs, and other related expenses are indemnifiable losses under the franchise agreement. In *Patel v. 7-Eleven, Inc.*,[106] a federal district court concluded that, under Massachusetts law, an indemnification clause stating the franchisee agreed to indemnify the franchisor "'from all losses arising out of or relating to your Store and its operation' up to $500,000" did not include attorney fees or costs from a legal dispute between parties because the "indemnification provision in the Franchise Agreement makes no mention of defense costs or attorneys' fees" and it would "not make sense" that indemnification would be capped at $500,000 if the provision were applicable to attorneys' fees.[107]

Conclusion

Whether a franchisor is just emerging on the scene or is a well-established player conducting a thorough review of their existing franchise agreement, one key takeaway remains constant: recent case law underscores that franchisors have significant opportunities to mitigate litigation risk by strategically tailoring their franchise agreements to include and modify both procedural and substantive provisions. These contractual clauses serve as powerful tools to safeguard the franchisor's interest, maximize effectiveness, and enhance enforceability. Franchisors should proactively leverage these provisions to create robust agreements that not only foster positive franchisor-franchisee relationships but also provide a solid framework for resolution of any dispute that may arise in the system. Franchisors, as with all provisions, should take care to ensure that they are drafted with the necessary particularity and in conformance with the controlling law so that they will be enforced as intended should a franchisor need to rely on them.

105. *Id.* at 100–01.
106. Patel v. 7-Eleven, Inc., 648 F. Supp. 3d 297 (D. Mass. 2023).
107. *Id.* at 301–02.

Revenue Generating Alternatives for Franchises and the Associated Risks

*Marc Lieberstein**

Mr. Lieberstein

Franchise brand owners[1] do an excellent job generating revenue from their franchise operations. FRANdata reported in its International Franchise Association 2024 Economic Outlook that, with over 800,000 franchise establishments operating in the United States, franchising, by itself, was responsible for over $850 billion in economic output and supported over eight million jobs.[2]

But do franchisors spend enough time considering other ways to monetize their franchise brands outside the franchise operation? Considering the economic success and popularity of the top franchise brands, one might expect at least one franchise brand to rank among the top global brand licensors. In 2023, however, License Global did not name a single franchise brand in its Top Ten list of Global Licensors.[3] Among the list are notable brand owners like Disney (first), Authentic Brands Group (third), Warner Bros. Discovery (fourth), Hasbro (sixth), and Mattel (eighth), which together accounted for almost $200 billion in licensing revenue.[4] According to the May 22, 2024, Licensing Letter in 2023 "[g]lobal sales for licensing hit a new high . . . of $356 [billion]."[5] Clearly, brand licensing represents a potential for significant revenue growth. In

1. The owner of a franchise system's intellectual property, including its trademarks, may not always be the franchisor of the franchise system. Some systems, for example, create an affiliate that owns all intellectual property and licenses that property to the franchisor, which in turn sublicenses its use to the franchisees. This article uses the term franchisor to describe the franchisor and any affiliate that owns the system's intellectual property interchangeably.

2. Ashley Rogers, Jin Qi & Khadija Cochinwala, *2024 Franchising Economic Outlook*, Int'l Franchise Ass'n (Feb. 14, 2024), https://www.franchise.org/sites/default/files/2024-02/2024%20Franchising%20Economic%20Report.pdf.

3. *The Top Global Licensors Report 2023*, License Glob. (July 27, 2023), https://www.licenseglobal.com/rankings-lists/top-150-leading-licensors.

4. *Id.*

5. Gary Symons, *Study Says Licensed Merch Sales Hits Record $356.5B in 2023*, Licensing Letter (May 22, 2024), https://www.thelicensingletter.com/study-says-licensed-merch-sales-hits-record-356-5b-in-2023.

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addition to the brand itself, franchisors also make use of various patents, trade secrets, and proprietary methods. Opportunities may exist for franchisors to license patents, trade secrets, and other proprietary methodologies. Aside from "straight" intellectual property licensing, franchisors also may consider alternative distribution channels, such as e-commerce, ghost kitchens, concessionaires, and nontraditional locations, to increase revenues. All of these alternatives, however, increase the risk of claims for encroachment, unfair competition, or breach of the franchise agreement.

This article examines these revenue generating alternatives for franchisors, along with their accompanying risks. Part I discusses traditional licensing, including technology and brand licensing. Part II focuses on revenue-generating alternative distribution channels. Part III analyzes the challenges franchisors may encounter adopting alternative distribution channels.

I. Traditional Licensing

Traditional licensing is a natural fit for franchisors to generate additional revenue. Similar to how franchise agreements allow other businesses to duplicate the franchisor's business across numerous locations, traditional license agreements allow other businesses to use the franchisor's brands or proprietary business methods or to sell the franchisor's products or services outside the franchised businesses.[6] Through these licensing arrangements, franchise brands may increase their marketplace exposure, elevate their brand awareness, and monetize their assets in a way that does not compete with their existing franchise business.[7] In fact, such alternative licensing may increase business for the franchise operation.[8]

Traditional licenses fall into two broad categories: (i) licenses for technology and know-how and (ii) brand or trademark licenses.[9] The risks to franchisors from such licensing activity outside the franchise relationship depends on the scope of the license granted and whether such license avoids competing—directly or indirectly—with existing franchise businesses. This article considers each category in turn.

A. *Technology and Know-How Licensing*

A franchisor may own proprietary technology, and sometimes even several patents on the methods by which its franchisees operate the franchise.[10]

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6. This can also work in the reverse where franchisors license to sell other brands' products through co-branding or collaboration.

7. For example, McDonald's has hired IMG, a top licensing agency, to "develop a wide range of licensed products and experiences globally, to build the brand, and drive its growth on a global basis." Symons, *supra* note 5.

8. *Id.*

9. *See generally* David A. Beyer, *Considerations in the Development of a Franchise System*, Franchise L. & Prac. (1996).

10. *See* 16 C.F.R. § 436(n) (requiring franchisors to disclose whether they own rights in or licenses to patents or copyrights that are material to the franchise).

Generally, franchise agreements with franchisees do not preclude the franchisor from licensing its technology assets to third parties outside the franchise operation.[11] Such a license may allow the franchisor to enjoy a revenue stream in the form of licensee royalty payments, while avoiding the costs associated with developing or manufacturing the licensed product or service.[12] Unlike the franchise relationship, in return for the license income stream and reduced costs, the franchisor does forgo some degree of control over the licensee's business in selling the licensed products or services and because the franchisor is not making and selling the licensed product or service to the market itself, it loses out on a portion of the downstream revenue that the product or service generates for the licensee.[13]

In the franchise context, a technology license makes sense where the franchisor owns patents or other intellectual property, like trade secrets, relating to methods for doing business that may apply to industries other than the one in which the franchise operates. Examples of such patents or intellectual property include point-of-sale systems, customer relationship management tools, or other industry-specific software. Licensing this technology should not increase the risk to the franchisor of any claim for breach of the franchise agreement because such activity could take place outside the franchise operation in non-competing areas of the marketplace.

Consider a restaurant franchisor that has developed intellectual property around food preparation, packaging, or shipment. Although the franchise businesses only serve hot food to consumers in physical restaurant locations, the franchisor's technology and know-how may have equal application in the consumer packaged-foods business directed to grocery stores or other retail food store locations. By licensing its technology, the franchisor monetizes its existing technology with third-party businesses that are in the packaged foods space and will use that technology without increasing competition for the franchisor's principal franchise restaurant business. A technology license like this brings little risk to the franchisor due to the non-competitive nature of the licensee's use of the licensed technology.

This analysis, of course, assumes that the licensee's use of the licensed technology will not hurt franchisee sales. If, however, a restaurant franchisor allows third parties to sell competing food products in local supermarkets, and consumers suddenly stop visiting the franchised restaurant locations, the franchisor may risk claims for encroachment, unfair competition, breach of contract, or lack of good faith from its franchisees.[14] Limiting the license to use for products that are not sold by the franchised businesses may further mitigate this risk. Similarly, terms in the franchising agreement allowing for such conduct will also reduce the risk.

11. Beyer, *supra* note 9, § 2.24.
12. *Id.*
13. *Id.*
14. *See* discussion *infra* Part III.B.

For example, in the past year McDonald's has filed several patent applications with the U.S. Patent and Trademark Office in connection with its development of goods and services in the metaverse.[15] In addition to using these patents in connection with the metaverse, McDonald's ultimately may use any patents that it obtains to support its franchised restaurants in the real world.[16] McDonald's also may decide to license its technology to non-competitor businesses, like clothing retailers, to conduct business in the metaverse. Franchisors can license other technology, like proprietary business methods and trade secrets, in the same manner, provided that all licensees are obligated to maintain the trade secret as confidential.[17]

B. *Brand Licensing*

Every franchise agreement involves a trademark license to a franchisee to use those trademarks in connection with operating the franchised business.[18] But, as noted earlier, there is usually nothing in any franchise agreement precluding the franchisor from licensing its trademarks in a variety of ways that do not compete with the franchised businesses.[19] In a typical franchise relationship, the franchisor licenses its trademark in exchange for royalties or other fees and, to maintain brand standards, exerts necessary control over the franchisee's business operations.[20] Franchisors willing to consider alternative brand licensing arrangements may find lucrative opportunities to license their trademarks to franchisees or non-franchisees for co-branding, collaborations, or partnerships with celebrities, influencers, or other brands, all of which may increase a franchise brand's exposure and potentially drive alternative non-franchisee revenue to a franchisor.

From a brand owner's perspective, collaborations provide an attractive option for launching new products, and they also generate hype, often without paid advertising. Moreover, brand licensing provides consumers the opportunity to show their loyalty to their favorite brands and their licensed partners, as well as introduce new customers to the collaborating brands. For example, Krispy Kreme recently teamed up with celebrity Dolly Parton to

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15. Gary Symons, *McDonalds Files Patents for its Launch into the McMetaverse*, Licensing Letter (Feb. 16, 2022), https://www.thelicensingletter.com/mcdonalds-files-patents-for-its-launch-into-the-mcmetaverse.

16. *See generally* Marc A. Lieberstein & Robert Potter, *Franchising in the Metaverse*, N.Y.L.J. (Feb. 22, 2022), https://www.law.com/newyorklawjournal/2022/02/22/franchising-in-the-metaverse.

17. CAE Integrated, L.L.C. v. Moov Techs., Inc., 44 F.4th 257, 262 (5th Cir. 2022) ("A trade secret is information which derives independent economic value from being not generally known or readily ascertainable through proper means.").

18. *See* 16 C.F.R. § 436.1(h)(1) (defining franchise to include commercial relationships where the franchisee, among other things, "[w]ill obtain the right to operate a business that is identified or associated with the franchisor's trademark").

19. Beyer, *supra* note 9, § 2.25; Lisa Pearson & Marc Lieberstein, *Brand x Brand: Collabs and Cobranding*, Licensing J., Sept. 2021, at 1.

20. 16 C.F.R. § 436.1(h)(2) (defining franchise to include commercial relationships where the franchisor, among other things, "[w]ill exert or has authority to exert a significant degree of control over the franchisee's method of operation").

release the Dolly Southern Sweets Doughnut Collection comprising four limited-edition doughnuts with unique names like the "Dolly Dazzler."[21] To encourage visits to franchise businesses on the launch day, Krispy Kreme offered a free doughnut to anyone willing to dress up as Dolly Parton or sing her songs in-store.[22]

In another brand collaboration, Dunkin' partnered with TikTok's most followed star at the time, Charli D'Amelio, to add her go-to coffee order, "The Charli," to the menu at all locations and on the Dunkin' app.[23] The Charli spurred a twenty percent overall sales boost for cold brews the day it was released, a forty-five percent increase the following day, and a fifty-seven percent increase in app downloads.[24] One year later, the collaboration continued with a limited-edition Charli x Dunkin' merchandise collection available exclusively through Dunkin'.[25] Products included a tumbler, a cold brew tap, and apparel emblazoned with the Dunkin' logo and color scheme.[26]

Dunkin' has continued to expand its merchandise sales through collaborations with celebrity endorsers. A recent Super Bowl advertisement featured the "DunKings," a fictional boyband including celebrities Ben Affleck, Matt Damon, and Tom Brady donning Dunkin'-branded track suits.[27] The day after the advertisement aired, Dunkin' listed DunKings merchandise for sale on its website, complete with the tracksuit, a bucket hat, and a tumbler.[28] The merchandise sold out within nineteen minutes and became the "fastest collection to sell out in Dunkin' history," according to a company spokesperson.[29]

Brand licensing is not limited to quick service restaurants. In partnership with Sony Pictures during the release of The Garfield Movie, Motel 6 designed Garfield-themed rooms available at ten Motel 6 locations complete with orange bedspreads, pizza-themed bedding, and mini fridges stocked with lasagna.[30]

These collaborations quantifiably benefit franchisors by generating alternative revenue for the franchisor or increasing sales at franchised locations.

21. Liv Weller, *Krispy Kreme®, Global Superstar Dolly Parton Partner for All-New 'Southern Sweets' Doughnut Collection*, Bus. Wire (May 14, 2024), https://www.businesswire.com/news/home/20240514987299/en/KRISPY-KREME%C2%AE-Global-Superstar-Dolly-Parton-Partner-for-All-New-Southern-Sweets-Doughnut-Collection.

22. *Id.*

23. *Calculating Charli D'Amelio's Massive Sales Lift for Dunkin'—StatSocial Influencer Attribution Use Case*, StatSocial (Nov. 11, 2020), https://www.statsocial.com/charli-damelio-dunkin-influencer-attribution.

24. *Id.*

25. Press Release, Dunkin', Sip in Style with the Charli X Dunkin' Merch Collection (Mar. 29, 2021), https://news.dunkindonuts.com/news/charli-dunkin-merch.

26. *Id.*

27. Katelyn Umholtz, *Here's How to Get Ben Affleck's Dunkin' Swag from Sunday's Super Bowl Ad*, Boston.com (Feb. 12, 2024), https://www.boston.com/news/entertainment/2024/02/12/dunkin-tracksuits-ben-affleck-dunkings-super-bowl-ad.

28. *Id.*

29. *Id.*

30. Press Release, G6 Hospitality, Motel 6 Appoints Garfield as First Ever Chief Pet Officer (Apr. 26, 2024), https://g6hospitality.com/motel-6-appoints-garfield-as-first-ever-chief-pet-officer.

They also increase brand recognition and goodwill. The chart below provides a summary of different alternative revenue generating programs (along with examples) available to franchisors across different industries based on the author's experience:

Alternative Revenue Concepts

Franchise Category	**Alternative Revenue Concepts**
Business services	Franchisor executing on its reservation of rights to operate in non-traditional locations, e.g., pop-up stores; malls; airports; producing and selling books, e-books, guides, or magazines related to the brand's industry; monetizing a blog, YouTube channel, or podcast related to the brand's industry through advertising and sponsorships.
Commercial and residential services	Via brand licensing, e.g., cleaning or janitorial franchise releasing its own cleaning products line.[31]
Lodging	Hotel brands partner with coffee brands, bath/body care brands, and even food/beverage brands (fractional franchise with a restaurant operating out of the hotel); hotel brands collaborating with entertainment brands to create a themed stay or lodging experience.[32]
Personal services	Via brand licensing or co-branding/collaborations: salons expand to offer branded haircare or beauty products through traditional retail channels;[33] fitness studios offer branded athletic apparel or gear.[34]

31. Carpet and upholstery cleaning franchise Chem-Dry sells branded carpet deodorizer and spot remover. *See Professional Carpet Cleaning Products*, ChemDry, https://www.chemdry.com/products-tips (last visited July 11, 2024).

32. Press Release, *supra* note 30.

33. In 2013, salon franchise Drybar launched a hair product line to be sold exclusively at Sephora, QVC, and Drybar locations nationwide. *See Drybar Launches Product Line; Appoints Two New Senior Execs*, PR Newswire (Jan. 3, 2013), https://www.prnewswire.com/news-releases/drybar-launches-product-line-appoints-two-new-senior-execs-185532952.html. As of 2024, Nordstrom, Ulta and Macy's also carry the product line, which has grown from sixteen to fifty-two hair products and tools. *Id.*

34. Weight Watchers partnered with the Traces wine brand to create a range of low-calorie, low sugar, vegan, and gluten-free wines. *See* Allison Watkinson, *Forget Diet Soda: Weight-Watchers Offers 'Diet Wine*,' Licensing Letter (May 30, 2024), https://www.thelicensingletter.com/traces-named-weightwatchers-uk-wine-partner.

Franchise Category	Alternative Revenue Concepts
Quick service restaurants (QSRs), retail food, products, and services, and table/full-service restaurants	Via brand licensing or co-branding/collaborations: developing a line of branded consumer-packaged goods/frozen food for sale in supermarkets/grocery stores;[35] pop-up locations and ghost kitchens (delivery-only alternative); expansion to luxury level location with influencer or celebrity; non-traditional locations: stadium concessions.[36]
Real estate	Using co-branding options with suppliers to the real estate market, e.g., construction contractors, real estate developers; offering branded e-commerce alternatives to real estate service providers in the area of loans, mortgages, title clearance; creating membership/loyalty programs offering special benefits, discounts, or services in exchange for a recurring membership fee.

II. Alternative Revenue Generating Distribution Channels

Beyond licensing arrangements, a franchisor may look to augment its revenue by selling its branded products or services through alternative distribution channels. These channels run the gamut from corporate-owned stores to e-commerce to so-called "ghost kitchens." Although franchisors may avail themselves of any number of distribution channels—the avenues available to the franchisor are limited only by the franchisor's creativity and, in some cases, the terms of the franchise agreement—one usually finds the alternative distribution channels in the franchisor's reservation of rights section for "non-traditional locations."[37]

A. *E-Commerce and Ghost Kitchens*

No post-pandemic discussion of franchise distribution channels would be complete without mentioning e-commerce and the many permutations of

35. TGI Fridays partners with Kraft Heinz to sell TGI Fridays-branded frozen appetizers for retail distribution. *See* Allison Watkinson, *TGI Fridays Signs Critical Deal with Long-Time Partner Kraft Heinz*, Licensing Letter (May 3, 2024), https://www.thelicensingletter.com/tgi-fridays-signs-critical-deal-with-long-time-partner-kraft-heinz.

36. As of 2018, franchise brand Tim Hortons was the top chain restaurant brand sold in NHL arenas with a presence in seven arenas. *See* Daniel Roberts, *Top Food Chains in Sports Arenas: Dippin' Dots, Papa John's Dominate*, Yahoo Fin. (Jan. 11, 2018), https://finance.yahoo.com/news/top-food-chains-sports-arenas-dippin-dots-papa-johns dominate-194713807.html.

37. *See* Jennifer Dolman, Scott Korzenowski & Erik Wulff, *STOP INVADING MY SPACE: Encroachment Issues in Franchising*, 51st Ann. Int'l Franchise Ass'n Legal Symposium, at 20 (2018) (identifying "non-franchised stores" and "non-traditional or seasonal locations" as potential alternative distribution channels); *see also* Thomas R. Ayres, *Bricks to Clicks: The Post-Pandemic E-Commerce Reckoning*, 41 Franchise L.J. 23, 24 (2021) (analyzing issues created by the increased prominence of e-commerce and digital distribution channels); James B. Egle & Isaac S. Brodkey, *Encroachment in the Era of Digital Delivery Platforms: Impact of Delivery Apps on Brick and Mortar Exclusive Territories*, 41 Franchise L.J. 195, 202 (2021) (identifying "third-party delivery services" as an additional alternative distribution channel).

digital distribution.[38] Two factors have propelled the rise of e-commerce. First, the increased consumer demand for the convenience and efficiency of online ordering and expedited delivery.[39] Online retail continues to eat into the share of total retail sales in the United States,[40] and franchise systems are not immune to this sea change in consumer preference.[41]

Second, the COVID-19 pandemic and resulting shutdowns pushed customers from dining rooms to drive-throughs and from in-person shopping to at-home delivery.[42] These changes cannot be separated from the hybrid work environment that has come to dominate for business professionals, white-collar employees, and other workers whose primary tool in their employment is their computer. Today's consumer can go to work, attend an exercise class, shop for groceries, and pick up dinner, all without stepping off their front porch.[43]

Franchises can take advantage of the increased prominence of e-commerce in a number of ways. For instance, franchises can improve the brand experience for their customers by creating e-commerce infrastructure that effectively serves as a one-stop shop for all things related to the franchise system.[44] An online-ordering portal, with options for delivery or curbside pick-up, can help franchises secure business from their customers. Franchisors also can incentivize franchisees to partner with delivery services like DoorDash, UberEats, or PostMates to help retain online-ordering market share. And, in the same vein, food and beverage franchises can use "ghost kitchens" or next-gen store designs to improve the delivery experience for consumers.[45]

Ghost kitchens are brick-and-mortar locations consisting of little more than a commercial kitchen.[46] The premises are optimized for online orders: there is no storefront, no dining room, and no need for a high-rent location in a heavily-trafficked area.[47] Indeed, ghost kitchens frequently are located

38. *See* Ayres, *supra* note 37, at 24–25 (discussing the explosion of "the use of e-commerce in various franchise models" following the advent of the COVID-19 pandemic).

39. Dolman, *supra* note 37, at 13–14 (discussing "the ongoing evolution and disruption of the retail market, both online and in physical outlets, resulting from increased e-commerce and convergence in the marketplace").

40. Melissa Repko, *Walmart Is Using Its Thousands of Stores to Battle Amazon for E-commerce Market Share*, CNBC (June 2, 2022), https://www.cnbc.com/2022/06/02/walmart-bets-its-stores-will-give-it-an-edge-in-amazon-e-commerce-duel.html. In fact, CNBC has reported that "consumers spent more money at Amazon than the big-box retailer [Wal-Mart] for the first time" in "the 12-month period from June 2020 to June 2021." *Id.*

41. Dolman, *supra* note 37, at 14 ("Franchise systems, in particular, stand to benefit from leveraging a diversified e-commerce strategy that builds a brand name online and leverages physical stores to reach online customers.").

42. *See generally* Ayres, *supra* note 37, at 23–24.

43. *Id.*

44. *See* Dolman, *supra* note 37, at 14.

45. Viggnesh Kandasamy, *How Are Ghost Kitchens Evolving Post-Pandemic?*, Forbes (Sept. 20, 2022), https://www.forbes.com/sites/forbestechcouncil/2022/09/20/how-are-ghost-kitchens-evolving-post-pandemic/?sh=198f387d55e5.

46. *Id.*

47. *Id.*

in industrial areas or other locations typically hostile to profitable in-person dining businesses.[48] As a business concept, ghost kitchens can take many forms. Some are simply converted restaurants, with the dining room closed and all sales made on a to-go basis or by drive-through orders.[49] Others are purpose-built for online orders only, with no public accommodations beyond a lobby or pick-up window for delivery drivers.[50] And others marry a king-sized kitchen with a pint-sized dining area, such as in food halls or other shared spaces, and seek to serve dine-in and carry-out customers alike.[51]

Ghost kitchens create revenue-generating business opportunities for both franchisees and franchisors. A franchisee may agree to open a franchised ghost kitchen, avoiding the time and expense associated with a branded trade-dressed dining room. Although the franchisee takes on the risk of operating a business entirely reliant on online ordering, in return the business would not shoulder the costs of building, cleaning, and maintaining a customer-facing space. Similarly, a franchisor could diversify its revenue streams by opening a corporate-operated ghost kitchen if it reserved these rights in its franchise agreement.[52]

This strategy makes particular sense for multi-brand franchisors, which can use a single kitchen to fulfill orders placed with multiple franchises. For instance, Inspire Brands opened a ghost kitchen in Atlanta to fulfill online orders for pick-up and delivery of food sold under the Arby's, Buffalo Wild Wings, Jimmy John's, and Sonic brands.[53]

Beware, however that franchisees may claim encroachment based on a franchisor operating a ghost kitchen or offering competitive goods or services through alternative distribution channels (even if reserved in the franchise agreement) near a franchisee location.[54] Moreover, although ghost kitchens seemed a perfect way for franchises to adapt to increased consumer demand, including consumer technological reliance, their effectiveness has decreased in the pandemic's wake because indoor dining has resumed some of its frequency, resulting in large franchise brands struggling to maintain delivery-only ghost kitchens or virtual brands alongside service for in-person diners.[55] The influx of clandestine "restaurant" options on delivery apps like Uber Eats has also confused consumers and led to food quality issues as delivery drivers are often dropping off multiple orders in one trip.[56] Uber

48. *Id.*
49. *Id.*
50. *Id.*
51. *Id.*
52. *See* discussion *infra* Part III.B
53. *Inspire Brands Launches Alliance Kitchen, the First-of-Its-Kind Kitchen for Delivery and Take-Out Orders in Atlanta*, Inspire Brands (Nov. 9, 2021), https://stories.inspirebrands.com/inspire-brands-launches-alliance-kitchen-ghost-kitchen-delivery-takeout-atlanta.
54. *See* Part discussion *infra* Part III.B.
55. Julie Creswell, *Ghost Kitchens Are Disappearing, Squeezed by Demand and Complaints*, N.Y. Times (Apr. 15, 2024), https://www.nytimes.com/2024/04/12/business/ghost-kitchens-restaurants-pandemic.html.
56. *Id.*

Eats removed 8,000 "storefronts" from its listings last year in response to these complaints,[57] and franchisors are following suit by eliminating or scaling down their plans for ghost kitchens.[58]

This change illustrates another risk with attempting to use alternative revenue generating distribution channels. Putting aside the risk of failure of the channel to work or gain acceptance, the franchise brand could suffer a negative reaction in the marketplace that hurts franchisee sales and harms the brand's value and goodwill.

As franchisors like Wendy's and Applebee's pivot from substantial ghost kitchen investments to increased focus on harmonizing in-store and to-go dining,[59] Wendy's Global Next Gen restaurant design could be instructive for alternative efficient service in the digitized world. Unveiled in 2022, the design plan "streamlines the experience for digital and delivery customers, unlocking up to 400 times the digital capacity of previous restaurant designs."[60] Over 200 Wendy's locations throughout 2024 will implement innovations like dedicated parking spots and walk-up windows for delivery drivers, self-order kiosks to simplify the ordering experience, and a galley kitchen design that runs from each store's front to back to support faster order fulfillment.[61] Popeyes is also re-vamping its kitchens through "easy-to-run kitchen conversions" as a response to "digital becoming a more meaningful channel."[62]

Another more recent alternative revenue generating (cost saving) distribution method lies in the increased use of non-human automation to operate the franchise location. McDonald's and another new burger chain in California, CaliExpress, among others, are opening freestanding kiosks and other forms of automated locations and are rolling such automated restaurants out to take orders, cook, and deliver food.[63] AI is also playing a role in

57. Nancy Luna, *'Ghost' Menu Massacre: Virtual Brands Face a Reckoning as Uber Eats Slashes 8,000 from Its App*, Bus. Insider (July 13, 2023), https://www.businessinsider.com/uber-eats-cuts-8000-virtual-restaurant-brands-2023-7.

58. Last year, Kroger severed a three-year partnership with ghost kitchen firm Kitchen United and closed all eight of its virtual food courts established within Kroger locations across the United States. *See* Catherine Douglas Moran & Aneurin Canham-Clyne, *Kroger, Kitchen United Shutter In-Store Ghost Kitchens*, Grocery Dive (Nov. 28, 2023), https://www.grocerydive.com/news/kroger-kitchen-united-shutter-in-store-ghost-kitchens/700933.

59. *See* Joanna Fantozzi, *Wendy's and More Restaurant Brands Are Moving Away from the Ghost Kitchen Model*, Nation's Rest. News (Mar. 20, 2023), https://www.nrn.com/quick-service/wendy-s-and-more-restaurant-brands-are-moving-away-ghost-kitchen-model.

60. *Wendy's Newest Restaurant Design for the Digital* Age, Wendy's (Aug. 15, 2023), https://www.wendys.com/blog/wendys-newest-restaurant-design-innovation.

61. *See* Ron Ruggless, *Wendy's Offers Digital-Focused Next Gen Design Standard*, Nation's Rest. News (Aug. 17, 2022), https://www.nrn.com/quick-service/wendy-s-offers-digital-focused-next-gen-design-standard.

62. Alicia Kelso, *Popeye's Is Making 30 'Distinct Changes' in Its Kitchen*, Nation's Rest. News (June 5, 2024), https://www.nrn.com/operations/popeyes-making-30-distinct-changes-its-kitchen ("Franchisees have shown a lot of interest . . . . [T]he main benefit is an improvement for team members, which should translate to a better guest experience through higher accuracy and faster speed.").

63. NBC News, *Robots Cook Your Burger and Fries at this New California Fast Food Restaurant*, YouTube (Apr. 13, 2024), https://www.youtube.com/watch?v=MKmuaxHL688; Techly Reports,

creating new efficiencies for franchise businesses, saving on employee and supply costs.[64] Franchisors who invest in these new technological alternative distribution channels for their franchise products and services may see increased profits via increased costs savings.

B. *Concessionaires and Non-Traditional Locations*

In addition, franchises may seek to sell their products or services at nontraditional locations, ranging from concession stands to department stores. These locations may be franchised, such as units in universities, military bases, workplaces, and expositions.[65] Or they may be non-franchised locations like kiosks, locations at airports and stadiums, or locations inside department stores, grocery stores, hotels, pharmacies, and convenience stores.[66]

Nontraditional locations can grant access to valuable captive audiences. If one of the 78,000 fans in attendance at Mercedes-Benz Stadium in Atlanta wants a chicken sandwich, for instance, the in-stadium Chick-fil-A is the only game in town.[67] Moreover, operating a nontraditional location or utilizing new delivery technology allows franchises to meet customers where they are—much like ghost kitchens and e-commerce. [68]

An added benefit to such non-traditional location expansion is that a franchisor may be able to avoid the franchise registration and disclosure obligations if the proposed operator for such location fits within one of the franchise exemptions available under state or federal law. The typical exemption that is often available in this situation is the large franchisee exemption because usually the experienced operators for such non-traditional locations are well-capitalized and exceed the net worth threshold of $6,165,500.[69]

III. Risks of Adopting Alternative Revenue Streams

A franchisor seeking to diversify its income streams faces various risks along the way. One of the more significant risks is that license agreements can result in "accidental franchises," where the business relationship qualifies as a franchise under federal or state law despite the parties' intention to create

Inside McDonald's First Robotic Restaurant | The Future of Fast Food, YouTube (Mar. 11, 2023), https://www.youtube.com/watch?v=29a4pFgBpeY.

64. *Id.*

65. Dolman, *supra* note 37, at 20.

66. *Id.*

67. Sean Ward, *Why Is There a Chick-fil-A in Mercedes-Benz Stadium?*, Chick-Fil-A (Dec. 22, 2017)-, www.chick-fil-a.com/stories/inside-chick-fil-a/why-is-there-a-chick-fil-a-in-mercedes-benz-stadium ("[Franchisee Jonathan] Hollis and his team serve so many guests during each event that they begin preparing nearly four hours before stadium doors open.").

68. In this respect, operating a non-traditional location is much like operating a ghost kitchen. *See* discussion *supra* Part II.A. In both endeavors, the franchise looks outside the box to fit customer preferences by employing an alternative distribution method.

69. 16 C.F.R. § 436.8.

a different relationship. Accidental franchises create compliance headaches and regulatory exposure for the franchisor.[70]

Franchisees also may bristle at the franchisor's efforts to increase revenue through alternative channels. Disgruntled franchisees may claim encroachment based on e-commerce or other digital operations, particularly when the goods or services offered through such alternative channels are competing with those offered by the franchisees. Franchisees may also claim that the franchisor is acting in bad faith or competing unfairly if its pursuit of alternative revenue sources somehow undermines franchisee operations.

A. *The Accidental Franchise*

Businesses are sometimes surprised to learn that an otherwise straightforward contractual relationship actually qualifies as a franchise under state or federal law.[71] Franchise laws cannot be waived, so a franchise may arise even if the parties expressly agree that their venture does not qualify as a franchise.[72] As a result, a franchisor that seeks to generate non-franchise income must scrutinize the franchise definitions under the Federal Trade Commission Rule on Franchising (FTC Rule) and applicable state law to ensure that its new alternative ventures do not qualify as franchises.[73]

Under the FTC Rule, a franchise arises if (1) the franchisee licenses or uses the franchisor's trademark; (2) the franchisor exerts significant control over, or provides significant assistance in, the franchisee's operations; and (3) the franchisee pays more than a designated amount in fees before or during the first six months of the franchise's operation.[74] State laws generally track the FTC Rule, although at least New York is an exception as its franchise law definition merely requires two elements: a trademark license and a fee; *or* a marketing plan and a fee.[75] In other states, the federal definition's second element, which tests control and assistance, is substituted with requirements for a marketing plan or a shared "community of interest" between the franchisor and franchisee in the marketing of goods or services, or an ongoing financial interest in the franchisee's business or the sale of the franchisor's goods or services.[76]

An example of a ostensible distributor relationship turning into a franchise relationship is found in *Major Brands, Inc. v. Mast-Jagermeister US, Inc.*,

70. *See, e.g.*, Megan B. Center, *Accidental Franchises: It Takes a Community (of Interest)*, 39 Franchise L.J. 545 (2020) (discussing accidental franchises).

71. *See, e.g.*, Paul R. Fransway, *Traversing the Minefield: Recent Developments Relating to Accidental Franchises*, 37 Franchise L.J. 217 (2017); Rupert M. Barkoff, *New York Franchise Act: Out in Left Field*, N.Y.L.J. (May 1, 2012).

72. *E.g.*, Safe Step Walk in Tub Co. v. CKH Indus., Inc., 242 F. Supp. 3d 245, 258 (S.D.N.Y. 2017) (finding licensee-licensor relationship "may plausibly constitute a franchisor-franchisee relationship under the FTC Rule").

73. The FTC Rule is codified at 16 C.F.R. §§ 436, 437.

74. 16 C.F.R. §§ 436.1(h), 436.8(a)(1).

75. Fransway, *supra* note 71, at 219–20; N.Y. Gen. Bus. Law § 681(3).

76. Fransway, *supra* note 71, at 219–20; *see* Major Brands, Inc. v. Mast-Jagermeister US, Inc., 2022 WL 3585605, at *2 (E.D. Mo. Aug. 22, 2022) (citing Mo. Rev. Stat. § 407.400).

where the court examined the "community of interest" factor for a Missouri-based relationship.[77] Applying the Third Circuit's guidance on whether a franchise exists under the New Jersey franchise statute, the court found a community of interest in support of a franchise relationship because the distributor had invested in and played a prominent role in marketing the product in Missouri, hired and trained an employee solely dedicated to selling the product, and sent two dollars to Jagermeister per case of product sold.[78]

In addition to the control element, accidental franchises can arise due to disguised franchise fees in a distribution agreement. Courts often find franchise fees in unexpected places. In *To-Am Equipment Co. v. Mitsubishi Caterpillar Forklift America, Inc.*, for instance, the district court found that payments to the manufacturer for its "sales and service publications"—totaling some $1,600 over a nine-year period—qualified as a franchise fee.[79] The Seventh Circuit affirmed, holding such payments brought the distributorship under the "sweeping" definition of a franchise under Illinois law.[80] And in *Wright-Moore Corp. v. Ricoh Corp.*, the Seventh Circuit affirmed the district court's denial of summary judgment to a manufacturer that required its distributor to maintain an allegedly excessive level of inventory.[81] The appellate court reasoned that, even though Indiana's franchise statute "expressly states that franchise fees do not include 'the purchase or agreement to purchase goods at a bona fide wholesale price,'" the cost of acquiring excess inventory can qualify as a franchise fee under certain circumstances, such as where the manufacturer requires its distributors to buy a quantity of goods "so unreasonably large that it is illiquid."[82]

The FTC Rule definitions and its state equivalents stand in tension with the trademark concept of "naked licensing," under which a trademark is deemed abandoned if licensed without restrictions on quality control as necessary to preserve the mark's image.[83] Too little control and the trademark

77. *See Major Brands*, 2022 WL 3585605, at *2.

78. *See id.* at *3.

79. To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc., 152 F.3d 658, 663 (7th Cir. 1998).

80. *Id.* at 662, 664.

81. Wright-Moore Corp. v. Ricoh Corp., 908 F.2d 128, 135–36 (7th Cir. 1990) (applying Indiana law).

82. *Id.*

83. Broeg v. Duchaine, 67 N.E.2d 466, 467–68 (Mass. 1946) (uncontrolled licensing may result in trademark ceasing to have any meaning); Dawn Donut Co. v. Hart's Food Stores, Inc., 267 F.2d 358, 367 (2d Cir. 1959) ("The Lanham Act clearly carries forward the view of these latter cases that controlled licensing does not work an abandonment of the licensor's registration, while a system of naked licensing does . . . . [U]nless the licensor exercises supervision and control over the operations of its licensees the risk that the public will be unwittingly deceived will be increased. . . ."); Heaton Distrib. Co. v. Union Tank Car Co., 387 F.2d 477, 485 (8th Cir. 1967) ("The generally accepted meaning of 'uncontrolled licensing' is where a trademark owner has licensed someone else to make or manufacture its products and then fails to control the quality of the products made by the licensee, thus permitting a deception of the public."); Barcamerica Int'l USA Trust v. Tyfield Imps., Inc., 289 F.3d 589, 596 (9th Cir. 2002) ("[W]here the licensor fails to exercise adequate quality control over the licensee, 'a court may find that the trademark owner has abandoned the trademark, in which case the owner would be estopped

owner may lose its trademark altogether; too much control and the license may accidentally create a franchise relationship. Although naked licensing and accidental franchising seem to require would-be licensors to walk a precarious tightrope, in practice brand license agreements alone rarely create franchise relationships, as the two doctrines look to different levels and types of control. Under the FTC Rule, "significant" control includes site approval and design or appearance requirements; designated hours of operation, production techniques, or accounting practices; required personnel policies or promotional campaigns; and restrictions on customers.[84] In addition, training programs or operating manuals, management advice, and use of systemwide networks or a website all indicate "significant assistance" under the FTC Rule.[85] The FTC's guidance, however, expressly exempts "trademark controls designed solely to protect the trademark owner's legal ownership rights in the mark under state or federal trademark laws" from its identified indicia of control, meaning that controls imposed simply to preserve the integrity of the brand license will not establish an accidental franchise.[86]

Consistent with FTC guidance, few reported decisions find franchise relationships arising from trademark licenses alone. To be sure, various courts have held that so-called "license agreements" actually established franchises, but the contracts at issue in these cases generally provide for substantial licensor control over licensee business operations, not mere control over the licensee's use of the licensor's mark.[87]

In any event, due to the fact-intensive nature of the naked licensing and accidental franchising analysis and the few bright lines provided by applicable law, a franchisor seeking to undertake licensing must scrutinize its anticipated license program to avoid creation of another franchise.[88] This scrutiny is particularly important when dealing with state franchise laws or

from asserting rights to the trademark.'"); FreecycleSunnyvale v. Freecycle Network, 626 F.3d 509, 515–16 (9th Cir. 2010) ("We have previously declared [in *Barcamerica*] that naked licensing is '*inherently* deceptive and constitutes abandonment of any rights to the trademark by the licensor.'").

84. Fed. Trade Comm'n, Franchise Rule Compliance Guide 3 (May 2008), https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf.

85. *Id.*

86. *Id.* at 4.

87. *See, e.g.*, Syncsort Inc. v. United States, 31 Fed. Cl. 545, 549 (1994) (holding license agreements constituted franchise agreements for purposes of tax treatment of payments received by licensor under licenses); Safe Step Walk in Tub Co. v. CKH Indus., Inc., 242 F. Supp. 3d 245, 258 (S.D.N.Y. 2017). Neither *Syncsort* nor *Safe Step* dealt with "simple" licenses: In *Syncsort*, the license agreement gave the licensor the right to prescribe quality standards for the licensee's operations and restricted the licensee's marketing of competitive products, among other things. 31 Fed. Cl. at 549. And in *Safe Step*, the license agreement allowed the licensor "to set minimum sales requirements," to assist with the licensee's marketing plan, to direct changes to the licensee's business model, and to terminate the license agreement for the licensee's failure to provide certain financial reports. 242 F. Supp. 3d at 258.

88. *See* cited cases *supra* note 83.

other franchise-adjacent issues not controlled by the FTC Rule and associated guidance.[89]

B. *Encroachment and Unfair Competition*

Franchisees often look askance at franchisor attempts to increase the franchisor's revenue that they perceive to come at the expense of the franchisee. Of course, a benefit to the franchisor does not necessarily entail a detriment to a franchisee, and franchisor use of e-commerce and alternative distribution channels can raise the franchise's brand profile to the advantage of all involved parties. But, rightly or wrongly, franchisees may claim to lose out where a franchisor seeks to market its own goods or services directly to buyers through alternative distribution channels.[90] These claims often are grounded in allegations of franchisor encroachment or unfair competition.

Encroachment in the traditional sense occurs when a franchisor allows another franchise unit to operate near an existing franchisee's physical premises.[91] But with the recent explosion of e-commerce, a franchisee might claim encroachment based on any number of things. For instance, a franchisor might accept and fulfill an online order by a customer located in a franchisee's exclusive territory. Similarly, a digital delivery platform might route a customer's order through a neighboring franchisee, effectively allowing the neighboring franchisee to sell to customers in the first franchisee's exclusive territory.

Due to the proliferation of arbitration provisions in franchise agreements, many disputes arising from electronic encroachment have been resolved confidentially and outside of the public judicial process.[92] But, as illustrated by a handful of decisions from federal courts, the typical analysis of an electronic encroachment claim starts (and often ends) with the language of the franchise agreement—much like in cases of physical encroachment.

In *Stillwell v. RadioShack Corp.*, the franchisees alleged that RadioShack had breached its franchise agreements by making direct internet sales to

89. For instance, the Internal Revenue Code provides that certain asset transfers from franchisees to franchisors do not qualify for preferential treatment as capital gains. 26 U.S.C. § 1253(a). Such transfers do not qualify as capital gains if the franchisor "retains any significant power, right, or continuing interest" in the franchise. *Id.* This includes the "right to prescribe the standards of quality of products used or sold, or of services furnished." *Id.* § 1253(b)(2)(C). Under this definition, trademark quality controls necessary to avoid naked licensing could establish "significant power" and require tax treatment of licensee payments as franchise fees rather than license fees or royalties.

90. Charles S. Marion, Daniel J. Oates & Ari N. Stern, *Stepping on Toes: Territorial Rights & Encroachment*, Am. Bar Ass'n, 42nd Ann. Forum on Franchising W-14, at 37 (Oct. 7–9, 2019) ("[F]ranchisors' efforts and strategies to expand their on-line presence and business can be viewed suspiciously by franchisees as an attempt by the franchisor to infringe upon their business and customers and cannibalize their revenue.").

91. *See, e.g.*, Barnes v. Burger King Corp., 932 F. Supp. 1420, 1425–41 (S.D. Fla. 1996) (analyzing various legal theories advanced by franchisee in response to franchisor opening another franchised location "approximately five blocks" from the franchisee's location).

92. Emily I. Bridges, *Keep Off My (Virtual) Lawn: Encroachment in the Age of the Internet*, 36 Franchise L.J. 415, 418 (2017).

customers residing in franchisee territories.[93] The franchise agreements granted the franchisees an Area of Primary Responsibility and provided that, within that territory, RadioShack would not (1) open a company store; (2) authorize the operation of a franchised store "without first giving Franchisee an option to open such unit"; or (3) authorize the establishment of an "Authorized Sales Center."[94] The franchisees claimed that, by marketing to customers in the franchisees' territories and otherwise competing with franchisees in their territories, RadioShack had breached the Area of Primary Responsibility provision.[95] RadioShack moved for summary judgment, and the district court granted the motion.[96] The court reasoned that the provision did not prohibit RadioShack from directing customers in franchisee territories to RadioShack's website or company-owned stores or otherwise competing with franchisees beyond the three ways enumerated in the franchise agreement.[97] Although the franchise agreements predated the modern Internet, at the time the agreements were executed RadioShack was engaged in "direct catalog sales via mail order and telephone," which the franchise agreement did not prohibit "in any fashion."[98] As a result, the court concluded that the franchise agreement "[did] not prohibit internet sales by RadioShack."[99]

Similarly, in *Newpaper, LLC v. Party City Corp.*, a Party City franchisee called Newpaper claimed breach of contract based on Party City's online sales to customers in the franchisee's territory.[100] The franchise agreement granted Newpaper the exclusive right to operate franchised stores in its territory.[101] But the agreement expressly placed no restriction on Party City's

> offering or selling products, including the same or materially the same products . . . as those offered and sold by the Newpaper franchised Party City retail goods stores to customers located within the Territory through any channel of distribution, including wholesale sales and sales by or through the internet, and from any premises other than a Party City-owned retail store premises located within the Territory.[102]

The parties also entered an "Internet Addendum" after Party City began selling its products online, under which they agreed that Party City was "not prohibited from selling any products over the Internet, to any customers regardless of location, and in any manner whatsoever."[103] Despite these provisions, Newpaper claimed that Party City's Internet sales breached the

93. Stillwell v. RadioShack Corp., 676 F. Supp. 2d 962, 968 (S.D. Cal. 2009).
94. *Id.* at 967–68.
95. *Id.* at 970.
96. *Id.* at 970–71.
97. *Id.* at 970.
98. *Id.*
99. *Id.*
100. Newpaper, LLC v. Party City Corp., 2013 WL 5406722, at *4 (D. Minn. Sept. 25, 2013).
101. *Id.* at *1. Although not at issue here, the agreement also allowed for three preexisting non-franchisee stores to continue operation in the franchisee's exclusive territory. *Id.*
102. *Id.* at *4.
103. *Id.*

franchise agreement's exclusivity clause.[104] The district court dismissed the breach claim with prejudice, concluding that "the [Franchise] Agreement expressly allows for [online] sales."[105] The court reasoned that the parties "unambiguously and unqualifiedly" agreed that Party City had the right to sell its goods "by or through the internet" and that Newpaper cited no contractual provision "that contradict[ed] or preclude[d] this right."[106]

Stillwell and *Newpaper* teach that, as with other encroachment claims, a franchisor's best defense to a claim of Internet encroachment is a well-drafted franchise agreement.[107] Despite prevailing on the encroachment claim even though its franchise agreements did not expressly reserve the right to sell products online, RadioShack had to shoulder the expense and burden of discovery before it could prevail on summary judgment. In contrast, Party City executed multiple agreements with its franchisee expressly allowing Party City to sell its products online and through alternative distribution channels. This language allowed Party City to obtain the dismissal of the breach claim, thereby minimizing the litigation expenses that it incurred in defending the encroachment claim. As illustrated by these decisions, franchisors should use specific contract language reserving their rights to operate alternative distribution channels, including but not limited to online sales and similar methods of distribution.[108]

Of course, contract language can only go so far in insulating franchisors from claims by franchisees. This is particularly the case where a franchisor acts in a way that directly competes with or otherwise unfairly undermines its franchisees.[109] In *Carvel Corp. v. Baker*, for instance, a franchisor of ice cream stores brought a declaratory judgment action against certain franchisees, seeking a declaration that the franchisor's sales of ice cream directly to supermarkets did not violate the franchise agreements.[110] Historically, the franchisor only allowed its products to be sold at franchised and company-owned stores, not supermarkets.[111] Indeed, the franchisor had "assured franchisees that [it] had no plans to enter the supermarket business due to the devastating effect such a policy would have on its franchisees."[112] But just two years after making these assurances, the franchisor began selling its products in supermarkets.[113] The franchisor moved for summary judgment, but the

104. *Id.* at *2.
105. *Id.* at *5.
106. *Id.*
107. *See* Marion, *supra* note 90, at 38 ("As with the other types of encroachment claims, the best way of minimizing the risk that there will be disputes arising from the franchisor's beginning to distribute and sell its products or services through alternative distribution channels is to include specific language in the franchise agreement detailing what the parties' rights are in such situations.").
108. *See* Bridges, *supra* note 92, at 426.
109. *See, e.g.*, Carvel Corp. v. Baker, 79 F. Supp. 2d 53, 66 (D. Conn. 1997).
110. *Id.* at 55.
111. *Id.* at 56.
112. *Id.*
113. *Id.*

district court denied the motion in large part.[114] The court reasoned that the benefit to franchisees in entering the franchise agreements included "participation in a 'unique system for the production, distribution, and manufacturing of [the franchisor's] products.'"[115] Because sales to supermarkets deprived franchisees of this benefit, the district court found an issue of material fact as to whether the franchisor had violated the implied covenant of good faith and fair dealing and therefore held summary judgment inappropriate.[116] The court reached this conclusion even though certain of the franchise agreements expressly stated that the franchisor had "sole and absolute discretion" to sell its products through "other distribution channels or concepts."[117] As the court explained, the franchisor made direct sales to supermarkets that were direct competitors of the franchise, and franchisees "could have reasonably expected" that the franchisor would not use alternative distribution channels "to compete directly against them, especially since distribution to supermarkets and other retail outlets was not a practice that existed prior to [execution of] the agreement."[118]

Carvel reveals the limits on the power of contract language: some of the franchise agreements expressly allowed the franchisor to sell products through "other distribution channels or concepts" in the franchisor's "sole and absolute discretion," which should have covered sales through supermarkets.[119] But because such sales directly undermined the franchisees' businesses—and because the franchisor had assured franchisees that supermarket sales were off the table just two years before implementing its supermarket program—the district court still denied the franchisor's motion for summary judgment.[120] Perhaps the franchisor could have pursued its supermarket program if its franchise agreements contained a stronger, more specific reservation of franchisor rights. As it stands, *Carvel* shows that even franchisors with well-drafted franchise agreements should scrutinize plans to implement alternative distribution channels. If an alternative distribution channel would undermine franchisees, promote intra-brand competition, or otherwise unfairly compete with franchisees, selling goods or services through that channel creates potential exposure for the franchisor.

IV. Conclusion

This article encourages franchise attorneys, franchisors, and franchisees, as well as licensing parties, to think about the variety of ways that franchise brands can generate revenue outside the traditional franchise relationship operation. Franchisors should not only strive to be creative and seek

114. *Id.* at 66.
115. *Id.* at 62.
116. *Id.* at 61–62.
117. *Id.* at 66.
118. *Id.*
119. *Id.*
120. *Id.*

alternatives for generating increased revenue and brand value, but also consider the ways such alternatives can increase brand recognition to drive more marketplace activity and business to their franchisees. Of course, venturing away from the day-to-day franchise agreement should be done only with careful consideration of the risks and the opportunities. The same diligence and attention paid to finding the right franchisee should also be invested in finding the right alternatives for the franchise brand and the desire to expand in an effort to generate alternative revenue streams.

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CLASS ACTIONS

***Provencher v. Bimbo Bakeries USA, Inc.*, Business Franchise Guide ¶ 17, 414, 705 F. Supp. 3d 238 (D. Vt. Dec. 4, 2023)**

Mr. Gruenberg

Ms. Kalmanson

Mr. Siljander

In a class action alleging distributors of Bimbo Bakeries were misclassified as independent contractors instead of employees, the U.S. District Court for the District of Vermont denied the motion for judgment on the pleadings of the defendants, a wholesale bakery and its affiliate, and granted the plaintiffs' motion to dismiss the defendants' counterclaim.

The complaint alleged that Bimbo distributors worked more than forty hours per week and were entitled to overtime pay that was not received under the federal Fair Labor Standards Act and the Vermont Employment Practice Act. Bimbo filed an answer and counterclaim, asserting that, if the distributors were deemed employees under Vermont law, Bimbo was entitled to restitution of benefits given to distributors based on their presumptive independent contractor status. The Department of Labor moved to intervene for the limited purpose of seeking dismissal of the counterclaim.

Bimbo then filed a motion for judgment on the pleadings of the claim alleging violation of the Vermont Employment Practices Act. Bimbo asserted that the distributors were not paid "wages" under the law because the distribution agreements with the distributors allowed the distributors to delegate their contractual obligations and because payments to distributors came from revenue generated from sales to customers. Bimbo also pointed to language in the agreements stating that the distributors were independent contractors.

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The court began its analysis by recognizing that the parties' agreed "wages" were defined in the statute as "remuneration payable for services rendered." The court, relying on recent Vermont Supreme Court law and weighing reasonable inferences in favor of the nonmoving party, found that the compensation paid to the distributors could be wages. The court observed that the distributors' compensation was paid for their services, not because of the financial growth of the company, although the compensation was contingent on the distributors' performance. The court equated the distributors to delivery drivers for the company. It noted that payments by the company were not "discretionary" and that Bimbo deducted fees from payments that it received purportedly on behalf of the distributors. Acknowledging grey areas in whether Bimbo or the distributors controlled delivery of the services, the court nonetheless found the allegations, treated as true, sufficient to make it plausible to conclude the distributors were paid "wages" under the statute, notwithstanding that the distributors could delegate their work under the agreements. Ultimately, the court determined that the level of control that Bimbo had over its distributors' earning abilities was a question of fact requiring further development. The court therefore denied Bimbo's motion.

With respect to Bimbo's counterclaim, the court declared that it was preempted by the federal Fair Labor Standards Act (FLSA), and that permitting an employer who failed to abide by wage laws the ability to claw back contractual benefits conferred on its employees would both encourage poor employer behavior and discourage employees from bringing misclassification claims. The court also addressed various constitutional claims raised by Bimbo, but remained steadfast that, while an employer could argue payments made should offset their FLSA liability, the FLSA would not permit a recoupment of all benefits given to the distributors based on the misclassification. The court dismissed Bimbo's counterclaim.

CONTRACT ISSUES

Aylin & Ramtin, LLC v. Barnhardt, Bus. Franchise Guide (CCH) ¶ 17,434, 2024 WL 325384 (N.D. Ill. Jan. 29, 2024)

The U.S. District Court for the Northern District of Illinois partially granted the Little Minds Learning Center (Little Minds) franchisor's motion for summary judgment, finding that claims under the Illinois Franchise Disclosure Act and certain misrepresentation claims were properly disposed, but that the franchisee's claims for breach of contract, breach of fiduciary duty, and fraudulent misrepresentation survived.

The franchisee, a foreign national from Iraq, purchased two franchise units from franchisor Little Minds through a visa program providing for citizenship in exchange for United States-based investments in certain businesses. As part of the parties' arrangement, a franchisor-affiliated entity entered into a management agreement to operate the franchisee's two franchise locations. Before the franchise locations ever opened, trouble arose between the parties, with the franchisee alleging that Little Minds improperly misappropriated

its investment funds into other activities. Little Minds acknowledged having made "intercompany loans" to pay for other franchise projects that it claimed were necessary to avoid negatively impacting the franchisee's locations. Ultimately the locations never opened after one landlord effectuated an eviction. The franchisor and its affilaites filed for Chapter 7 bankruptcy protection. The two entity defendants—the franchising and management entities—were discharged, and the individual managing the defendant entities voluntarily waived discharge. This lawsuit followed.

The franchisee alleged that the management entity breached the management agreements for the two locations by failing to pay rent, maintain records, and open the childcare center franchises within a year. The defendant entity argued that the franchisee first breached by failing to provide funding in a timely manner. The court found a genuine issue of material fact existed as to when the first material breach occurred based on evidence that funds had been timely paid.

The court also denied summary judgment of the franchisee's claim that the management company and its individual manager breached fiduciary duties. The court rejected the individual's attempts to dismiss even though the individual was not party to the management contract because he had named himself as manager of the management entity, and a power of attorney specifically named him as an agent with authority over the franchisee's operating account. The court dismissed the fiduciary claims made by the franchisee himself, as opposed to the contracting entity, finding that the defendants (who were not managers of the franchisee entity) did not owe him a fiduciary duty in his individual capacity.

Turning to the franchisee's claims for fraudulent and negligent misrepresentation, the court determined first that the contracts at issue did not contain misrepresentations—only promises of future conduct more appropriately couched as a breach of contract claim. The court therefore determined no misrepresentation claim could be made from the contracts. The court next concluded that, because of the economic loss doctrine, the franchisee's claim for negligent misrepresentation could not survive. However, the court determined that the franchisee's claims that defendants intentionally misrepresented their use of the franchisee's funds and need for additional funds were exceptions to the economic loss doctrine and denied summary judgment.

The court then considered the franchisee's claims under the Illinois Franchise Disclosure Act (IFDA). Opining that the IFDA does not cover claims "based on opinions or statements relating to future or contingent events, such as future costs, sales, and profitability," and rationalizing that the alleged misrepresentations actually were made in the development of the locations and not in connection with an offer or sale, the court dismissed the IFDA claims.

As to remedies, the court determined that damages, and not rescission, would be an appropriate remedy for the franchisee's claims given the substantial performance by the parties, and therefore dismissed a declaratory judgment claim.

***CHHJ Franchising LLC v. Spaulding*, Bus. Franchise Guide (CCH) ¶ 17,432, 2024 WL 229406 (M.D. Fla. Jan. 22, 2024)**

The College Hunks Hauling Junk franchisor sued a former franchisee and owner in the U.S. District Court for the Middle District of Florida, alleging that it breached in-term and post-termination noncompetition agreements and failed to cease using the College Hunks' trademarks in a competing business after the franchise relationship terminated.

College Hunks alleged the franchisee continued to operate a moving business from the same location where its franchise was located and advertised its own name and the College Hunks brand after receiving notice that College Hunks had terminated its franchise agreement. College Hunks alleged claims for breach of the franchise agreement and guaranty, trademark infringement, and unfair competition under federal and state law. It also asserted claims for preliminary and permanent injunction and attorney's fees. The franchisees filed a motion to dismiss, alleging all federal counts failed to state a claim and that the court should, after dismissing them, decline to exercise jurisdiction over state law claims and dismiss the entirety of the case.

The district court noted that the purported counts for injunction and attorney's fees were not actually claims, but rather remedies, and dismissed them. However, the court determined that College Hunks adequately pled its claims for trademark infringement and unfair competition. The court noted that College Hunks' amended complaint alleged that the franchisee continued to use a sign on the exterior of its building that contained College Hunks' mark and continued to advertise and provide moving services. The court stated that the franchisees' opposing factual statements were not sufficient at the pleading stage to dismiss the claims. The court also rejected the franchisee's argument that a mere sign on a building was insufficient to show use of the franchisor's mark in the sale or advertising of services because it found the presence of the franchisee's moving truck with its own moving company name outside of the franchisee's office was sufficient to show the franchisee's building was connected to the services that the franchisee was alleged to have been providing. The court also found that the fact the former franchisee's phone numbers were still connected in phone listings with College Hunks' trademark was likely to cause confusion. While the court noted College Hunks did not identify any actual consumers who were confused, it stated that the pleadings placed College Hunks' claims "above the speculative level," sufficient to survive the motion to dismiss.

***G&S Beshay Trading Co., LLC v. 7-Eleven, Inc.*, Business Franchise Guide ¶ 17,422, 2024 WL 21391 (D.N.J. Jan. 2, 2024), *appeal filed* June 20, 2024.**

In a lawsuit that followed the collapse of the franchise relationship, the U.S. District Court for the District of New Jersey held that the franchisee could not relitigate claims that it had lost earlier and awarded damages on the franchisor's counterclaims.

G&S Beshay Trading Co., LLC (Beshay) was a franchisee of 7-Eleven, Inc. (7-Eleven), the convenience store franchise. When the parties' franchise relationship deteriorated, Beshay sued 7-Eleven, and 7-Eleven filed counterclaims. Beshay claimed fraud in the inducement, breach of the implied covenant of good faith and fair dealing, and breach of contract. 7-Eleven sought to dismiss Beshay's complaint in the entirety, and Beshay filed an amended complaint. 7-Eleven answered and asserted counterclaims for breach of the two underlying agreements—the franchise agreement and guaranty by Mr. Beshay, the sole owner of Beshay Co.

7-Eleven later moved for summary judgment on its counterclaim damages. The court had previously determined that the franchisee's offensive claims where without merit. That, in turn, resulted in the court having concluded that 7-Eleven's counterclaims did have merit. On summary judgment, the only issue before the court on 7-Eleven's motion was 7-Eleven's damages. The court granted 7-Eleven's motion for summary judgment and entered judgment for $42,123.88. In doing so, the court determined that most of Beshay's arguments in opposition to 7-Eleven's motion for summary judgment were revisiting arguments that were already resolved by the court's prior decision dismissing Beshay's claims and, therefore, failed under the "law of the case doctrine." The court found that the prior "findings were [not] clearly erroneous or manifestly unjust," and, therefore, the court would not reconsider such findings. The court determined summary judgment was appropriate because 7-Eleven met its burden with the evidence provided in its motion—including "detailed testimony and accounting records." Accordingly, the court granted 7-Eleven the damages it sought of $42,123.88. Beshay has filed an appeal in the U.S. Court of Appeals for the Third Circuit, which remains pending.

DAMAGES

***Aylin & Ramtin, LLC v. Barnhardt*, Bus. Franchise Guide (CCH) ¶ 17,434, 2024 WL 325384 (N.D. Il., Jan. 29, 2024).** This case is summarized under "Contract Issues."

FORUM SELECTION

***Honest Abe Roofing Franchise, Inc. v. Lesjon Holdings, LLC*, Bus. Franchise Guide (CCH) ¶ 17,409, 705 F. Supp. 3d 872 (S.D. Ind. Dec. 6, 2023)**
In this case, the U.S. District Court for the Southern District of Indiana was called to determine which forum selection clause must be enforced. Franchisor Honest Abe Roofing Franchise, Inc. (Honest Abe) is "a roofing franchise business." Its franchisee Lesjon Holdings, LLC (Lesjon) was run by its sole member. The parties entered into litigation after a dispute over Lesjon's performance of its obligations under franchise-related agreements. Lesjon filed a motion to dismiss Honest Abe's lawsuit, arguing improper venue.

The relevant franchise agreements had competing forum-selection clauses. The Guaranty signed by Lesjon's owner had a forum selection clause providing for jurisdiction in Indiana, which Honest Abe argued was

mandatory. The Franchise Agreement, however, had a forum selection clause providing for jurisdiction in Illinois, where Lesjon had agreed to operate its franchise in Illinois.

As the federal court explained, the issue was that "[b]oth clauses appear contradictory" and "mandatory, but only one clause can be enforced." The court said that its "analysis turn[ed] on which of [the] contractual terms are primary, and which are secondary." The court determined that "claims under the Franchise Agreement are primary, and those under the Guaranty are secondary" because "a breach of the Guaranty requires a breach of the Franchise Agreement." Therefore, "[u]nless public interest factors militate[d] to the contrary," the court held that the appropriate venue was Illinois under the Franchise Agreement. *Id.*

After analyzing public interest factors, the court determined that "[t]he interest-of-justice factors weigh in favor of transferring [the] case to the Central District of Illinois, consistent with the forum selection clause in the Franchise Agreement." It went on to analyze whether the Southern District of Indiana was even a proper venue under the federal venue statute in the first place, determining that "Illinois is a proper venue. Indiana is not." Accordingly, the court granted the motion in part and transferred the case to the U.S. District Court for the Central District of Illinois.

FRAUD

***Aylin & Ramtin, LLC v. Barnhardt*, Bus. Franchise Guide (CCH) ¶ 17,434, 2024 WL 325384 (N.D. Ill., Jan. 29, 2024).** This case is summarized under "Contract Issues."

INJUNCTIVE RELIEF

***Brava Salon Specialists, LLC v. Swedish Haircare, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,401 2023 WL 7709310 (W.D. Wisc. Nov. 15, 2023)** In this decision, a federal district court refused to modify an injunction to allow a manufacturer to take certain actions that would have impaired plaintiff's exclusive territory and instead allowed the plaintiff to add the defendant's international parent and add a claim under the Wisconsin Fair Dealer Law (WFDL).

Franchisee Brava Salon Specialists, LLC (Brava) had a contract that allowed it to distribute haircare products manufactured by REF North America, Inc. (REF) and appointed it the exclusive distributor of the products in Wisconsin, Minnesota, North Dakota, and Iowa. REF then started to fill direct orders made online. Brava brought suit, claiming that this violated it exclusive territory rights. The court agreed and entered a preliminary injunction preventing REF from selling its products in the exclusive territory online into Brava's territories and to take steps to prevent that its other dealers did not make online sales or other sales into the exclusive territory.

REF, believing that the inability to sell product on Amazon.com was harmful to its entire brand, made changes to its sales practices on Amazon

without telling Brava. It then sought permission from the court after the fact to amend the injunction to allow it to sell products on Amazon so long as it provided Brava with a summary of Amazon sales and paid Brava an amount equal to what it would have earned on the sales. It also said that it would ensure that products were not listed on Amazon at a price below the manufacturer's suggested retail price. Brava opposed the change, arguing that it would simply be a change to the distribution agreement, in violation of the WFDL. Specifically, Brava claimed that it was not given notice of the proposed change as required under the WFDL. Further, the court explained that REF had not satisfied the WFDL's substantive requirements of showing that there was an objectively ascertainable needs for the change, it was a proportionate response to the need, and that it was nondiscriminatory. The court highlighted the lack of concrete evidence to support REF's position and denied the motion to change the injunction.

The court then addressed whether Brava could amend the complaint to add REF's international parent and to add WFDL claims based on REF's recent attempts to change the parties' relationship. The court granted both requests. As to the foreign parent, it found that there were sufficient allegations of the foreign parent's direct involvement in the matter to allow for the amendment. As to the additional WDDL claims, the court held that Brava could not have anticipated the claims and that any disputes about their sufficiency were fact questions that could not be resolved on a motion to amend.

***CHHJ Franchising LLC v. Spaulding*, Bus. Franchise Guide (CCH) ¶ 17,432, 2024 WL 229406 (M.D. Fla. Jan. 22, 2024)**. This case is summarized under "Contract Issues."

***LeTip World Franchise LLC v. Long Island Social Media Group LLC*, Bus. Franchise Guide (CCH) ¶ 17,435, 2024 WL 380985 (D. Ariz. Feb. 1, 2024)**

The U.S. District Court for the District of Arizona granted a business leads franchisor's request for a preliminary injunction enforcing noncompetition covenants in franchise agreements with a former franchisee.

The franchisor alleged that the franchise agreements were terminated by the franchisor after the franchisee displayed on his boat a modified version of one of the franchisor's trademarks containing a sexual inuendo and failed to remove it after formal demand from the franchisor. The franchisor alleged that, after termination, the franchisee announced on his Linkedin profile that he was starting a new position as a regional director for a competing business with the same address as the former franchisee address.

The franchisor filed a complaint and motion for preliminary injunction a week before the franchisee's purported "launch party" date, seeking to prevent its occurrence. The court embarked on the familiar likelihood of success and irreparable harm analysis. First, the court determined that the post-termination covenants' two-year duration was reasonable. While the franchise agreements

provided that the geographic scope included not only the franchisee's territory, but also any area in which the franchisor or its franchisees operated, the franchise agreements' language provided that the scope would be narrowed to only the franchisee's territory if a court believed the larger scope was too broad. The court opined that it did not believe a geographic scope beyond the former franchisee's territory was reasonable and noted that counsel for the parties at the hearing agreed the geographic scope of the noncompetition agreement would not extend beyond the franchisee's territory. The court concluded that the franchisor showed a likelihood of success for its claim that the franchisee violated the noncompetition agreement.

The court similarly concluded that the franchisor showed a likelihood of success for its tortious interference claim, which alleged the other defendants—the new competing entity through which the franchisor operated and a third party who was involved in the new business—intentionally interfered with its business expectancies by causing the franchisee and its owners to breach their franchise agreement and franchise owner agreement.

The court succinctly concluded that creating a new business venture seeking the same customers that the former franchisee solicited in the same territory in which it operated was causing irreparable harm. It also determined that the equities favored the franchisor and that the public interest was served by protecting a company's proprietary information and contractual rights.

LABOR AND EMPLOYMENT

***Provencher v. Bimbo Bakeries USA, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,414, 705 F. Supp. 3d 238 (D. Vt. Dec. 4, 2023)**. This case is summarized under "Class Actions."

NON-COMPETE AGREEMENTS

Baldwin v. Express Oil Change, LLC, Bus. Franchise Guide (CCH) ¶ 17,410, 87 F.4th 1292 (11th Cir. 2023)

In December 2023, the Eleventh Circuit issued its decision reviewing the lower court's preliminary injunction in *Baldwin v. Express Oil Change, LLC*, which enjoined enforcement of a restrictive covenant between franchisor Express Oil Change, LLC (Express) and a former employee (Baldwin).

Express is "a national automotive service chain," and Baldwin worked for Express "as an employee of various franchisees" for more than twenty years. In its decision, the appellate court addressed "a novel issue of [Georgia] state law: the proper application of the presumptions of reasonableness contained in the Georgia Restrictive Covenants Act (GRCA)." Applying the GRCA, "the lower court preliminarily enjoined the enforcement of a restrictive covenant" between Express and Baldwin. Specifically, in the covenant (which Baldwin signed in connection with new ownership of the franchise), Baldwin "promised that he would not 'engage in, invest in, become an owner of, advise, or become a landlord and/or lender of, or employed by, or construct

a facility for . . . a Competitive Business' within a defined 'Non-Competition Area.'" The covenant defined the non-competition area to include all of Georgia and Alabama, as well as "a five (5) mile radius of any automotive repair or service facility business operated by [Express and affiliates] in the continental United States." This definition ultimately meant Baldwin could not compete within five (5) miles of "at least 1,100 franchises in 29 states."

The covenant provided a four-year term but provided that, "after 18 months, the non-competition area would no longer include the entirety of Georgia and Alabama, and Baldwin would be permitted to become an employee of a competitive business, even within the reduced non-competition area." *Id.*

Baldwin continued working for Express for a period of time after the new ownership took place, but his employment ultimately ended. When he was looking into "purchasing an independent repair shop located just under five miles from an Express location," he sought permission from Express, which was denied. He then sued Express, challenging the validity of the geographic scope and timeframe of the restrictive covenant under the GRCA. He argued that the "term of the covenant was presumptively unreasonable and the geographic scope of the covenant was unreasonably broad."

After an evidentiary hearing, the trial court "issued a preliminary injunction partly enjoining Express from enforcing Baldwin's covenant." The court found that "Express had a legitimate business interest in 'preventing Baldwin from luring away its technicians and, vicariously, its customers.'" However, "the district court concluded that two aspects of [the geographic scope] of the covenant were unreasonable and unenforceable under the GRCA": (1) "the scope of the geographic restrictions—the entirety of two states and the five-mile radius surrounding more than 1,100 franchised locations—was far greater than necessary to protect Express's interest in retaining its technicians"; and (2) the covenant's four-year term was presumptively unreasonable under the GRCA, which presumes anything over two years to be unreasonable. The district court further edited the covenant and enjoined Express from enforcing the covenant except as revised. As to the geographic scope, the district court limited the covenant to "competitive activities within five miles of any" of the eighteen locations that Baldwin managed while working for Express.

Upon review, the Eleventh Circuit agreed with the district court that the covenant's geographic scope was unreasonable because it went much further than was needed to protect Express's legitimate interests. As to the time frame, the Eleventh Circuit determined that "the district court applied the wrong presumption when it concluded that the covenant's duration was unreasonable under the GRCA." Specifically, the Eleventh Circuit held that the district court should have applied the statutory five-year presumption rather than the two-year presumption due to Baldwin's relationship with Express. Thus, the court affirmed in part, vacated in part, dismissed the appeal in part, and remanded the case to the lower court for further consideration.

***LeTip World Franchise LLC v. Long Island Social Media Group LLC*, Bus. Franchise Guide (CCH) ¶ 17,435, 2024 WL 380985 (D. Ariz. Feb. 1, 2024).** This case is summarized under “Injunctive Relief.”

STATE DISCLOSURE/REGISTRATION LAWS

***Aylin & Ramtin, LLC v. Barnhardt*, Bus. Franchise Guide (CCH) ¶ 17,434, 2024 WL 325384 (N.D. Ill. Jan. 29, 2024).** This case is summarized under “Contract Issues.”

STATUTORY CLAIMS

***Brava Salon Specialists, LLC v. Swedish Haircare, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,401, 2023 WL 7709310 (W.D. Wisc. Nov. 15, 2023)**. This case is summarized under “Injunctive Relief.”

***Provencher v. Bimbo Bakeries USA, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,414, 705 F. Supp. 3d 238 (D. Vt. Dec. 4, 2023)**. This case is summarized under “Class Actions.”

TORTIOUS INTERFERENCE

***Reecon North America, LLC v. Enerco Group, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,417, 2023 WL 8529131 (W.D. Pa. Dec. 8, 2023)**

The U.S. District Court for the Western District of Pennsylvania denied a motion to dismiss claims for tortious interference made by a distributor, who alleged a former potential purchaser interfered with the distributor’s exclusive supply agreement with a supplier by entering into its own supply agreement with the supplier.

In due diligence, and having entered into a nondisclosure agreement, the potential purchaser learned that the distributor had an exclusive supply agreement with the supplier and, nevertheless, entered into a separate distribution agreement with the same supplier while the distributor’s exclusive supply agreement remained in effect. The distributor discovered the potential purchaser’s misdeeds in separate litigation brought by the supplier alleging breach of the exclusive supply agreement by the distributor.

The potential purchaser argued that the distributor could not state a claim for tortious interference because the supplier had sued the distributor for breach of the exclusive supply agreement before the present case was filed, and therefore there was no enforceable agreement with which to interfere. The court refused this argument, stating no finding had been made that the distributor breached the exclusive supply agreement.

The potential purchaser also argued it was privileged to interfere with the exclusive supply agreement because it was a competitor of the distributor. However, the court noted that the competitor exception applied only to prospective contractual relations, which competitors could jointly pursue, and did not apply to the prospective purchaser’s efforts to persuade the supplier to breach its existing contract (not terminable at will) with the

distributor. The court therefore denied the potential purchaser's motion to dismiss the claim.

The court also refused to stay the case pending the outcome of the state litigation because the court concluded that the existing state-court case was not a parallel state-court action and there were not other extraordinary circumstances warranting abstention. Applying the *Colorado River* doctrine, the court found that the state court litigation was not duplicative because the potential purchaser was not even a party to the state case and "the overlap of one party does not make the two cases sufficiently parallel." The court then weighed the six *Colorado River* factors and, noting that "abstention is the exception, not the rule," found little in the six factors to support a stay. The court, therefore, refused to dismiss or stay the case.

TRADEMARK INFRINGEMENT

***CHHJ Franchising LLC v. Spaulding*, Bus. Franchise Guide (CCH) ¶ 17,432, 2024 WL 229406 (M.D. Fla. Jan. 22, 2024)**. This case is summarized under "Contract Issues."

***LeTip World Franchise LLC v. Long Island Social Media Group LLC*, Bus. Franchise Guide (CCH) ¶ 17,435, 2024 WL 380985 (D. Ariz. Feb. 1, 2024)**. This case is summarized under "Injunctive Relief."

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE TRADE PRACTICES

***CHHJ Franchising LLC v. Spaulding*, Bus. Franchise Guide (CCH) ¶ 17,432, 2024 WL 229406 (M.D. Fla. Jan. 22, 2024)**. This case is summarized under "Contract Issues."

***United States v. Burgerim Group USA, Inc.*, Bus. Franchise Guide (CCH) ¶ 17,405, 2024 WL 661189 (C.D. Cal. Jan. 19, 2024)**

In February 2022, the United States sued Burgerim Group USA, Inc. (Burgerim USA), Burgerim Group, Inc. (Burgerim Inc. and together with Burgerim USA, Burgerim), and Oren Loni (Loni) seeking a "permanent injunction and monetary judgments for civil penalties and consumer redress under Section 5 of the Federal Trade Commission Act (FTC) and the FTC's Franchise Rule. The United States alleged that Burgerim and its CEO Oren Loni "sold at least 1,550 franchises of their casual, fast food burger restaurant" between 2015 and 2019. Franchisees were required to pay "a fee between $50,000 and $70,000 for a single franchise location," which "did not include other costs such as securing a location, constructing the restaurant, outfitting it with necessary equipment, and obtaining products and supplies." Despite being "banned and/or sanctioned in several states," Burgerim "continue[d] to advertise the franchise opportunity on their website." In addition to the high fees, Burgerim and Loni "intentionally downplayed the financial risk of their operation in various ways" and provided prospective franchisees with "deficient FDDs."

The United States filed a complaint against Burgerim and Loni. In November 2023, "the Court entered an Order for Permanent Injunction and Monetary Judgments for Civil Penalty and Consumer Redress as to Defendant Loni, per the parties' stipulation." Burgerim failed to appear. After the clerk entered a default against Burgerim, the United States sought default judgment.

On January 19, 2024, the court granted the United States' motion for default judgment. The court found that the government's alleged "'numerous claims to prospective franchisees' that were either expressly false or likely to mislead." "For example, [Burgerim] promised to refund franchise fees if a customer was unable to open for business, but did not do so in the majority of cases." *Id.* Overall, the court found that the "the allegations and evidence provided in support of the [motion for default judgment] satisfy the elements of [the government's] Section Five claim." Likewise, the court determine that the allegations were sufficient to substantiate the government's claim under the Franchise Rule.

The court entered a permanent injunction against Burgerim to prevent Burgerim "from participating in the exact conduct that gives rise to this lawsuit, such as the sale of additional franchises, making misrepresentations in relation to any business opportunity, and standard provisions for FTC compliance reporting and monitoring."