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Deadline for 2017 Edward Wood Dunham Rising Scholar Award Announced

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

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

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

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

Gary R. Batenhorst

You will be receiving this edition of the Franchise Law Journal as we move into another summer season. We hope you enjoy good weather and some time away from the challenges of practicing franchise law. When you make time for some franchise reading, we have some great articles for your review.

Let me start with a final pitch for this year’s Edward Wood Dunham Rising Scholar Award. More information can be found on the Award in this issue. It is a writing competition for franchise lawyers from zero to four years out of law school, and it’s a wonderful way to start a Forum writing career. The deadline for entries for this year’s competition is July 17, 2017. Now on to the Spring issue.

We lead off with Forum stalwart, Tami McKnew, and her colleague Emily Bridges, providing an excellent synopsis of the federal Defense of Trade Secrets Act in I’ve Got a Secret . . . and I’m Willing to Use It! Franchisors, Franchisees, and Trade Secrets. This new statute provides federal law protection for trade secrets, an important component of most franchise systems. Many of you will recognize Emily as the winner of the 2016 Edward Wood Dunham Rising Scholar Award for her article on encroachment in the age of the Internet, which appeared in the Winter 2017 issue of the Journal.

Many franchise agreements contain forum selection clauses. The decision by the U.S. Supreme Court in the Atlantic Marine case gave added strength to these clauses. But as John Doroghazi and David Norman tell us in What’s Left to Litigate About Forum Selection Clauses? Atlantic Marine Turns Four, there are still some open issues in the enforcement of these clauses. This is a must read for lawyers looking to enforce or upend forum selection clauses.

Puerto Rico has a franchise relationship statute that is the subject of a very interesting article by Ricardo Casellas Sánchez and Carla Loubriel Carrión entitled Litigating Dealer Termination Cases in Puerto Rico. Although it is a U.S. commonwealth, Puerto Rico is a civil law jurisdiction. The authors give us an

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Gary R. Batenhorst (gbatenhorst@clinewilliams.com) is a partner in the Omaha office of Cline Williams Wright Johnson & Oldfather, L.L.P, where he focuses on franchising and distribution, business organization, and mergers and acquisitions. He welcomes comments from readers.
excellent primer on the differences that flow from this distinction and provide a wealth of helpful information on litigating these cases in both federal and commonwealth courts.

In 2010, the Supreme Court decided the *Mac’s Shell* case dealing with constructive termination in the context of the Petroleum Marketing Practices Act. In *Seven Years Hence: Constructive Termination Since Mac’s Shell*, Jessica Farley, Joseph Goode, and Mark Leitner provide a very useful look at how constructive termination claims, both in PMPA cases and in other areas, have fared since this decision.

As an aging baby boomer, I am aware that much has been written about aging baby boomers and some of the issues they face, financially and otherwise. We are pleased to make a welcome contribution to that scholarship with *Succession Planning for Franchisees* by Bruce Schaeffer and Eli Akhavan. As many franchise owners look to transition their businesses, whether to third parties or family members, they face a daunting series of issues, including tax, estate planning, and franchise relationship matters. Bruce is a well-known author on franchise valuation issues, and we are pleased to have him and Eli provide very helpful information on this topic.

We close the articles in this issue with *Are Material Changes to Renewal Franchise Agreements Subject to the Implied Covenant of Good Faith and Fair Dealing?* Keith Kanouse, Evan Goldman, and Scott Salmon give us a thought provoking perspective on the issues that arise when franchisees are presented with material changes in the franchise agreement when they seek to renew.

Rounding out this issue is an excellent set of *Currents* by lead editor Trish Treadwell and Maral Kilejian and Kevin Shelley. Thanks to each of them for their hard work, and special thanks to Trish for her excellent work in editing the article on litigating dealer cases in Puerto Rico. One final note of thanks goes to Associate Editor Dan Oates. Dan has for a number of years taken responsibility for updating the cumulative index of *Journal* articles. The recently updated index now appears on the Forum’s website where it serves as a valuable resource for your franchise research. We appreciate all of Dan’s efforts in keeping it up to date.
SAVE THE DATE

40th Annual Forum on Franchising
October 18 – 20, 2017
JW Marriott Desert Springs
Palm Desert, CA
I’ve Got a Secret . . . and I’m Willing to Use It! Franchisors, Franchisees, and Trade Secrets

Natalma M. (Tami) McKnew and Emily I. Bridges

Trade secrets are important assets of many franchise systems. They provide value to franchisors and franchisees, whose decision to become a franchisee may be based on the perceived value of the trade secrets and know-how the franchisor will impart to the franchisee. A trade secret can be as amorphous as a business method or process, or as precise as proprietary software, a recipe, or a formula. The key, as set forth in most state enactments of the Uniform Trade Secrets Act (UTSA), is that the trade secret “derives independent economic value, actual or potential, from not being generally known to, and not be readily ascertainable by proper means by . . . other persons” and “is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.”

But depending on the jurisdiction in which the UTSA’s application may be tested, the same “thing” may or may not meet the definition of a “trade secret.” And some states may be willing to grant temporary or preliminary injunctive relief quickly to prevent the misappropriation or unauthorized use of a trade secret, although others may not. Remedies may also vary from state to state: enhanced damages may not be available, attorney fees may not be recoverable, and permanent injunctive relief may or may not be an accepted remedy. There is also no specifically authorized seizure remedy. Both franchisor and franchisee operate in a fog-covered landscape.

Enter the Defend Trade Secrets Act (DTSA), enacted as an amendment to the Economic Espionage Act (EEA), 18 U.S.C. §§ 1831, et seq., which

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1. See, e.g., Washington’s version of the Uniform Trade Secrets Act, WASH. REV. CODE § 19.108.020(1).
became effective on May 11, 2016. Several sections that create a federal civil cause of action for trade secret misappropriation or disclosure complete with rapidly deployable actions to halt ongoing violations and enhanced remedies for injured parties were added to EEA’s pre-existing criminal sanctions for criminal economic espionage. Although the importance of a uniform federal cause of action for trade secret misappropriation (and jurisdiction in federal court) should not be underestimated, the DTSA does not preempt state UTSAs, inviting conflict not only among the various states, but between the DTSA and state versions of the UTSA.

This article explores the DTSA, reviews the limited case law under the Act, addresses nascent issues that may inform emerging DTSA jurisprudence, and offers practice tips to franchise lawyers.

I. The Statute

In 1996, the Economic Espionage Act\(^2\) created a federal criminal cause of action for economic espionage, specifically providing in 18 U.S.C. § 1831(a):

> Whoever, intending or knowing that the offense will benefit any foreign government, foreign instrumentality, or foreign agent, knowingly—

(1) steals, or without authorization appropriates takes, carries away, or conceals, or by fraud, artifice, or deception obtains a trade secret;

(2) without authorization copies, duplicates, sketches, draws, photographs, downloads, uploads, alters, destroys, photographs, replicates, transmits, delivers, sends, mails, communicates, or conveys a trade secret;

(3) receives, buys or possesses a trade secret, knowing the same to have been stolen or appropriated, obtained, or converted without authorization;

(4) attempts to commit any offense described in any of paragraphs (1) through (3); or

(5) conspires with one or more other persons to commit any offense described in any of paragraphs (1) through (3), and one or more of such persons do any act to effect the object of the conspiracy,

Shall . . . be fined not more than $5,000,000 or imprisoned not more than 15 years, or both.

The EEA created a uniform federal means to protect trade secrets with all the attendant force of federal criminal enforcement. But it did not provide a correlative private cause of action. Variations of the UTSA formed a patchwork of protection for trade secrets, and decades of case development had fleshed out the scope of those statutes.\(^3\) Although each state’s version of the UTSA creates a cause of action for claims arising out of the misappro-


\(^3\) Forty-eight states have adopted some version of the Uniform Trade Secrets Act. New York and Massachusetts have not.
pribation or wrongful use of a trade secret, consistency among the states as to their scope and application varies—sometimes drastically so.

The efficacy of a private federal civil cause of action for trade secret misappropriate was the subject of a long-running debate that intensified in 2012, when federal civil trade secret legislation was introduced in the Senate, then amended and reintroduced in 2014.\(^4\) On the other side of the Hill, the Trade Secrets Protection Act of 2014 was introduced in the House. Finally, in 2016, S. 1890, incorporating features from both the earlier House and Senate proposals, became law.\(^5\) The goals of the DTSA mirrored those of the EEA, albeit in a civil, rather than criminal, format: a federal cause of action for misappropriation or disclosure of trade secrets with enforcement teeth. Thus, the DTSA provides federal jurisdiction, includes enhanced remedies for violations, and provides a basis for expedited actions. It does not preempt state trade secret laws, however.

Much of the language of the DTSA mirrors that of the UTSA, with numerous nearly identical provisions. Both the UTSA and the DTSA provide that a claim for misappropriation must be brought within three years after the misappropriation has been discovered or should have been discovered through reasonable diligence.\(^6\) The two acts also offer a trade secret owner similar civil damage recoveries. If a trade secret owner proves misappropriation, civil recovery may include actual damages as well as damages for any unjust enrichment caused by the misappropriation that is not addressed in any actual loss computation.\(^7\) An alternative remedy available under both the UTSA and the DTSA allows a trade secret owner to collect damages measured by a reasonable royalty for unauthorized misappropriation.\(^8\) Both the UTSA and the DTSA provide that, if the misappropriation is willful and malicious, a court may award exemplary damages of no more than two times the compensatory damages awarded.\(^9\) Finally, both the UTSA and the DTSA permit the recovery of reasonable attorney fees in cases of willful and malicious misappropriation.\(^10\)

Notwithstanding the similarities, however, the DTSA is not a mere federal enactment of the UTSA.

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5. Legislative history of the DTSA includes a House Judiciary Committee Report, two hearings in 2014 (in the House and in the Senate), a Senate hearing in 2015, written statements submitted in connection with those hearings, and written responses to questions posed by legislators. Although a complete review of these documents is not within the scope of this article, a fair observation is that the concerns and views recited herein were expressed by legislators, witnesses, and commentators during the process of enacting the DTSA.
6. UNIFORM TRADE SECRETS ACT § 6; 18 U.S.C. § 1836(d). Individual states may have different statutes of limitations for misappropriation actions.
A. Federal/State Interaction

Although the scope of the DTSA has yet to be explored, some of the statutory differences may prove more significant than a comparison with the UTSA may suggest, particularly as early DTSA cases in federal court reflect litigants piggybacking DTSA and state UTSA claims.\(^{11}\) Some DTSA remedies differ from those typically available under state UTSA, and even the definition of “trade secret” differs, as a Washington district court observed in *Earthbound Corp. v. MiTek USA, Inc.* without further exegesis.\(^{12}\) The DTSA defines a trade secret as:

\[
\text{[A]ll forms and types of financial, business, scientific, technical, economic, or engineering information, including patterns, plans, compilations, programs, devices, formulas, designs, prototypes, methods, techniques, processes, or codes, whether tangible or intangible, and whether or how stored, compiled, or memorialized physically, electronically, graphically, photographically, or in writing if—}
\]

(A) the owner thereof has taken reasonable measures to keep such information secret and (B) the information derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable through proper means by, another person who can obtain economic value from the disclosure or use of the information.\(^{13}\)

By contrast, the UTSA, including the 1985 amendments, defines a “trade secret” as:

\[
\text{[I]nformation, including a formula, pattern, compilation, program, device, method, technique or process, that (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.}
\]

During legislative consideration of the DTSA, commentators mentioned the increasing difficulty in applying the pre-electronic language of the UTSA in a sophisticated electronic, cyber-based marketplace in which information can be instantly and widely transferred around the world. UTSA specifically address paper records, files, hard copy transmission, and physical archives—typical media in the pre-cyberworld. Whether the definitional difference between UTSA and the DTSA will significantly impact the scope of assets protected under federal as opposed to state law remains to be seen.

This simple observation of the court in *Earthbound* illuminates a potential conundrum for courts interpreting and enforcing the DTSA—to what precedents might a court refer for guidance? Decades of well-developed jurisprudence under state UTSA would seem a tempting point of reference, yet as the court in *Earthbound* observed, the DTSA is not identical to the UTSA. Further, the very fact that Congress enacted a *federal* civil remedy for trade

\(^{11}\) For reference, this article was mostly written in January 2017, although research and outlining preceded the writing.


\(^{13}\) 18 U.S.C. § 1839.
secret misappropriation reflects congressional sentiment that a distinct federal law was needed.

As the U.S. District Court for the Middle District of Florida noted in Adams Arms, LLC v. Unified Weapon Systems, Inc., the DTSA prohibits two kinds of misappropriation—acquisition of trade secrets and disclosure of trade secrets.\textsuperscript{14} Although the definition of “misappropriation” under the UTSA and the DTSA are substantively similar, there are stylistic differences.\textsuperscript{15} One difference that may prove noteworthy involves the definition of “improper means” under each Act. “Improper means” under both the UTSA and DTSA include “theft, bribery, misrepresentation, breach or inducement of a breach of a duty to maintain secrecy, or espionage through electronic or other means.”\textsuperscript{16} The UTSA and DTSA may differ, however, in what types of acts are not considered “improper means.” Under the UTSA, “improper means” is defined by negative implication; “proper means” is defined, leaving the “improper means” label available for other conduct. The UTSA defines “proper means” to include:

1. Discovery by independent investigation;
2. Discovery by ‘reverse engineering,’ that is, by starting with the known product and working backward to find the method by which it was developed. The acquisition of the known product must, of course, also be by a fair and honest means, such as purchase of the item on the open market for reverse engineering to be lawful;
3. Discovery under a license from the owner of the trade secret;
4. Observation of the item in public use or on public display;
5. Obtaining the trade secret from published literature.\textsuperscript{17}

The DTSA operates from the opposite end of the definition without a definition of “proper means,” but instead refers to what does \textit{not} comprise “improper means.” Under the DTSA, improper means: “does not include reverse engineering, independent derivation, or any other lawful means of acquisition.”\textsuperscript{18} By not limiting what constitutes “proper means” of obtaining information, a court applying the DTSA could declare methods as permissible (or impermissible) that might have been defined differently under a state UTSA.

Entirely unique to the DTSA are provisions that offer protection to whistleblowers who disclose trade secrets for the purpose of reporting a possible violation of law.\textsuperscript{19} These immunity provisions grant specific protection for an individual who discloses a trade secret to a government official, or even a private attorney, for the purpose of reporting a potentially unlawful act. The whistleblower cannot be held criminally or civilly liable under any federal or state statute if he discloses the trade secret in confidence to a permissible

\textsuperscript{14} No. 8:16-cv-503, 2016 WL 5391394, at *5 (M.D. Fla. Sept. 27, 2016).
\textsuperscript{15} Compare UNIFORM TRADE SECRETS ACT § 1(2) with 18 U.S.C. § 1839(5).
\textsuperscript{16} UNIFORM TRADE SECRETS ACT § 1(1); 18 U.S.C. § 1839(6)(A).
\textsuperscript{17} Comment, UNIFORM TRADE SECRETS ACT § 1(1).
\textsuperscript{18} 18 U.S.C. § 1839(6)(B).
\textsuperscript{19} 18 U.S.C. § 1833(b)(1).
person so that the person may investigate the claim of unlawful activity, or if the disclosure is made in a court filing so long as the filing is made under seal. Whistleblower immunity is considered an affirmative defense, and individuals accused of misappropriation must provide evidence other than their own statements to support a claim for whistleblower protection.20

The DTSA requires employers to provide notice of the DTSA’s whistleblower protections to employees, contractors, or consultants. The notice must appear “in any contract or agreement . . . that governs the use of a trade secret or other confidential information.”21 If an employer does not provide the notice, the employer is prohibited from recovering either exemplary damages or attorney fees under the DTSA.22

Although the DTSA uses the word “employer,” a franchisor may be subject to the notice requirement. The term “employee” to whom an employer must give notice, includes any individual performing work as a contractor or consultant for an employer.23 A court may view a franchisee as either a contractor or consultant for the franchisor; thus, a franchisor should consider providing a DTSA notice to franchisees in the franchise agreement.

The DTSA’s seizure provisions were the most controversial aspects of the legislation.24 They have no statutory equivalent in the UTSA. For some, seizure represented a means to quickly halt the theft of trade secrets; for others, it suggested law enforcement personnel dressed in black with battering rams breaking into the homes of entrepreneurs and harassed employees. Legislators and commentators expressed concern over: (a) whether and how much force law enforcement should be permitted to use to effect seizure; (b) the unintended effects of seizure on hosts of cloud data storage and other innocent parties; (c) potential use of seizure to shut down entrepreneurial competitors or doom them in the press; (d) the danger of seizing innocent data (perhaps even the target’s own trade secrets); and (e) the in terrorem effect of even a threat of seizure on employees and small business. The debate resulted in DTSA provisions that are designed to safeguard against what may broadly be defined as potential abuse. Whether those safeguards are balanced between rendering the DTSA ineffective and preventing abuse will have to wait for the case law to develop.

The DTSA defines a judicial inquiry on seizure in a manner that is similar to a preliminary injunction standard of proof, but on steroids. Ex parte seizure orders may issue only in “extraordinary circumstances.”25 To support any seizure request, on notice or ex parte, the applicant/plaintiff must demonstrate by “clear” evidence: (a) immediate and irreparable harm, (b) the in-

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adequacy of any alternate equitable relief, (c) a balance of harms that favors the plaintiff, and (d) a likelihood of success on the merits. In addition, the applicant must show that the defendant actually possesses the trade secrets; that absent seizure that person would “destroy, move, hide or otherwise make such matter inaccessible to the court”; and that “the applicant has not publicized the requested seizure.” The seizure order must describe the objects for seizure “with particularity” and as narrowly as possible to achieve the purposes of seizure.

Once ordered, the DTSA requires that the seizure be accomplished in “a manner that minimizes any interruption of the business operations of third parties and, to the extent possible, does not interrupt the legitimate business operations” of the defendant. The seized matter is to be “protected from disclosure by prohibiting access by either the applicant” or the defendant, and any access during litigation must be controlled by the court to minimize disclosure. The order must define the scope of law enforcement’s seizure actions, including the hours during which seizure may be made and “whether force may be used to access locked areas.” The applicant also must post security “for the payment of the damages that any person may be entitled to recover as a result of wrongful or excessive seizure or wrongful or excessive attempted seizure.”

The court must schedule a seizure hearing as soon as possible, but in all events not more than seven days after the order is signed, and during the interim the court must protect the defendant from publicity arising from the seizure. The burden of proof is on the plaintiff, the seizure will be dissolved or modified if the applicant fails to satisfy its burden, and expedited discovery is specifically authorized.

II. Early Cases—What Do We Know?

Advocates and opponents of the DTSA naturally viewed its prospects differently. Would the DTSA be a uniform, accessible, effective, and appropriate weapon against the malicious misappropriation of trade secrets? Or would the DTSA become a cudgel used by big business against entrepreneurs and ex-employees to stifle competition? The debate prompted many alterations, in particular to the seizure remedy, to the DTSA before its en-

34. 18 U.S.C. § 1836(C).
35. 18 U.S.C. § 1836(F).
actment. But many aspects of the debate remain for clarification by the courts.

Relatively few DTSA cases have been decided since the statute became effective. Complaints have been filed, but most of the sparring to date has been in the motion for temporary/preliminary injunction or dismissal stage. Thus, the opportunity for clarification—or for that matter, for the development of any significant DTSA jurisprudence—is extremely limited. Glimpses into potential development of the DTSA may be evident in these early cases, but the record is thus far silent on many controversial issues. For the franchise bar, it is notable that none of the reported cases involve franchising in any substantive way.36

A. DTSA Gatekeeping

The DTSA became effective on May 11, 2016. An early and obvious question of applicability arose in Adams Arms.37 The defendant moved to dismiss the plaintiff’s DTSA claims, arguing that the alleged wrongful actions occurred before the effective date of the statute. Observing that the DTSA prohibits two kinds of misappropriation—acquisition of trade secrets and disclosure of trade secrets, the court concluded that although the claimed wrongful acquisition had occurred prior to the effective date of the DTSA, actionable disclosure, including as a continuing violation under 18 U.S.C. §1836(d), may have occurred subsequent to that date, Thus, the motion was denied.38 The court specifically declined to decide whether and to what extent an aggrieved plaintiff could recover for DTSA violations that began before the statute’s effective date. 39 The Adams Arms case highlights a fundamental—and for now unanswered—question: in the event of a continuing violation, can recovery be had for effects prior to the effective date of the DTSA, or would recovery be limited to effects suffered subsequent to the statute’s effective date?

Two cases have addressed the issue of standing under the DTSA, both focusing on 18 U.S.C. § 1836(b)(1), which affords the “owner of a trade secret”

36. Allstate Insurance Co. v. Rote, 3:16-cv-01432, 2016 WL 4191015 (D. Or. Aug. 7, 2016), involved enforcement of a non-compete and non-disclosure agreement against an ex-agent who did business exclusively under the Allstate brand. On a motion for preliminary injunction, the court did not prevent competition by the ex-agent, but required all confidential data to be returned to Allstate. Although Allstate’s complaint alleged violations of both the Oregon version of the UTSA and the DTSA, the court did not appear to rely on the DTSA in fashioning preliminary relief. Despite its promising caption, Panera, LLC v. Nettles and Papa John’s International, Inc., No. 4:16-cv-1181-JAR, 2016 WL 4124114 (E.D. Mo. Aug. 3, 2016), does not deal with a franchise-related issue, but with an IT specialist who wanted to jump to Panera from Papa John’s.


38. Id. at *6; see also Dazzle Software II, LLC v. Kinney, Case No. 16-cv-12191, 2016 WL 6248906 (E.D. Mich. Aug. 22, 2016) (without substantive analysis, the court granted a motion to dismiss, but with leave for plaintiff to amend after discovery into defendant’s conduct subsequent to May 11, 2016).

39. Id. at *6.
a private cause of action for misappropriation. In HealthBanc International, LLC v. Synergy Worldwide, Inc., the plaintiff alleged that the defendant’s printed product labels constituted a disclosure of licensed trade secrets.\(^{40}\) The court held that although it appeared the plaintiff may have been the licensor of the technology, it was not an owner and thus could not assert a claim under the DTSA.\(^{41}\) The court in Phyllis Schlafly Revocable Trust v. Cori reached a similar conclusion.\(^{42}\) The case involved misappropriation of a donor database by ex-employees; the existence of related litigation in other states complicated matters. On the plaintiff’s motion for a temporary restraining order, the court launched the usual TRO test, but stalled at the “likelihood of success” prong. Considering both the case at bar and the other pending cases, whether the plaintiff was the “owner” of the alleged trade secrets was debatable,\(^{43}\) and the motion was denied.

These unremarkable cases highlight an issue that may be especially pertinent to franchisors. Holding companies or parent or affiliated entities often own the intellectual property employed in a franchise system and license it to the franchising entity. The franchisor then sublicenses rights to franchisees to exploit the intellectual property consistent with the terms of the franchise agreement. In that structure, it appears the actual owner of the trade secret, rather than the franchisor, will be required to bring any DTSA claim. By contrast, in many states, trade secret licensees/sub-licensors have standing to take action against misappropriation under UTSAs.\(^{44}\)

B. Temporary/Preliminary Relief

Courts assessing motions for injunctive relief under UTSAs and the DTSA recite the same multipart test, namely likelihood of success on the merits, irreparable harm, balance of the equities, and public interest. In fact, many of the courts that have addressed such motions in a piggybacked case asserting both DTSA and state UTSA claims do not specifically associate the standard with one or the other statute.\(^{45}\) The DTSA does not specifically require any alternate test for the issuance of temporary or preliminary relief.\(^{46}\)

\(^{41}\) Id. at *6.
\(^{42}\) No. 4:16-cv-01631, 2016 WL 6611133 (E.D. Mo. Nov. 9, 2016).
\(^{43}\) Id. at *3–4.
\(^{44}\) Unsurprisingly, whether a licensee has standing, and whether that standing extends to both exclusive and non-exclusive licensees, varies from state to state. See, e.g., DTM Research v. AT&T Corp., 245 F.3d 327 (4th Cir. 2001) (Maryland law; fee simple ownership not required for standing); Faveley Transp. USA, Inc. v. Wabtec Corp., 758 F. Supp. 2d 211 (S.D.N.Y. 2010) (exclusive licensee has standing to sue under New York law); Metso Minerals, Inc. v. FLSmidth-Excel, LLC, 733 F. Supp. 2d 969 (E.D. Wis. 2010) (licensee has standing to bring trade secret misappropriation claim).
\(^{46}\) By contrast, as discussed in greater detail below, the DTSA’s seizure remedy mandates a separate and more demanding standard.
In UTSA jurisprudence, each element of the TRO/PI test receives judicial attention. In early DTSA cases, however, several courts have cited the DTSA as grounds for truncating two elements: irreparable harm and public interest. In *Engility Corp. v. Daniels*, the court brushed over the “irreparable harm” inquiry, declaring that the element “automatically” weighs in the trade secret owner’s favor because the DTSA “by statute provides injunctive relief to prevent . . . violations.” And in *Earthbound*, the court suggested a self-proving “public interest” element, observing that

the Economic Espionage Act, as amended by the [DTSA] establishes criminal penalties for misappropriation of trade secrets . . . which demonstrates Congress’s belief that such conduct is harmful not only to the individual or entity whose secrets are purloined, but also to the public. . . . Theft of trade secrets, and allowing the thieves to retain and use the confidential information they purloined, undermines business development and stability; preventing such conduct is in the public’s interest.

One may understandably wonder whether this approach is consistent with the U.S. Supreme Court’s decision in *eBay v. MercExchange*, in which the Court declared, in the context of a patent infringement action, that the imposition of injunctive relief depends upon the application of the traditional four factor test and that harm may not be presumed. Regardless of the fate of the irreparable harm and public interest factors under the DTSA, its criminal roots may afford a trade secret owner a psychological advantage in any TRO/PI hearing. Note, for instance, the manner in which the court in *Earthbound* described the DTSA as “the Economic Espionage Act, as amended by the Defend Trade Secrets Act.”

Remedies inconsistent with state law have already posed a potential problem to courts fashioning remedies under the DTSA. The DTSA addresses the issue, specifically barring injunctive relief that “conflict[s] with an applicable State law prohibiting restraints on the practice of a lawful profession,

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47. Engility Corp. v. Daniels, No. 16-cv-2473, 2016 WL 7034976, at *11 (D. Colo. Dec. 2, 2016). The court did not rely totally on the DTSA, however. It cited Tenth Circuit jurisprudence, which “excuses irreparable harm . . . when the evidence shows that a defendant is or will soon be engaged in acts or practices prohibited by statute, and that the statute itself provides for injunctive relief to prevent such violations.” Id.


trade or business.” The court in *Engility Corp.* deftly waltzed between the DTSA and the restraints of Colorado law in fashioning a remedy, ultimately devising one that appeared to the court to accomplish the purpose of the injunction while not running afoul of Colorado law. In particular, the court determined that a blanket requirement that the defendants refrain from competing against Engility was inconsistent with Colorado law and narrowed the restriction to specific customers.

Early applications for temporary or preliminary relief in DTSA cases suggest that: (1) the DTSA has been wielded against ex-employees, (2) preliminary relief has issued where the plaintiff has strong evidence and there are egregious facts, (3) courts have acted quickly, (4) seizure has not been granted, and (5) courts have carefully structured preliminary remedies. Although most of the early DTSA cases involve departing employees, two arise from relationships among competitors.

*Henry Schein, Inc. v. Cook* appears to be the first case filed under the DTSA. In round one, after the plaintiff tried to serve notice on the defendant, the court granted an *ex parte* TRO against the plaintiff’s ex-employee Cook with remarkable speed on June 10, 2016. Cook had resigned and become an employee of a competitor. Plaintiff *Henry Schein, Inc.* (HSI) determined that as Cook left, she forwarded “a wide array of confidential and trade secret information,” including “comprehensive, confidential HSI customer practice reports . . .,” equipment inventory, price quotations, and proposals in process, from her work email to her personal email. She also logged into the HSI system that updated these items and did not return her laptop for two weeks. Additionally, she unsuccessfully tried to access the HSI system a day after she resigned. When she returned her computer to HSI, she had tried to erase the emails she sent to herself. In addition to taking this information, Cook attempted to divert HSI customers to her new employer before her departure, even visiting customers and removing some HSI information from their businesses. Applying the usual test for injunctive relief, the court readily granted the TRO.

Round 2: a decision on whether a preliminary injunction should issue occurred on June 22, 2016, less than two weeks later. On the DTSA claim, the court found a likelihood of success on the merits and concluded that HSI’s potential loss of relationships constituted irreparable injury. The ex-employee argued that she did not intend to use HSI’s information for personal gain, but the court held that her intent was irrelevant under both the DTSA and the state UTSA. The court continued the TRO as a prelimi-
nary injunction, but eliminated the portion of the TRO that prohibited Cook from soliciting HSI customers.57

The speed with which the judge acted in the *Henry Schein* case, and the exceedingly short set of deadlines he imposed on the parties and a third-party forensic expert who had yet to be retained, were remarkable. Seizure was neither requested nor specifically granted, but under the rubric of expedited discovery the court ordered devices to be turned over to the forensic expert for imaging, the collected images to be provided to defense counsel, and defense counsel to begin producing the images to the plaintiff’s counsel within approximately two weeks. Written discovery responses and complete production were required about one week later, and a preliminary injunction hearing was scheduled for June 21, 2016, less than one month following issuance of the TRO.58

Another notable DTSA opinion is *Getty Images v. Motamedi*, in which the court granted the plaintiff’s motion for a TRO, expedited discovery and issued a Hague Convention request a mere four days after the case was filed.59 Defendant Motamedi, a vice president at Getty Images, had signed a non-disclosure agreement and been apprised in writing of Getty’s non-disclosure policies. Motamedi decided to join a former colleague in a new venture in the United Kingdom and compete against Getty. In preparation for her new venture, Motamedi emailed Getty confidential and trade secret data to the new company. Getty uncovered evidence of these transmissions and other questionable communications in the defendant’s Getty email account and speculated that her non-Getty emails and her electronic devices would provide a “treasure trove” of damning information. As in other cases, the plaintiff’s forensic evidence weighed heavily in the court’s decision granting a TRO, expediting discovery and issuing the Hague Convention request. 60

*Engility Corp.* demonstrates the value of pre-hearing factual development (particularly forensic evidence) and a well-conducted motion hearing.61 One can reasonably characterize the facts as egregious. The defendant ex-employee’s twists and turns, admissions, and denials in the face of Engility’s evidence, prompting the court to frankly dismiss his testimony as incredible, played a major role in the outcome.62 Engility is a defense contractor that provides hi-tech communications solutions to the U.S. military. As the

57. Although the court did not mention it, the elimination of the non-solicitation portion of the TRO appeared to be intended to comply with California’s prohibition of non-competes. This juxtaposition of the DTSA with state statutes, especially in the area of remedies, appears more sharply drawn (and with far more analysis) in *Engility Corp.*, discussed in greater detail below.

58. It is worth noting that a different judge in the same court (Western District of Washington) handled an earlier DTSA case in exactly the same way, including authoring some of the language that appears in the plaintiff’s motion for TRO in *Getty Images*, discussed below, without attribution. See detailed discussion of *Earthbound*, below.


60. *Id.* at *1*.


62. *Id.* at 4–6.
“face” of Engility to U.S. military officials, Daniels was privy to a wide range of highly confidential information and had signed a confidentiality agreement. While still working for Engility, Daniels set up another company, intending to compete for the same business. Daniels gave notice to Engility and returned his company computer and additional information on a flash drive. But Daniels (as he finally admitted) kept some Engility trade secrets, offering varying and increasingly less believable explanations for his behavior. Engility’s forensic evidence, and the deposition of its forensic expert, belied the truth. Company emails and computer and flash drive metadata indicated modifications and erasures after his departure date. Surveillance tapes also confirmed Daniels’ tardy return of some company property.

In palpable understatement, the court wrote: “[Daniel’s changing] testimony somewhat reduced Daniels’ credibility in the court’s eyes, but a later admission had an even more damaging effect.” Daniels finally admitted that he had not erased the hard drives and, therefore, had a complete copy of the flash drive even after he had supposedly returned everything. He nevertheless insisted that he had finally deleted everything and had given the drive to his lawyer.

On these facts and evidence, the court had no difficulty issuing an injunction, even applying a “clear and unequivocal” standard of proof because of the extraordinary nature of a preliminary injunction. The court made short shrift of the likelihood of success factor, expressing frank disbelief in any of Daniels’ testimony. Nor were the balance of harms or public interest elements difficult. Irreparable harm was a different matter. Engility had not demonstrated irreparable harm with the specific factual support the court might have preferred. But, as noted above, the court concluded that DTSA’s provision for injunctive relief in the face of a violation satisfied the irreparable injury element because the Tenth Circuit’s test for injunctive relief “excuses irreparable harm . . . when the evidence shows that a defendant is or will soon be engaged in acts or practices prohibited by statute, and that statute itself provides for injunctive relief to prevent such violations.” The DTSA, 18 U.S.C. § 1836(b)(3)(A), authorizes injunctive relief to prevent misuse of trade secrets, and the Colorado trade secrets act does likewise; the irreparable harm element of the test thus “automatically favor[ed] Engility.”

Engility had submitted a proposed preliminary injunction, which prohibited any use, disclosure, or destruction of Engility information and prohib-

64. Id. at *7 (citing Greater Yellowstone Coal. v. Flowers, 321 F.3d 1250, 1256 (10th Cir. 2003)).
65. Id. at *8.
66. Id. at *11–12.
67. Id. at *11.
68. Id.
ited the defendants from accepting business from the affected Engility clients. The court agreed with the first two conditions, but found the non-compete provision worrisome. Could the injunction restrict competition by Daniels? The DTSA prohibits an injunction that prevents a person from entering into an employment relationship, but “employment relationship” does not encompass an outside contractor relationship. The DTSA also prohibits an injunction that would conflict with state non-compete laws. The court determined that Colorado presumptively invalidates non-competes, but exempts from that prohibition contracts for the protection of trade secrets, which are enforced in Colorado to the extent necessary to protect trade secrets. The court thoughtfully crafted a non-compete in the preliminary injunction that restricted the defendants’ ability to compete for business from Engility’s targeted customers only.

_Earthbound Corp._ is one of two cases that apply the DTSA to business-to-business activities. In this case, however, the competitor relationship was coupled with an ex-employee’s activities. Earthbound developed a proprietary Super-Template, which manipulates “engineering calculations on load pressures, deflection and elongation, design methodology, product selection, inventory and pricing” in support of its business providing “services and systems for earthquake tie-down and connections in building construction.” Earthbound’s sales arm was a third party, Intact Structural Supply, LLC (ISS). Personnel at ISS had broad access to Earthbound trade secret and confidential data, including the Super-Template, financial goals, strategic planning, sales projections, and customer list. None of the ISS employees who were included as defendants in the action had signed confidentiality or non-compete agreements with Earthbound or ISS.

MiTek had unsuccessfully tried twice to buy Earthbound and in each case signed confidentiality agreements. During discussions regarding a possible purchase transaction, Earthbound disclosed the names of key ISS personnel to MiTek, along with an explanation of their position, knowledge, and duties. The key ISS personnel subsequently decided to move to MiTek (after MiTek had offered them a signing bonus, which was paid while they were still employed). The employees did not give notice to Earthbound until several months later, and incredibly, each asked to stay at Earthbound to transfer work to successors, notwithstanding that they were already on MiTek’s payroll. Unsurprisingly, Earthbound did not agree. Each employee returned laptops and company phones to Earthbound, but the phones had been returned to factory settings (wiped) and all data had been removed from laptops, etc. Wiping phones and laptops, together with the employees’ odd re-

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quest that they be allowed to remain at Earthbound while on MiTek’s pay-
roll, raised Earthbound’s suspicions. However, a customer telling Earth-
bound that it had received an unsolicited bid from MiTek for a job that it
had planned to award to Earthbound, at a lower price than Earthbound,
likely turned suspicion into belief. Earthbound’s lawyer sent a cease and des-
sist to MiTek and the ex-employees, demanding, among other things, a re-
turn of everything, nonuse, etc. All of the defendants denied wrongdoing and
refused to provide any information.

Earthbound engaged a forensic expert prior to filing its complaint. From
Earthbound’s records, she gathered a raft of information showing that one
ex-employee in particular, both before and after giving notice to Earth-
bound, sent confidential information from his email to his wife’s email,
moved Earthbound files to his cloud storage or his DropBox account, in-
serted USBs on multiple occasions and downloaded files, and engaged in
other questionable behavior. The description of the evidence she gathered
was compelling. When confronted with these facts, the employees did not
deny taking data, but instead argued that no one told them it was confiden-
tial or proprietary.

When Earthbound filed its complaint (asserting both a DTSA claim and a
Washington UTSA claim) and motion for temporary restraining order, it al-
ready had substantial evidence of misappropriation. This proved critical to
the court’s decision to grant the TRO. Citing primarily the Washington ver-
sion of the UTSA, the court devoted many pages to explaining the evidence
provided by the forensic expert, brushed away a weak defense, and entered an
aggressive TRO that required (1) the surrender of electronic storage means,
hard drives, and devices for independent analysis by a third-party forensic ex-
pert; (2) nondisclosure, nonuse, and preservation of data; and (3) the defen-
dants to give two-hour depositions prior to the PI hearing.73 The court ob-
served that the misappropriation analysis would also support a violation of
“the Economic Espionage Act, as amended by the Defend Trade Secrets
Act” and that “[t]he EEA establishes criminal penalties for misappropriation
of trade secrets . . . [which] demonstrates Congress’s belief that such conduct
is harmful not only to the individual or entity whose secrets are purloined,
but also to the public.”74

The final case of note in the infancy of the DTSA is Mission Management
Corp. v. Blackbaud, Inc., which is unique among DTSA cases in that it involves
only business-to-business misadventures.75 Mission Management and Micro-
edge, a company purchased by Blackbaud, participated in a joint project to
develop an analytical database to assess the utility and likely effects of social
programs. The parties negotiated at least two agreements, but executed only
a letter of intent. The plaintiff alleged that its proprietary “Outcomes Data-

73. Id. at *11–12.
74. Id. at *10.
base” was subsumed into the “Outcomes” product offered by Blackbaud after it purchased Microedge. The plaintiff surmised, among other things, that one of Microedge’s purposes was to boost its value in Blackbaud’s purchase transaction based on the incipient release of the new joint database product. The defendant moved to dismiss the Illinois UTSA and DTSA claims asserted by the plaintiff. Of all the interesting issues that could be raised on a Rule 12(b)(6) motion based on these allegations, the only one that the court addressed was a fairly uninteresting one—whether the plaintiff adequately alleged the existence of trade secrets. Based on unsurprising prior Illinois UTSA cases, the court found that plaintiff had adequately alleged its trade secrets and denied the motion.\footnote{Id. at *5–6.}

C. Whistleblower Exemption

Thus far, only one defendant has attempted to rely on the DTSA’s whistleblower exemption. In \textit{Unum Group v. Loftus}, the court confronted a fact pattern in which one of Unum’s employees, Loftus, was caught on camera on multiple occasions hauling documents in boxes out of its offices.\footnote{See \textit{Unum Group v. Loftus}, No. 4:16-cv-40154, 2016 WL 7115967 (D. Mass. Dec. 6, 2016).} He finally returned a laptop, but no documents.

Loftus moved to dismiss Unum’s DTSA and UTSA claims, relying on the whistleblower protection provisions in the DTSA.\footnote{18 U.S.C. § 1833(b).} But there was no indication that Loftus took any of the steps that a whistleblower would have taken; he admitted taking documents, but the only support for his whistleblower defense seemed to be his word. The court required Loftus to promptly turn over to the court all the documents, regardless of media, he had removed; all other copies of the documents, even those in Loftus’ attorney’s possession were ordered destroyed; no documents were to be provided to others; Loftus was required to mirror his computer hard drive and flash drive; and Loftus and his lawyer were required to sign affidavits attesting to the completion of these tasks.\footnote{Unum, 2016 WL 7115967, at *4.} The court’s comments on Loftus’ whistleblower exemption criticize (and give small credence to) what appears to be a clumsy effort to apply the exemption.

D. Protective Discovery and Seizure

The \textit{Unum} case is also notable for its discussion of procedural aspects of the DTSA that were added to protect trade secrets during the litigation process. During legislative hearings on the DTSA, several commentators expressed concerns regarding the potential disclosure of trade secrets and reactions to those concerns found their way into the Act. Even prior to the DTSA, the Economic Espionage Act authorized courts to take “necessary and appropriate [action] to preserve confidentiality” and, in addition, im-
posed conditions on a court’s ability to order disclosure of trade secrets in litigation.\textsuperscript{80} When the DTSA was adopted, additional protective measures were included in the context of civil seizure.\textsuperscript{81} Although the plaintiff did not request, nor did the court expressly grant, seizure in \emph{Unum}, the court applied many of the protective measures specifically authorized in 18 U.S.C. § 1836(b)(2)(D), especially requiring that produced data be maintained by the court only, even to the exclusion of defense counsel.\textsuperscript{82}

Interestingly, although seizure was not involved in any of the cases discussed above, the courts moved extremely quickly on plaintiffs’ motions for temporary or preliminary relief. The \emph{Henry Schein} and \emph{Getty Images} cases are particularly good examples of the sense of urgency that the DTSA imparts. The court in \emph{Getty Images} granted the plaintiff’s motion for TRO, expedited discovery, and issued a Hague Convention request four days after the case was filed and followed it up by ordering aggressive expedited discovery. In \emph{Henry Schein}, the court granted an ex parte TRO against HSI’s ex-employee one day after suit was filed and granted preliminary injunctive relief less than two weeks later.\textsuperscript{83}

Although seizure under the DTSA has not been granted or analyzed in detail, it has been requested in at least one instance. In \emph{OOO Brunswick Rail Management v. Sultanov},\textsuperscript{84} plaintiff OOO Brunswick requested the court enter a seizure order for the laptops and mobile phones in possession of a former employee.\textsuperscript{85} Rather than analyzing the DTSA’s seizure requirements, the district court simply stated that seizure under the DTSA was unnecessary because it would order the former employee to deliver the devices to the court under Federal Rules of Civil Procedure Rule 65 at a scheduled hearing and ordered that the devices not be accessed or modified. Although the court mentions the DTSA’s seizure remedy, it provides no guidance as to evidentiary requirements or other interpretation.

What little we can glean from the DTSA cases thus far suggests that, in applying the seizure remedy, courts will be inclined to act quickly, may force the parties to litigate on a fast track, and will be respectful of the trade secrets at issue. But does that answer the fears of commentators on either side of the legislative debate: will the DTSA have a chilling effect on ex-employees/entrepreneurs (higher price of entry and litigation)? Is the weapon it provides to big business immense, while smaller entities will be discouraged (by price) from using it? Will the seizure remedy be abused? These questions obviously await resolution, but a look at an analogous civil seizure remedy may provide some hints.

\textsuperscript{80} 18 U.S.C. § 1835(a).
\textsuperscript{81} 18 U.S.C. § 1836(b)(2).
\textsuperscript{82} \textit{Unum}, 2016 WL 7115967, at *4.
\textsuperscript{83} \textit{Henry Schein}, Inc. v. Cook, No. 16-cv-03166, 2016 WL 3418537, at *10 (N.D. Cal. June 22, 2016)
\textsuperscript{85} \textit{Id.} at *2.
The DTSA’s seizure remedy was modeled after provisions in the Lanham Act, which allows seizures of counterfeit goods. Although generalization is dangerous, courts applying the Lanham Act seizure remedy have typically demanded strict compliance with the statutory requirements and have ordered seizure (rather than injunctive relief) only where there is evidence of the defendant’s prior disobedience of court orders. In *Lorillard Tobacco Co. v. Bisan Food Corp.*, for instance, the U.S. District Court for the District of New Jersey refused to issue a seizure order, observing that the statute “contains rock solid requirements that I find are not met here.” In particular, the court found nothing to suggest prior disobedience on the part of the defendant. The Third Circuit affirmed, concluding that the plaintiff failed to demonstrate that “the person against whom seizure would be ordered . . . would destroy, move, hide or otherwise make such matter inaccessible to the court,” the same language that appears in the DTSA. However, in *Dell v. Belgiumdomains, LLC*, a Florida district court came to a different conclusion and issued a seizure order against alleged cybersquatters. Notably, the evidence sought to be seized was primarily electronic (making it easy to destroy), cybersquatters have routinely ignored judicial proceedings, the defendants had no physical presence in Florida, and they used fictitious names and shell entities to shield their activities.

As in the DTSA, the Lanham Act seizure provision includes a penalty for bad faith or wrongful seizure. Where seizure has been implemented in bad faith or impermissibly against non-counterfeit goods, courts have awarded damages to the injured party. In *Prince of Peace Enterprises, Inc. v. Top Quality Food Market, LLC*, for example, a seizure order had issued and been executed. On a motion to dismiss, the court found the plaintiff did not have standing under the Lanham Act and much of the seized product was not counterfeit and awarded damages to the aggrieved defendant based on the wrongful seizure, referring the issue of amount to the magistrate. *Waco International v. KHK Scaffolding Houston, Inc.* also turned into a victory for the defendant. After a seizure that yielded many, perhaps mostly, non-infringing goods, the court dissolved the seizure order but entered a narrow injunction at the same time. The defendant’s counterclaim for wrongful seizure was successful and the jury awarded damages in the form of attorney fees. The appellate court affirmed.

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87. 377 F.3d 313, 317 (3d Cir. 2004).
91. Id. at 394, 396.
92. 278 F.3d 523 (5th Cir. 2002).
93. Id. at 536–37.
III. What’s a Lawyer to Do?

The only realistic conclusion at this moment in time is that there is no conclusion. The DTSA is an infant and its story is only beginning. Early cases may provide a clue to its development, but so many aspects of the statute remain untested that even an educated guess is chancy. How do we, as lawyers representing franchisors and franchisees, deal with the DTSA? Practice tips, some obvious and others less so, can be gleaned from the language of the DTSA, the early cases, and analogous statutes.

For preventive maintenance (transactional counsel):

- Consider adding the notice required by the DTSA in franchise agreements. A franchisee may qualify as a “contractor” under the statute, and the DTSA also mandates notice to “employees.” It’s worth considering whether the advantages of providing notice (recovery of enhanced damages and attorney fees) warrants any perceived risk that doing so may support an argument that the franchisee is the franchisor’s employee.
- Nondisclosure provisions in franchise agreements should be supported by identifying the claimed trade secrets not only generally (as is usual in franchise agreements) but more specifically in the operations manual.
- Marking physical media containing claimed trade secrets as confidential may have added significance under DTSA, as may other methods of protection (e.g., password-protected online access only).
- Carefully consider ownership of trade secrets in the franchise corporate structure. Putting ownership of trade secrets in the franchising entity may not be desirable for many reasons (e.g., tax, income distribution, and exposure to third party claims). But if the owner of trade secrets is required to be a plaintiff in any DTSA action, are the business reasons for separate ownership still compelling?

For emergency responders (litigators):

- Weigh the risks of aggressive enforcement and strongly consider potential benefits (or adverse consequences) of federal jurisdiction. Aggression requires strong support and could backfire.
- Hire a forensic expert prior to filing and develop evidence of theft or disclosure.
- Avoid an *ex parte* motion for temporary restraining order if possible. Try serving notice on the defendant.
- Don’t skimp on the hearing for a temporary restraining order/preliminary injunction—make it a compelling evidentiary hearing.
- Don’t rely on the DTSA to satisfy elements of the injunction standard of proof—*eBay* may intrude.
- Offer the court a proposed order that respects the limits of state law.
In the franchise industry, counselors must consider not only the effects of actions in a particular dispute, but the upstream and downstream effects throughout the system. The DTSA, for better or worse, offers the opportunity for consistent national protection of trade secrets. Predictability is highly valued, but an adverse outcome may unduly impact an entire franchise system. The DTSA increases potential rewards and potential risks.
It is no secret that home turf is an advantage. Plants grow best in their native soil and climate. Sports teams win more often on their home court or field.1 This trope remains true in litigation. An attorney litigating in his or her home court knows the judges and can tailor litigation strategy to the assigned judge’s preferences and proclivities. The at-home attorney already knows the local procedural rules and practices, including quirks that can trip up out-of-towners. Use of home courts reduces travel, which in turn limits financial costs and lost time and energy. It minimizes the inconvenience to client employees who are witnesses. And, as an added bonus, it often creates the exact opposite burdens on the opposing party.

For some or all of these reasons, many franchisors include a forum selection clause in their franchise agreements and other standard contracts. These clauses usually provide that any litigation relating to the franchise agreement (or depending on the wording, the parties’ relationship) may be brought only in a certain state or federal court. Yet, franchisees2 often ignore forum selection clauses and bring lawsuits in their home courts. In federal court, fran-


2. Obviously, a franchisor may also sue a franchisee in an improper forum, and the franchisee can seek to enforce the forum selection clause. In the authors’ experience, that is not common. Therefore, this article will focus on the usual scenario where the plaintiff-franchisee sues the defendant-franchisor in a forum different than the one chosen in the forum selection clause.
chisors often respond by attempting to have the lawsuit transferred to the contractually selected forum under 28 U.S.C. § 1404(a), the federal venue transfer statute that allows for a transfer to a different federal venue “for the convenience of parties and witnesses, in the interest of justice.” Federal courts decide § 1404(a) motions by weighing various public and private interest factors. Historically, federal courts considered a forum selection clause just one of the factors in this analysis; although it was a “significant factor,” the existence of a forum selection clause was hardly dispositive. That changed four years ago. The U.S. Supreme Court’s 2013 decision in *Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas* made clear that if a forum selection clause is *valid*, the case should be litigated in the contractually selected forum in all but the “most unusual of cases.”

Now that almost four years have passed since *Atlantic Marine* was decided, it is time to consider what forum selection clause battles still remain in the context of franchise litigation. Part I of this article will briefly recap how courts decide § 1404(a) motions generally and what impact forum selection clauses have on that analysis, both before and after *Atlantic Marine*. Part II will discuss potential arguments that franchisees may use to try and avoid a transfer pursuant to a forum selection clause. Part III will discuss the subject where there is the least consensus post-*Atlantic Marine*: what courts should do when the forum selection clause covers only some of the parties or claims. Finally, Part IV provides some thoughts on whether *Atlantic Marine* has really changed any of the incentives for franchisees to disregard forum selection clauses when filing suit and how franchisors can maximize their chances of enforcing forum selection clauses.

### I. The § 1404(a) Transfer Analysis Before and After *Atlantic Marine*

In most circumstances, the proper procedure for seeking a transfer between two federal courts is a motion to transfer pursuant to 28 U.S.C.

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4. This article focuses on how federal courts handle forum selection clauses. States often have their own rules regarding the treatment of forum selection clauses, but those rules are beyond this article’s scope. It is also worth noting that forum selection clauses often have less strategic value in state court. If a franchisor is sued in a foreign state court, the franchisor will be able to remove the case to federal court if the case is one of financial significance. See 28 U.S.C. § 1332 (diversity jurisdiction requires over $75,000 at issue, among other things). Conversely, if the case cannot satisfy the diversity jurisdiction amount-in-controversy requirement, it may not be cost-effective to litigate forum selection clause issues in state court.

5. Other transfer statutes exist besides § 1404(a), but they apply in much more limited circumstances. See 28 U.S.C. § 1406 (providing for transfer case where venue is not proper); 28 U.S.C. § 1407 (allowing for the transfer of related cases to a single forum—regardless of whether there would otherwise be personal jurisdiction or venue—for multidistrict litigation treatment).
§ 1404(a). That statute provides: “For the convenience of parties and witnesses, in the interest of justice, a district court may transfer any civil action to any other district or division where it might have been brought or to any district or division to which all parties have consented.” To obtain a § 1404(a) transfer, the franchisor must first show that the case could have been brought in the transferee district, i.e., any district where the franchisor is subject to personal jurisdiction and venue would be proper. Assuming these threshold requirements are met, the court then balances a number of factors to determine whether matters of convenience and the interests of justice favor the case proceeding in the transferee district. Courts articulate these factors in various ways and often divide them into the categories of private interest factors and public interest factors. The private interest factors usually include the franchisee’s choice of forum, the location of non-party and party witnesses, the convenience of the parties, and the locus of operative facts. The public interest factors often include judicial efficiency, obstacles to a fair trial, the advantages of having a local court determine questions of local law, and any another circumstance that impacts the interests of justice. The burden is on the movant franchisor-defendant to prove that transfer is warranted, and district courts have broad discretion in deciding § 1404(a) motions because the factors are applied case-by-case. Due to “plaintiff’s venue privilege,” the franchisee’s choice of forum is usually entitled to deference and courts will therefore not grant a transfer unless the franchisor makes a strong showing that the case belongs in another district.

6. The proper procedure for enforcing a forum selection clause that selects venue in a state court or foreign country’s court is a motion to dismiss under the doctrine of forum non conveniens. See, e.g., Atl. Marine, 134 S. Ct. at 580.
10. For example, courts in the Second Circuit consider nine factors in this analysis: (1) the plaintiff’s choice of forum; (2) the convenience of witnesses; (3) the location of relevant documents and relative ease of access to sources of proof; (4) the convenience of parties; (5) the locus of operative facts; (6) the availability of process to compel the attendance of unwilling witnesses; (7) the relative means of the parties; (8) the forum’s familiarity with the governing law; and (9) trial efficiency and the interest of justice, based on the totality of the circumstances. See D.H. Blair & Co., Inc. v. Gottlieb, 102 F.3d 95, 106–07 (2d Cir. 2000). The standard is substantially similar in other circuits. See, e.g., Jones v. GNC Franchising, Inc., 211 F.3d 495, 498–99 (9th Cir. 2000); Terra Int’l, Inc. v. Miss. Chem. Corp., 119 F.3d 688 (8th Cir. 1997).
12. See, e.g., In re Ricoh Corp., 870 F.2d 570, 573 (11th Cir. 1989) (noting that “the burden is on the movant to establish that the suggested forum is more convenient”).
15. See, e.g., Emp’rs Mut. Cas. Co. v. Bartile Roofs, 618 F.3d 1153, 1168 (10th Cir. 2010) (noting that the party seeking a transfer of venue must make a strong showing that the plaintiff’s chosen forum is inconvenient); In re Volkswagen of Am., 545 F.3d at 315 (stating that the party seeking transfer has the burden of showing “good cause” for transfer—that is, the party must “satisfy the statutory requirements and clearly demonstrate that a transfer is ‘[f]or the conve-
Moreover, if a transfer is granted, the original forum’s choice of law rules follow the case to prevent a defendant from invoking § 1404(a) “to gain the benefits of the laws of another jurisdiction.” Absent unusual circumstances, the forum where the franchisor is headquartered is likely to be the only forum for which a franchisor can advocate in a § 1404(a) motion because that is the forum not only where personal jurisdiction and venue would otherwise be proper, but also where the locus of facts is likely to be and most witnesses will be found.

Before Atlantic Marine, courts treated a valid and enforceable forum selection clause as a “significant factor that figures centrally in the district court’s calculus,” that was to be accorded “substantial” weight. Under this standard, courts would often transfer a case to the contractually selected forum even when the various factors, in whole, were neutral or slightly in favor of denying transfer. However, because courts retained considerable discretion, a forum selection clause was just one factor to be considered and did not guarantee that a case would be transferred.

In 2013, the Supreme Court decided Atlantic Marine. In that case, a Virginia-based contractor entered into a subcontract with a Texas-based company. The subcontract contained a forum selection clause providing that disputes between the parties “shall be litigated in the Circuit Court for the City of Norfolk, Virginia, or in the United States District Court for the Eastern District of Virginia, Norfolk Division.” But when a dispute arose, the Texas-based subcontractor ignored the clause and sued in federal district court in Texas. Among other things, the contractor moved to have the case transferred under § 1404(a) to

nicen of parties and witnesses, in the interest of justice’’); In re United States, 273 F.3d 380, 388 (3d Cir. 2001) (noting that “the burden is on the moving party to establish that a balancing of proper interests weigh in favor of the transfer,” but that “the defendant is not required to show truly compelling circumstances . . . for change . . . of [venue, but rather that] all relevant things considered, the case would be better off transferred to another district” (alterations in original)).

16. Van Dusen, 376 U.S. at 638.
17. Wilson v. DirectBuy, Inc., 821 F. Supp. 2d 510 (D. Conn. 2011) (transferring three putative class actions to district where defendant is headquartered). Wiggin and Dana LLP was counsel to DirectBuy, Inc.
19. See Bus. Integration Tech., Inc. v. Mulesoft, Inc., No. 4:10-cv-2185 FRB, 2011 U.S. Dist. LEXIS 105406, at *23 (E.D. Mo. Sept. 16, 2011) (granting transfer motion and noting that forum selection clause “weighs ‘significantly’ in this Court’s transfer analysis, particularly when, as here, a balance of the other factors fails to tip the scale in favor of either forum”); Griggs v. Credit Sols. of Am., Inc., No. 4:09-cv-1776 ERW, 2010 U.S. Dist. LEXIS 64443, at *14 (E.D. Mo. June 29, 2010) (transferring case when, aside from forum selection clause, all transfer factors were neutral or slightly in favor of denying transfer).
20. For example, in Fibra-Steel, Inc. v. Astoria Industries, Inc., 708 F. Supp. 255, 257 (E.D. Mo. 1989), the court refused to transfer a case to the district specified in the parties’ forum selection clause because “[t]he Court cannot say that the forum selection clause, without more, weighs heavily enough to tip the scales away from plaintiff’s choice of forum.” The Fibra-Steel court even castigated the parties for focusing too much of their briefing on the forum selection clause at the expense of the other factors. See id. (“In this case both parties have focused almost exclusively on the impact of the choice-of-forum clause and failed almost entirely to address the other factors which the court should consider.”).
a Virginia federal district court. Even though both parties agreed that the forum selection clause was valid, the district court, and then the Fifth Circuit, held that transfer was not appropriate in light of various public and private interest factors.22

Reversing the lower court, the Supreme Court unanimously held that when the parties have agreed to a valid forum selection clause, “a district court should transfer the case unless extraordinary circumstances unrelated to the convenience of the parties clearly disfavor a transfer.”23 In reaching this conclusion, the Supreme Court explained that a “valid” forum selection clause requires an adjustment to both the § 1404(a) analysis (for transfers among federal courts) and forum non conveniens analysis (for dismissal in favor of a state or foreign court)24 in three ways. First, “the plaintiff’s choice of forum merits no weight,” and the plaintiff, “as the party defying the forum selection clause,” now “bears the burden of establishing that transfer to the forum for which the parties bargained is unwarranted.”25

Second, in deciding the motion to transfer, the district court “must deem the private-interest factors to weigh entirely in favor of the preselected forum” because “when parties agree to a forum selection clause, they waive the right to challenge the preselected forum as inconvenient or less convenient for themselves, or their witnesses, or for their pursuit of the litigation.”26 The result is that a district court can consider only “the public interest factors,” which “will rarely defeat a transfer motion.” The Supreme Court emphasized that “the practical result is that forum selection clauses should control except in unusual cases” and that cases where a court refuses to transfer despite a forum selection clause “will not be common.”27

Finally, the Court made clear that unlike in a usual § 1404(a) transfer, the original forum’s choice of law rules will not follow the case when the transfer is pursuant to a forum selection clause. The Court noted that this rule was appropriate because “not only would it be inequitable to allow the plaintiff to fasten its choice of substantive law to the venue transfer, but it would also encourage gamesmanship.”28

II. Possible Ways to Escape *Atlantic Marine*

Following *Atlantic Marine*, courts have generally enforced valid forum selection clauses in franchise agreements.29 Moreover, district courts appear to

22. *Id.* at 576–77.
23. *Id.* at 575.
24. *Id.* at 580.
25. *Id.* at 581.
26. *Id.* at 582.
27. *Id.* at 583 (“In all but the most unusual cases, therefore, ‘the interests of justice’ is served by holding parties to their bargains.”).
28. *Id.* at 583.
29. See, e.g., Hyatt Franchising, L.L.C. v. Shen Zhen New World I, LLC, No. 16 C 8306, 2017 WL 372313, at *6 (N.D. Ill. Jan. 26, 2017) (denying motion to transfer because lawsuit was filed in
be extremely hesitant to find that “extraordinary circumstances” relating to only the public interest factors override a valid forum selection clause. Of the hundreds of forum selection clause cases decided after Atlantic Marine, the authors located fewer than ten cases (many of which are discussed below) refusing to enforce a valid forum selection clause due to exceptional circumstances related solely to public interest factors. The clear takeaway is that the best way to avoid Atlantic Marine is to demonstrate that the forum selection clause is invalid or inapplicable, which will result in the traditional § 1404(a) test applying. Below are four ways that a franchisee can attempt to avoid Atlantic Marine and, where possible, some recommendations on how franchisors can defend against these attacks.

A. Escape Route #1: Challenge the Clause’s Validity and Enforceability

As made clear throughout this article, the enforcement of valid forum selection clauses is “virtually automatic” post-Atlantic Marine. Of course, a litigant can make the other arguments discussed in this article, and these arguments might work once in a while. But the one surefire way to escape the Atlantic Marine analysis is to argue that the case does not even apply because the forum selection clause is not valid. After all, the Atlantic Marine court clarified that its analysis applies only where there is a valid forum selection clause. In the franchise context, a franchisee that wants to resist a forum selection clause will often argue that the forum selection clause is invalid because it violates a state law that prohibits forum selection clauses in franchise agreements.

Atlantic Marine says nothing about what makes a forum selection clause valid or invalid; in that case, the clause’s validity was uncontested and so
the Supreme Court simply assumed that the clause was valid. However, the Supreme Court has addressed the validity (or invalidity) of forum selection clauses, most notably in its seminal 1972 decision *M/S Bremen v. Zapata Off-Shore Company.* In *Bremen*, the Supreme Court held that a “forum [selection] clause should control absent a strong showing that it should be set aside.” Most relevant to the franchise litigation context, “[a] contractual choice-of-forum clause should be held unenforceable if enforcement would contravene a strong public policy of the forum in which suit is brought, whether declared by statute or by judicial decision.”

*Bremen*, however, was a federal admiralty case—not a commercial matter involving state law claims.

Does the *Bremen* rule apply to ordinary commercial matters, such as the typical franchise case that involves only state law claims? Or should a federal court sitting in diversity jurisdiction apply the law of the forum state (or some other state) to determine the validity of a forum selection clause? The answer varies by circuit. Most circuits have held that federal law applies when determining the validity of forum selection clauses because it is fundamentally a procedural issue, but at least one circuit—the Seventh Circuit—continues to maintain that state law applies. Meanwhile, the First Circuit has noted this circuit split, but has thus far avoided taking a position either way.

This issue—whether state or federal law applies when determining the validity of forum selection clauses—would make for an interesting article itself. However, in the authors’ view, this issue will rarely, if ever, be outcome determinative in franchise litigation. Franchisees that wish to avoid the enforcement of a forum selection clause typically argue that enforcement violates a specific state statute or (more rarely) a state common law rule announced in judicial decisions. If federal law applies to the validity issue,

34. 407 U.S. 1 (1972).
35. Id. at 15.
36. Id. Additionally, a forum selection clause can be invalidated under the *Bremen* test if the party resisting enforcement can “clearly show that enforcement would be unreasonable and unjust, or that the clause was invalid for such reasons as fraud or overreaching.” Id.
37. Sachs, *supra* note 30, at 767 & n.40–41 (“When the claims [asserted in the case] arise from state law only, the circuits have long disagreed on which standards apply, a split that has persisted in published opinions even after *Atlantic Marine*.”).
38. See, e.g., Martinez v. Bloomberg LP, 740 F.3d 211, 222 (2d Cir. 2014) (discussing “circuit split concerning whether a federal court sitting in diversity jurisdiction should apply federal or state law to determine the enforceability of a forum selection clause designating a domestic forum” and citing cases); Jackson v. Payday Fin., LLC, 764 F.3d 765, 774 (7th Cir. 2014) (reiterating the Seventh Circuit’s rule post-*Atlantic Marine* that the validity of forum selection clauses is analyzed under the law designated in the parties’ contractual choice-of-law clause); Black Hills Truck & Trailer, Inc. v. MAC Trailer Mfg. Inc., No. 13-4113-KES, 2014 WL 5782452, at *4 & n.3 (D.S.D. Nov. 6, 2014) (noting that majority of courts have applied federal law as discussed in *Bremen* and its progeny and citing cases).
39. See Rivera v. Centro Medico de Turabo, Inc., 575 F.3d 10, 16–17 (1st Cir. 2009); Lambert v. Kysar, 983 F.2d 1110, 1116 n.10 (1st Cir. 1993).
the franchisee resisting the forum selection clause will argue that a state statute or common law rule constitutes a strong public policy basis for denying a motion to transfer. Alternatively, if state law applies to the validity issue, the franchisee can simply make the direct argument that state law renders the clause invalid. Either way, a federal court sitting in diversity jurisdiction will consider any applicable state law concerning the validity of forum selection clauses.

At least ten states—California, Connecticut, Illinois, Indiana, Iowa, Louisiana, Michigan, Minnesota, North Carolina, and Rhode Island—have fairly broad state franchise relationship laws that seem to offer an escape from *Atlantic Marine*. In varying levels of detail, these state laws either call for venue within that state, ban forum selection clauses calling for a venue outside the state, or both. These, without more, would seem to provide protection for a franchisee that wants to litigate a dispute at home. After all, these state laws plainly evidence the state’s strong public policy against requiring franchisees to litigate disputes outside the state. However, federal cases after *Atlantic Marine* have not consistently reached that conclusion. Moreover, the conclusion that the courts do reach will depend on the case’s procedural posture and the precise wording of the applicable state law.

Take, for example, three cases where franchisees raised arguments concerning the California Franchise Relations Act. This state law provides that “[a] provision in a franchise agreement restricting venue to a forum outside this state is void with respect to any claim arising under or relating to a franchise agreement involving a franchise business operating within this state.” In *Frango Grille USA, Inc. v. Pepe’s Franchising Ltd.*, a plaintiff franchisee asserted various state law claims arising out of its franchise agreement.

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40. See, e.g., Waguespack v. Medtronic, Inc., 185 F. Supp. 3d 916, 931 (M.D. La. 2016) (“Post-Atlantic Marine, courts continue to analyze whether the forum selection clause is unreasonable because its enforcement would contravene a strong public policy of the forum state.”) (citing In re Union Elec. Co., 787 F.3d 903, 909 (8th Cir. 2015)).

41. Perhaps the only important difference lies in the burden of persuasion borne by each side. Under the *Bremen* rubric, the party resisting enforcement of a forum selection clause bears the responsibility of making a “strong showing that [the clause] should be set aside.” M/S Bremen v. Zapata Off-Shore Co., 407 U.S. 1, 15 (1972). In other words, the court begins from the presumption that the forum selection clause is valid. State laws concerning the validity of forum selection clauses may not operate from the same presumption or place the burden on the party resisting enforcement. As a practical matter, this distinction is unlikely to tip the scale in most circumstances.

42. *CAL. BUS. & PROF. CODE* § 20040.5; *CONN. GEN. STAT.* § 42-133(f)(F); 815 *ILL. COMP. STAT.* 705/4; *IND. CODE* § 23-2-2.7-1(10); *IOWA CODE* § 523H.3(1); *LA. REV. STAT.* 12 § 1042; *MICH. COMP. STAT.* § 445.1527(F); *MINN. R.* § 2860.4400(J); *N.C. GEN. STAT.* § 22B-3; *R.I. GEN. LAWS* § 19-28.1-14. See also Jackson & Meany, *supra* note 1, at 21–22 (providing useful chart of these statutes). Other states have statutes that prohibit forum selection clauses in particular types of franchise agreements, such as restaurant franchise agreements (Arkansas Procedural Fairness for Restaurant Franchisees Act, *ARK. CODE ANN.* § 4-72-601 et seq.) or motor vehicle dealer/franchise agreements (*S.D. CODIFIED LAWS* § 32-6B-49.1).

43. *CAL. BUS. & PROF. CODE* § 20040.5.

44. *CAL. BUS. & PROF. CODE* § 20040.5.
with the defendant franchisor.\footnote{No. 14-cv-2086, 2014 WL 7892164, at *1 (C.D. Cal. July 21, 2014).} The party’s franchise agreement called for any legal proceedings arising out of the agreement to be brought in London, England. The U.S District Court for the Central District of California readily concluded that the California law “invalidate[d] the forum selection clause . . . and render[ed] the Atlantic Marine analysis inapplicable.”\footnote{Id. at *3.} Conversely, the California law did not have an impact on a Pennsylvania court’s analysis in \textit{Saladworks, LLC v. Sottosanto Salads, LLC}.\footnote{No. 13-cv-3764, 2014 WL 2862241 (E.D. Pa. June 23, 2014).} There, a plaintiff franchisor (based in Pennsylvania) sued a defendant franchisee (located in California) in Pennsylvania federal court. The parties’ franchise agreements contained a forum selection clause requiring claims arising under the franchise agreement to be brought in Pennsylvania.\footnote{Id. at *3.} The California-based franchisee argued that the forum selection clause was invalid under the California Franchise Relations Act. The court rejected that argument without much analysis because “the plain language of the parties’ agreement shows that the parties clearly contemplated suit being brought in Pennsylvania” and the franchisee could not “show that enforcement of the forum selection clause would be unreasonable.”\footnote{Id. (citing Maaco Franchising, Inc. v. Tainter, No. CIV.A. 12-5500, 2013 WL 2475566, at *4 (E.D. Pa. June 10, 2013)).} The \textit{Saladworks} court cited to a prior Pennsylvania district court decision for the proposition that “the majority [of federal courts outside California to consider the issue] have not invalidated forum selection clauses or opted to transfer cases to California pursuant to [the California Franchise Relations Act].”\footnote{In the view of the authors, there is a reasonable reading of the California Franchise Relations Act that supports the outcome in the \textit{Saladworks} case (even if the court did not fully explain its reasoning). The Act prohibits “[a] provision in a franchise agreement restricting venue to a forum outside this state.” \textit{Cal. Bus. \\& Prof. Code} § 20040.5 (emphasis added). By its plain terms, the law invalidates only provisions that restrict venue to a place outside California. In other words: a franchisor cannot require that venue for a franchise dispute lie \textit{exclusively} outside California. Accordingly, a California-based franchisee should not be \textit{forced} to trek to another state to file a suit against its franchisor. But the California law does not prohibit a franchisee or franchisor from \textit{choosing} to initiate litigation in a court outside California. Accordingly, if an out-of-state franchisor chooses to sue a California-based franchisee in a courthouse outside of California, the California Franchise Relations Act should not invalidate the franchisor’s choice.}.

In view of \textit{Saladworks} and other federal court decisions, franchisees should be aware that statutory provisions such the California Franchise Relations Act may not be enforced by federal courts outside the state in which the statute has been adopted.\footnote{No. 16-cv-01966, 2016 WL 4269869 (N.D. Cal. Aug. 15, 2016).} And, sometimes, the Act may not be enforced even if the case is litigated in California. For example, in \textit{Fraser v. Brightstar Franchising LLC},\footnote{Id. at *4 (E.D. Pa. June 10, 2013)).} the U.S. District Court for the Northern District of California held that the California law could not invalidate the forum selection clause.
because the franchise at issue did not operate anywhere in California and the Act, by its own plain terms, applies only to “a franchise business operating within [California].” 53 Although one of the franchise’s owners was a resident of California, the franchise itself operated in Georgia; accordingly, the Act was inapplicable.

The procedural posture of the case—namely, who (franchisor or franchisee) initiates the suit—has been the key factor in cases involving Minnesota franchisees. Under Minnesota law, a franchisor may not “require a franchisee to waive his or her rights to a jury trial or to waive rights to any . . . forum.” 54 In *Family Wireless #1, LLC v. Automotive Technologies, Inc.*, several Minnesota franchisees (along with franchisees from other states) filed suit against their mutual franchisor in Michigan. 55 The plaintiffs from Minnesota were all parties to franchise agreements containing a forum selection clause specifying a Connecticut forum. But the U.S. District Court for the Eastern District of Michigan held that these forum selection clauses were invalid because they required the franchisee to initiate litigation outside Minnesota. 56 In two other cases, however, federal courts reached a different conclusion where a franchisor sued a Minnesota franchisee in federal court outside Minnesota. 57 The franchisees argued that Minnesota law required that all litigation against them take place in Minnesota and moved for a transfer of venue. The courts disagreed and denied the motions to transfer because a franchisor does not run afoul of Minnesota law by choosing to sue a franchisee in a different state. 58 The crucial difference was who filed suit: franchisee or franchisor. If the franchisor gets to the courthouse first, it may well avoid the impact of the state law prohibiting forum selection clauses in franchise agreements. Thus, a franchisor should make sure to understand the intricacies of the potentially applicable statues in making decisions about litigation strategy.

In sum, franchisees that wish to escape *Atlantic Marine*’s pro-forum selection clause framework should research whether any state laws might invalidate the clause. Depending on the jurisdiction, the franchisee can argue that the state law applies to issues of validity or that the state law evidences a strong public policy against enforcement of the clause. But franchisees should be aware that state laws are likely to be construed narrowly, and their applicability may depend on the procedural posture of the case. Conversely, in states with venue provisions in their franchise relationship laws, franchisors should strongly consider “grabbing the forum” by filing a preemptive lawsuit.

53. *Id.* at *5 (quoting CAL. BUS. & PROF. CODE § 20040.5).
54. MINN. R. § 2860.4400; *see also* MINN. STAT. § 80C.21.
56. *Id.*
B. Escape Route #2: Argue the Forum Selection Clause Is Permissive

There are two common types of forum selection clauses: mandatory clauses and permissive clauses.¹⁹ Mandatory clauses “contain clear language showing that jurisdiction is appropriate only in the designated forum,” while permissive clauses “authorize jurisdiction in a designated forum, but do not prohibit litigation elsewhere.” Proving a clause is permissive instead of mandatory can make all the difference in a § 1404(a) motion because the vast majority of courts apply the *Atlantic Marine* framework only to “mandatory” forum selection clauses—not permissive ones.⁶¹ Accordingly, when a forum selection clause is considered “permissive,” courts usually hold that the traditional § 1404(a) approach controls; therefore, the court considers the whole range of pre-*Atlantic Marine* factors—plaintiff’s choice of forum, location of witnesses, convenience of parties, locus of operative facts, and so forth.⁶² Accordingly, a franchisee seeking to escape *Atlantic Marine*’s framework should carefully analyze and test the franchise agreement’s forum selection clause to determine whether it could be deemed permissive.

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⁵⁹. There is another less common type of forum selection clause: the so-called “hybrid” forum selection clause. As the name implies, hybrid clauses combine elements of mandatory clauses and permissive clauses; they are initially permissive in that they allow one party to select a forum, but then become mandatory by binding the other party to that forum once the lawsuit is filed. For example, a hybrid clause might read: “Seller and Purchaser, waive any objection to the venue of any action filed in any court situated in the jurisdiction in which the property is located and waive any right to transfer any such action filed in any court to any other court.” Ocwen Orlando Holdings Corp. v. Harvard Prop. Trust, LLC, 526 F.3d 1379, 1381 (11th Cir. 2008).


⁶¹. Carl’s Jr. Rests. LLC v. 6Points Food Servs. Ltd., No. CV 15-9827-GHK (ASX), 2016 WL 3671116, at *3–4 (C.D. Cal. July 7, 2016) (holding that *Atlantic Marine* applies only to mandatory forum selection clauses); Waste Mgmt. of La., L.L.C. v. Jefferson Parish ex rel. Jefferson Parish Counsel, 594 F. App’x 820, 821–22 (5th Cir. Nov. 28, 2014) (noting that the “vast majority of district courts deciding this issue have rejected *Atlantic Marine*’s application to permissive forum selection clauses” and collecting cases); Networld Commc’ns Corp. v. Croatia Airlines, D.D., No. CIV.A. 13-4770 SDW, 2014 WL 4724625, at *3 (D.N.J. Sept. 23, 2014) (applying traditional test after determining forum selection clause was permissive). Some district courts have come to the opposite conclusion. See FDIC v. Primelending, No. 15-cv-2480, 2016 WL 125632, at *2 n.10 (N.D. Ohio Mar. 31, 2016) (The court found that “*Atlantic Marine* applies to this case regardless of whether the forum selection clause is mandatory or permissive. It is true that the forum selection clause the Supreme Court analyzed in *Atlantic Marine* was mandatory. However, the language of the Court’s discussion seems to reach all valid forum selection clauses, regardless of their permissiveness.”); Enkema v. FTI Consulting, Inc., No. 3:15-cv-1167, 2016 WL 951012, at *3 (M.D. Tenn. Mar. 14, 2016) (“[T]he broad language of the *Atlantic Marine* Court does not indicate that there is any distinction in analysis between a mandatory clause and a permissive clause.”); United Am. Healthcare Corp. v. Backs, 997 F. Supp. 2d 741 (E.D. Mich. 2014) (same).

Because the mandatory-permissive distinction can flip the entire analysis, it is important to understand the distinction between the two types of clauses. For example:

- A classic mandatory forum selection clause might state: “Jurisdiction shall be in the State of Colorado and venue shall lie in the County of El Paso, Colorado.” By its plain terms, this clause mandates a specific forum for litigation.63

- A classic permissive forum selection clause might state: “An action may be maintained in the State of Kansas and the County of Wyandotte.” By its plain terms, this forum selection clause permits—but does not require—litigation in a specific forum (Kansas).64

These examples may seem clear enough, but there are many clauses that appear, at first blush, to be mandatory that are actually construed as permissive. Take this example: “Any litigation concerning this contract shall be governed by the law of the State of Florida, with proper venue in Palm Beach County.”65 Clearly mandatory, right? After all, the clause uses a mandatory word—“shall”—and it specifies the “proper” place for the litigation: Palm Beach County, Florida. But a court did not think so. According to a Florida state appellate court, the clause is permissive because although the venue clause unequivocally states that Florida law shall apply to any litigation of the contract, it lacks mandatory language or words of exclusivity to show that venue is proper only in Palm Beach County . . . That is to say, the clause does not unequivocally mandate that a controversy or dispute be litigated in Palm Beach County, nor does it waive any other territorial jurisdiction. The language merely allows a party to file suit in Palm Beach County.66

The conclusion reached by the Florida state court concerning this forum selection clause appears to be consistent with the general rule followed by federal and state courts. A review of the case law demonstrates that courts will closely scrutinize the language of the clause and will deem a clause to be mandatory only when “jurisdiction is specified with mandatory terms such as ‘shall,’ or exclusive terms such as ‘sole,’ ‘only,’ or ‘exclusive,’” while a clause will be deemed permissive “if jurisdiction is not modified by mandatory or exclusive language.”67 In view of this rule, here are some simple edits (in italics) that make the clause just discussed a mandatory one:

64. Id.
65. This clause was at issue in Regal Kitchens, Inc. v. O’Connor & Taylor Condominium Construction, Inc., 894 So. 2d 288, 290 (Fla. Dist. Ct. App. 2005).
66. Id. at 291–92.
67. See, e.g., Caperton v. A.T. Massey Coal Co., 690 S.E.2d 322, 337–40 (W. Va. 2009) (citing authorities from various federal and state courts); see also K & V Sci. Co., Inc. v. Bayerische Motoren Werke Aktiengesellschaft, 314 F.3d 494, 499 (10th Cir. 2002) (“[W]here venue is specified [in a forum selection clause] with mandatory or obligatory language, the clause will be enforced; where only jurisdiction is specified [in a forum selection clause], the clause will gen-
• “Any litigation concerning this contract shall be governed by the law of the State of Florida, with proper venue only in Palm Beach County.”
• “Any litigation concerning this contract shall be governed by the law of the State of Florida, and proper venue shall be in Palm Beach County.”
• “Any litigation concerning this contract shall be governed by the law of the State of Florida, with proper venue exclusively in Palm Beach County.”

To avoid providing franchisees with this potential escape hatch, franchisors should review their forum selection clauses to ensure that the clause unambiguously states that the venue and forum selected are exclusively in the federal or state courts of a particular location and that this forum selection is expressed in mandatory terms using unambiguous words such as “only,” or “exclusively.”

C. Escape Route #3: Argue the Claims Asserted Are Outside the Scope of the Forum Selection Clause

The next avenue of escape for franchisees is to assert that the forum selection clause does not apply to some or all of the claims at issue.68 This argument is likely to be a non-starter in any franchise litigation where the franchise agreement has a broadly worded forum selection clause, i.e., one using language such as all disputes “relating to the party’s relationship” or all disputes “arising out of or relating to this agreement.” In that situation, courts will apply the forum selection clause “to tort and other non-contract claims that require interpretation of the contract or otherwise implicate the contract’s terms.”69 That clause should cover most of the standard franchisor-
franchisee claims, such as fraudulent inducement, wrongful termination, and failure to pay fees or maintain standards.

This argument, however, becomes more promising the farther removed the tort claims are from the contract, the more narrowly the forum selection clause is drafted, or when the rights being asserted do not originate in the contract itself. For example, if a franchisee alleged that a franchisor made derogatory statements about his work habits, hygiene, or personal life, those claims would likely fall outside even a broad forum selection clause because the tort does not have anything to do with the contractual relationship. Another example is the recent decision in *Xiao Wei Yang Catering Linkage in Inner Mongolia Co., LTD. v. Inner Mongolia Xiao Wei Yang USA, Inc.* In that case, the parties entered into a cooperation agreement in China with the purpose of bringing Xiao Wei Yang Catering, a Chinese restaurant franchise, to the United States. After entering into the agreement, the defendant held itself out as Xiao’s first U.S. franchisee, traded on its reputation, and used its specialized knowledge, all without paying any fees or money to Xiao. Xiao brought suit, asserting numerous claims, including unfair competition and violation of trademark law. The “franchisee” defendant argued that the case had to be dismissed pursuant to a forum selection clause calling for any disputes to be resolved in China. The U.S. District Court for the District of Massachusetts held that that forum selection clause did not apply to Xiao’s trademark-related claims because Xiao was not relying on the cooperation agreement to establish its trademark ownership rights, but on its direct rights as a trademark holder. The district court also noted that to the extent the defendant would assert a right to use the trademarks under the cooperation agreement, that defense was not sufficient cause to conclude the forum selection clause applied.

The takeaways here are, first, that a forum selection clause is not automatically applicable, especially as the claims become less related to the contract.

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70. *Relmada Therapeutics, Inc. v. Laidlaw & Co. (Uk) Ltd*, No. 215-CV-02338-JCM-CWH, 2016 WL 3661927, at *2 (D. Nev. Sept. 29, 2016) (“a ‘pure’ tort claim that is independent of the contract will not be governed by a forum selection clause”); *Terra Int’l*, 119 F.3d at 694 (“Whether tort claims are to be governed by forum selection provisions depends upon the intention of the parties reflected in the wording of particular clauses and the facts of each case.”).
71. *J.R.S., Inc. v. Panduit Corp.*, No. 08-CV-0653-CVE-FHM, 2009 WL 37601, at *3 (N.D. Okla. Jan. 6, 2009) illustrates this situation well. There, the plaintiff claimed that the defendant had made derogatory statements about his craftsmanship to other customers and brought defamation and tortious interference claims. The defendant tried to enforce a forum selection clause in the contract between the parties. The court held that because the defamation and tortious interference claims could be resolved without considering the parties’ contract, the forum selection clause did not apply.
73. *Id.*
74. *Id.* at 80.
Second, the franchisor can try to minimize the “outside of the scope” argument by drafting the forum selection clause as broadly as reasonably possible.75

D. Escape Route #4: Say a Prayer and Argue Exceptional Circumstances

As noted above, a party seeking to avoid a forum selection clause can always argue that an exceptional circumstance exists. This argument has occasionally worked and, in the right set of circumstances, is worth trying.76 For example, in *Credit Suisse AG v. Appaloos Investment Limited Partnership I*, the plaintiff tried to use a forum selection clause specifying the current forum to oppose transfer.77 Even though there was a valid forum selection clause, the U.S. District Court for the Southern District of New York transferred the case because the plaintiff had filed the lawsuit in the district specified by the forum selection clause for the sole purpose of interfering with the orderly administration of a bankruptcy pending in the transferee district.78 In that situation, ensuring the integrity of the bankruptcy process outweighed the policy of enforcing a forum selection clause.79 In *Bollinger Shipyards Lockport, L.L.C. v. Huntington Ingalls Inc.*, the U.S. District Court for the Eastern District of Louisiana found that exceptional circumstances existed when a party, after litigating for multiple years before the court, sought a transfer pursuant to a valid forum selection clause.80 The court held that in these circumstances, the judicial economy gained by its familiarity with the case and the issues in it outweighed the forum selection clause.81 Other courts have reached the same conclusion, but based on the doctrine of waiver.82

The most surprising application of the extraordinary circumstances exception is *Silvis v. Ambit Energy, L.P.*83 There, a Pennsylvania resident

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75. In the context of an arbitration clause (which is “in effect, a specialized kind of forum selection clause,” Scherk v. Alberto-Culver Co., 417 U.S. 506, 519 (1976)), a district court recently refused to enforce an arbitration clause that applied to any interaction between AT&T and one of its customers, whether it took place before, during, or after the contract relationship, because it reasoned that no person could have reasonably agreed to such a clause. See *Wexler v. AT&T Corp.*, 15-cv-686 (FB) (PK), 2016 WL 5678555 (E.D.N.Y. Sept. 30, 2016).

76. Although not worth a lengthy discussion here, two courts have found exceptional circumstances exist where a federal law requires a lawsuit to be brought only in a certain district. See *Stewart v. Am. Van Lines*, No. 4:12-cv-394, 2014 WL 243509 (E.D. Tex. Jan. 21, 2014) (venue provision in Carmack Amendment); *Bronstein v. U.S. Customs & Border Protection*, No. 15-cv-02399-JST, 2016 WL 861102 (N.D. Cal. Mar. 3, 2016) (refusing to enforce forum selection clause in passenger’s cruise ticket where claim against cruise line was joined with claim against federal government under the Federal Tort Claims Act). In *Stewart*, the court also focused on the fact that a transfer would have deprived the plaintiff, an indigent consumer, from being able to litigate her claim in court.


78. *Id.* at *8–12.

79. *Id.*


81. *Id.* at *4.


brought a putative class action against his Texas-based electricity supplier claiming that the supplier had deceptively advertised its rates. The supplier moved to have the case transferred to Texas due to a forum selection clause in the parties’ supply agreements. The U.S. District Court for the Eastern District of Pennsylvania refused to enforce the clause, concluding that Pennsylvania’s regulation of the energy market, the fact that the class was limited to Pennsylvania residents, and that a Pennsylvania court would be more comfortable applying Pennsylvania law warranted a departure from *Atlantic Marine*. In the authors’ view, the *Silvis* decision is not reconcilable with *Atlantic Marine*’s framework because these considerations do not present the type of “extraordinary circumstances” contemplated by the Supreme Court. Rather, the *Silvis* decision appears to be driven by sympathies towards the plaintiff’s allegations of consumer deception. In any event, this case demonstrates that a franchisee with a strong opposition to the franchisor’s chosen venue should almost always take a run at the “extraordinary circumstances” argument. A judge who is especially sympathetic to the franchisee’s allegations may find that “extraordinary circumstances” exist (even when they do not).

### III. What to Do When the Clause Only Partially Applies

One of the largest open questions after *Atlantic Marine* is how to handle cases where the forum selection clause applies only to some of the claims or some of the parties in the case. As seen below, courts have not reached a consensus on the appropriate approach or outcome.

When faced with this issue, some litigants have asked that the claims covered by the forum selection clause be severed from the rest of the case pursuant to Federal Rule of Civil Procedure 21 and transferred to the chosen forum. The Fifth Circuit examined this issue in *In re Rolls Royce Corporation*. There, following a helicopter crash, the helicopter’s owner filed suit in Louisiana against Rolls Royce, the manufacturer of the helicopter’s engine, and two other companies. Rolls Royce’s warranty contained a valid forum selection clause calling for an Indiana forum, but the contracts between the owner and the other two defendants did not have a forum selection clause. Rolls Royce moved to have the claims against it severed and transferred to Indiana,

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84. *Id.* at 398–400; contra Pitney Bowes, Inc. v. Nat’l Presort, Inc., 33 F. Supp. 2d 130, 131–32 (D. Conn. 1998) (holding that familiarity with a forum’s law should not drive transfer analysis because “[f]ederal courts are accustomed in diversity actions to applying laws foreign to the laws of their particular state”). In addition, it could be as easily argued that Texas has a significant interest in regulating businesses headquartered there. Trinity Indus. Leasing Co. v. Midwest Gas Storage, Inc., No. 1:11-CV-01579-JMS, 2013 WL 212929, at *3 (S.D. Ind. Jan. 18, 2013) (“Illinois has a strong interest in regulating companies headquartered there, and ensuring that they comply with applicable laws.”).

85. “Misjoinder of parties is not a ground for dismissing an action. On motion or on its own, the court may at any time, on just terms, add or drop a party. The Court may also sever any claim against a party.” FED. R. CIV. PROC. 21.

86. 775 F.3d 671 (5th Cir. 2014).
which the plaintiff and other defendants opposed. The U.S. District Court for the Western District of Louisiana denied the request and Rolls Royce appealed, claiming that *Atlantic Marine* required severance and transfer.87

Although the Fifth Circuit agreed that severance and transfer was appropriate, it nevertheless concluded that *Atlantic Marine* did not mandate that result. Rather, the Fifth Circuit held that a forum selection clause does not negate the normal severance analysis, which looks largely at issues of judicial economy.88 The Fifth Circuit then laid out a three-part test for courts to use when deciding whether claims subject to a forum selection clause should be severed and transferred:

First, pursuant to *Atlantic Marine*, the private factors of the parties who have signed a forum agreement must, as matter of law, cut in favor of severance and transfer to the contracted for forum. Second, the district court must consider the private factors of the parties who have not signed a forum selection agreement as it would under a Rule 21 severance and section 1404 transfer analysis. Finally, it must ask whether this preliminary weighing is outweighed by the judicial economy considerations of having all claims determined in a single lawsuit. In so determining, the district court should consider whether there are procedural mechanisms that can reduce the costs of severance, such as common pre-trial procedures, video depositions, stipulations, etc. Such practices could echo those used by judges in cases managed pursuant to multidistrict litigation statutes.89

After setting out “this necessarily [] fact sensitive analysis,” the Fifth Circuit explained that it should often result in severance and transfer.90 To reach this conclusion, the appellate court discussed how cases centralized for multidistrict litigation pursuant to 28 U.S.C. § 1407 are not subject to *Atlantic Marine* and should not be due to the large need for judicial economy and centralization.91 The Fifth Circuit then contrasted that situation to a normal multi-party litigation to illustrate that the public interests are not usually so strong in those cases as to decline to sever and transfer the claims covered by the forum selection clause.92

*Roll Royce* was not a unanimous decision. Rather, in the concurrence, Judge Edith Jones rejected the majority’s three-factor test, noting that “*Atlantic Marine* cannot be so cabined” as to apply only to two-party lawsuits.93 After highlighting that numerous district courts had enforced forum selection clauses in multi-party litigation without any concern for a Rule 21 severance analysis, Judge Jones explained that it was myopic to think that a unanimous Supreme Court believed it was limiting *Atlantic Marine* to “simple two-party disputes” that are “near a vanishing breed of litigation.”94 The

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87. *Id.* at 674–75.
88. *Id.* at 680–81.
89. *Id.* at 681.
90. *Id.* at 681–82.
91. *Id.* at 682.
92. *Id.* at 682–83.
93. *Id.* at 684 (Jones, J., concurring).
94. *Id.*
concurrence further emphasized that the majority opinion was at odds with the Supreme Court’s focus on enforcing the “settled expectations” of parties that have chosen a particular forum and also created the unnecessary risk of “easy manipulation, because . . . any clever party to a lawsuit can readily join another party in an attempt to avoid the forum selection clause.”  

The severance and transfer approach does not seem to be the most popular approach for courts and litigants, likely because it creates duplicative litigation. Instead, many courts faced with partially applicable forum selection clauses simply decide whether they will transfer the entire case. This is the approach that has been most popular in franchise cases post-Atlantic Marine. For example, in Family Wireless #1, LLC v. Automotive Technologies, Inc., a group of more than forty plaintiffs that collectively owned more than a hundred Wireless Zone franchises located in thirteen states filed a lawsuit in the U.S. District Court for the Eastern District of Michigan alleging that their franchisor had breached the franchise agreement and committed various torts. Twenty-four of the plaintiffs had signed at least one (and in many cases multiple) forum selection clause calling for litigation in Connecticut, where the franchisor was headquartered. Of the remaining seventeen plaintiffs, only ten were located in Michigan.

The franchisor moved to transfer the entire case to Connecticut. The district court agreed and transferred the entire case. The court reasoned that it had to weigh the § 1404(a) factors for the two groups of plaintiffs (those bound by a forum selection clause and those that were not). It first found that the private interest factors all weighed in favor of transfer for the forum selection clause plaintiffs. It next held that for the non-forum selection clause plaintiffs, the private interest factors largely favored transfer because, except for the ten Michigan plaintiffs, none of the other plaintiffs was located in Michigan and therefore had no connection to the forum. The court also emphasized that the locus of operative facts was in Connecticut where the franchisor was headquartered and that most of the relevant witnesses were found there. Finally, the court analyzed the public interest factors and found that the best way to “reconcile” the two important interests of judicial economy and enforcing forum selection clauses in this case was to transfer the entire case to Connecticut.

Bent v. Zounds Hearing Franchising, LLC is another franchise case where the district court decided to transfer the entire action even though the forum selection clause applied only to some of the parties. There, the plaintiff

95. Id.
96. No. 15-cv-11215, 2015 WL 5142350 (E.D. Mich. Sept. 1, 2015). The authors were counsel for the defendant in that case.
97. Id. at *6.
98. Id.
99. Id. at *7.
100. Id.
franchisee claimed that the franchisor, its owner, and a franchise consulting service violated the New York Franchise Sales Act and committed other torts. Pursuant to a forum selection clause in the franchise agreement, the franchisor and its owner successfully moved for a transfer of the claims against them to Arizona. The consulting service then requested a transfer as well. The U.S. District Court for the Southern District of New York determined that it should transfer the remaining claims because most of the § 1404(a) factors favored transfer, including that the operative events and witnesses were largely in Arizona, and having the entire case proceed in one forum was the most logical outcome. Indeed, in rejecting the plaintiff’s severance argument, the court concluded that severance would “hinder—not serve—the interests of justice and judicial efficiency.”

The case law, however, does not uniformly favor transferring the entire case to the forum selected by only some of the parties. A good example in the franchise context is Get in Shape Franchise, Inc. v. TFL Fishers, LLC. There, a fitness studio franchisor brought suit in Massachusetts after its Indiana-based franchisee stopped operating, failed to fully de-identify, and sold the franchise’s assets to a family member. Following the asset sale, the

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102. Id. at *1.

103. Id. at *9; see also Fraser v. Brightstar Franchising LLC, No. 16-cv-01966, 2016 WL 4269869, at *6–7 (N.D. Cal. Aug. 15, 2016) (transferring claims against franchisor pursuant to forum selection clause and then transferring claims against other defendants because having “identical claims” proceed in one forum “alone warrant[ed] transfer,” and the private interest factors favored transfer as well); TK Prods., LLC v. Buckley, No. 3:16-cv-803-SI, 2016 WL 7013470 (D. Or. Nov. 29, 2016) (transferring entire case, including claims and defendants not subject to forum selection clause, because transfer would prevent duplicative litigation); Kresser v. Advanced Tactical Armament Concepts, LLC, No. 3:16-cv-255 (E.D. Tenn. Sept. 16, 2016) (transferring case even though not all parties were subject to forum selection clause).


105. For example, many district courts have refused to transfer the entire case to the forum selected by the forum selection clause where the clause only covers a small percentage of the total claims at issue. See Eastcott v. McGraw-Hill Global Educ. Holdings, LLC, No. 16-cv-904, 2016 WL 3959076 (E.D. Pa. July 22, 2016) (refusing to transfer pursuant to forum selection clauses where the clauses applied in only seven percent of claims at issue in case); Axis Oilfield Rentals, LLC v. Mining, Rock, Excavation & Constr., LLC, No. 15-cv-1627, 2015 WL 5774801 (E.D. La. Sept. 30, 2015) (deciding that transferring pursuant to forum selection clause was not warranted where clauses applied in only eleven percent of the purchase orders at issue).

106. 167 F. Supp. 3d 173 (D. Mass. 2016). A similar case is Howmedia Osteonics Corp. v. Sarkasia, No. 14-cv-3449 (CCC), 2015 WL 1780941 (D.N.J. Apr. 20, 2015). There, the plaintiff alleged that the defendants, a group of its former employees, had been improperly soliciting customers in California. The defendants, each residents of California, moved to dismiss on personal jurisdiction grounds and, in the alternative, moved to transfer. The plaintiff argued that the court should deny transfer because some of the defendants signed forum selection clauses selecting New Jersey. The district sided with the defendants, finding that New Jersey had no connection to the suit; that at least one of the defendants was subject to a Michigan forum selection clause while others were not subject to a forum selection clause; that at least one defendant was not subject to personal jurisdiction in New Jersey; and that the most important witnesses in the case, seven non-parties who were purportedly solicited, all lived in California. Against this backdrop, the court concluded that it would make no sense to create three cases about the same set of facts scattered throughout the country and that the case belonged where it could be tried all at once—in California.
family member proceeded to operate a fitness studio in the former franchise location with the former franchisee “volunteering” her services. The franchise agreement contained a Massachusetts forum selection clause. After determining that a preliminary injunction should enter against the franchisee, the U.S. District Court for the District of Massachusetts noted that it did not have personal jurisdiction over the other defendants (the franchisee’s family and the new entity operating in the franchise location) and that those claims had to be transferred to the jurisdiction where the fitness studio was located. The court then decided that it should transfer the entire case, including the claims subject to the forum selection clause, to that jurisdiction because the need to avoid duplicative litigation and the transferee state’s interest in regulating its citizens outweighed the forum selection clause.

The takeaway from these cases is that in most franchise litigation where only some of the parties or claims are covered by forum selection clauses, the best approach is typically to seek a transfer of the entire case and emphasize (as was done in Family Wireless) that the only way to satisfy the twin interests of advancing judicial economy and enforcing forum selection clauses is to transfer the entire matter. Absent unusual circumstances such as those in Get in Shape, that should result in a franchisor receiving its chosen forum while preventing competing lawsuits. The takeaway for franchisees is that they should carefully consider which parties to join in a particular lawsuit.

IV. Should Atlantic Marine Actually Impact a Franchisee’s Strategic and Tactical Decisions?

Although Atlantic Marine has undoubtedly made transfer pursuant to a forum selection clause much easier and more likely, there is still no guarantee that a forum selection clause will always result in a transfer to the contractually selected forum. Therefore, the most important conclusion four years removed from Atlantic Marine is that franchisees still have a strategic incentive to ignore a forum selection clause and file the lawsuit wherever they wish. There is no real downside for a franchisee to lose a venue battle, other than the attendant cost and potentially a claim for prevailing party attorney fees. If the franchisor does everything right and the case is transferred, the franchisee is just litigating where the case was supposed to be anyway. Unlike making a weak argument on a substantive issue, there is no real risk to the franchisee’s credibility because transfer is a procedural issue decided by a judge who, if the case is transferred, will never think about it.

108. The fact that the franchisee was representing herself and could not afford to litigate in two forums at once also seemed to influence the district court’s decision. Id. at 206.
109. Id. at 206–07; see also In re LMI Legacy Holdings, Inc., 553 B.R. 235, 258 (D. Del. 2016) (refusing to sever and transfer portion of case that was subject to forum selection clause because that would result in an “inefficient use of judicial resources, prejudice[] to the other Defendants, and create a risk of inconsistent and conflicting adjudications.”).
again. Conversely, the upside of defeating a transfer motion is considerable. Aside from the obvious practical advantages (less expensive to litigate, familiar courts, friendlier jury pool, etc.), there could be a substantive advantage due to how choice of law rules work. A federal court sitting in diversity applies the choice of law principles of the forum state. Some states consider statutes of limitation as procedural rules and, under choice of law principles, will apply the forum state’s limitations periods even if there is a choice of law clause. Thus, a franchisee may sue in a forum for the purpose of achieving more favorable statutes of limitation, and if a forum selection clause is defeated, can rely on those statutes of limitation.

The question then becomes: what, if anything, can the franchisor do to maximize the likelihood that the forum selection clause is enforced? First, the franchisor should conduct a careful analysis of its forum selection clause to make sure it is mandatory and broadly worded to apply to any claim related to the parties’ relationship. Second, the franchisor must raise the forum selection clause at the very beginning of the litigation. Third, the franchisor should consider placing other provisions, such as a contractual limitations period, in the franchise agreement that lessen the incentives for ignoring the forum selection clause. Finally, the franchisor can attempt to recover attorney fees for breach of a forum selection clause under a general prevailing parties’ fee provision, or, for added protection, include an attorney fee provision related specifically to enforcing the forum selection clause. While these steps will not guarantee that a franchisee will file in the contractually selected venue or that a court will enforce the parties’ forum selection clauses, they will maximize the chances of the litigation occurring in the selected court.

111. See, e.g., ABF Capital Corp. v. McLauchlan, 167 F. Supp. 2d 1011, 1014 (N.D. Ill. 2001) (Under Illinois choice of law principles, the Illinois statute of limitations applies even where contract called for New York law.).
112. See, e.g., Air Brake Sys., Inc. v. TUV Rheinland of N. Am., Inc., 699 F. Supp. 2d 462, 470 (D. Conn. 2010) (collecting cases for the proposition that Connecticut and federal “jurisprudence has recognized that parties to a contract may require a specific period of time within which to assert their respective claims, and that longer statutes of limitation do not prevent such agreements as a matter of principle”).
Litigating Dealer Termination Cases in Puerto Rico

Ricardo F. Casellas Sánchez and Carla S. Loubriel Carrión

Puerto Rico has two special laws that govern relationships between principals or suppliers and their dealers or sales representatives: the Dealer’s Contract Act of 1964, commonly known as Law 75, and the analogous Sales Representative Act of 1990, known as Law 21. These relationship laws are remedial statutes that provide for preliminary injunctive relief and compensatory damages to qualified dealers, distributors, franchisees, wholesalers, sales representatives, and other agents down the distribution chain for an unjustified termination, refusal to renew, or impairment of the existing relationship or contract. Although these laws are similar to relationship statutes in many states, Puerto Rico’s civil law tradition and court system make the litigation of dealer disputes unique in this jurisdiction.

This article begins by providing an introduction to those aspects of the Puerto Rico legal system and culture that have the most bearing on this type of commercial litigation. It then highlights some of the ways in which the federal and local courts have diverged in their analysis and application of Laws 75 and 21, specifically in the context of preliminary injunctions and forum selection clauses, and how that may influence a dealer or manufacturer’s litigation strategy. After providing a substantive overview of the most important provisions of Puerto Rico’s special laws protecting dealers and sales representatives, this article concludes by delving into recent experiences litigating dealer termination cases in the U.S. District Court for

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the District of Puerto Rico, and provides some applied insights into local jury trial practice. The authors hope that this overview of the subject will provide a useful guide to practitioners in the field.

I. Puerto Rico’s Unique History and Circumstances Influence the Litigation of Dealer Disputes

A. The Civil Code As a Source of Law

Unlike the states of the Union, except for Louisiana, Puerto Rico remains a civil law jurisdiction. Tracing its roots to Spain, Puerto Rico’s civil law system is characterized by an integrated system of laws regulating the conduct of natural and juridical persons or entities that is codified in civil and mercantile codes or statutes. Unless an issue is controlled by a special law, the Civil Code, as the general law, supplements the interpretation of special laws and creates or defines the rights and obligations of persons or entities.

There is a rich legal and cultural heritage in civil law jurisdictions. A distinctive feature of Civil Code jurisdictions is that courts place a “heavier reliance” on the opinion of learned commentators in their law review articles, treatises, and publications. Another feature is that Civil Code jurisdictions use comparative law to search for persuasive authorities in other jurisdictions, including the common law and foreign states. In this regard, because the Puerto Rico Civil Code was originally modeled after the Spanish Civil Code of 1888, courts interpreting the Puerto Rico Civil Code or any related

3. See P.R. LAWS ANN. tit. 31, §§ 1 et. seq. (1930); Laubie v. Sonesta Int’l Hotel Corp., 752 F.2d 165, 167 (5th Cir. 1985) (“In Louisiana, a civil law jurisdiction, the legislative will, as expressed in the articles of the Code, is supreme. Case law, although valuable, is of secondary importance.”); Matos-Rivera v. Flav-O-Rich, 876 F. Supp. 373, 377 (D.P.R. 1995) (“In a civil-law jurisdiction, case law can be primary if it is presented as such a long line of precedents that the case law has become customary law. Otherwise, case law is secondary authority. And either as customary law or as a single case, precedent is imperative to filling in the gaps or making up for the deficiencies of the legislation in a civil-law jurisdiction.”).

4. See P.R. LAWS ANN. tit. 31, §§ 1 et. seq. (1930); P.R. LAWS ANN. tit. 10 §§ 1002 & 1301 (1932).


7. Valle v. Am. Int’l Ins. Co., 8 P.R. Offic. Trans. 735, 737–38 (1979). Of course, comparative law is not foreign to decision-making in the common law approach or by federal courts, particularly on constitutional issues. “[A] U.S. Court interpreting a federal statute or constitutional provision can look at the reasoning of a foreign or international tribunal on similar issue.” Al-Bihani v. Obama, 619 F.3d 1, 33 n.18 (D.C. Cir. 2010) (Kavanaugh, J., concurring) (citing Ruth Ginsburg, A Decent Respect to the Opinions of [Human] Kind: The Value of a Comparative Perspective in Constitutional Adjudication, Address to the International Academy of Comparative Law (July 30, 2010). While foreign decisions do not rank as precedent, they can be informative and just as persuasive as reasoned law review articles or commentators on the subject matter. Id.
doctrines may primarily look for guidance in Spanish Supreme Court decisions and treatises analyzing analogous code provisions or statutes, but these sources of comparative law are by no means exclusive.8

These observations are relevant because Laws 75 and 21 have been found not to provide exclusive remedies for violations by dealers or their principals.9 This means that the Civil Code applies as a supplemental source of authority when not inconsistent with the special laws themselves.10 In addition to actionable claims for termination or impairment of contract under Laws 75 and 21, a dealer or sales representative can also assert claims sounding in tort (usually described as extra-contractual claims) or in contract that arise from the Civil Code, the Mercantile Code, and their interpretive jurisprudence.11 The Civil Code provides defenses that may relieve or excuse compliance with an obligation in a contract when one of the parties has breached an essential and reciprocal obligation.12 Rules of interpretation governing civil contracts also apply to the construction of mercantile contracts, such as those governed by Laws 75 and 21.13

There are also instances when the Civil Code does not apply. For example, because Laws 75 and 21 specifically prescribe three-year limitations periods for filing claims, those dispositions govern in breach of contract claims arising from protected relationships rather than the fifteen-year statute of limitations established in the Civil Code for regular claims of breach of contract.14 Recently, in Trafon Group, Inc. v. Butterball, LLC,15 the First Circuit affirmed both an order denying a preliminary injunction and the ensuing judgment dismissing a Law 75 action as time-barred, based on its interpre-

8. See Matos-Rivera, 876 F. Supp. at 376 n.1, 381.
11. Id.
12. See, e.g., Fabregas v. Mayaguez Light, 43 P.R. Dec. 207 (1932) (holding that, under Art. 1077 of the Puerto Rico Civil Code, P.R. LAWS ANN. tit. 31, § 3052, a creditor that failed to fulfill an essential obligation to repair a structure quickly as required by the contract cannot demand the debtor to pay an outstanding balance for services rendered and stipulated in that contract); Mora Dev. v. Sandin, 118 P.R. Dec. 733, 742 (1987) (applying same principle).
13. Pursuant to the Civil Code, if the literal terms of an agreement, its conditions, and its exclusions are clear and specific, leaving no room for ambiguity or for diverse interpretations, they must be applied. Unisys v. Ramallo, 128 P.R. Dec. 842, 852 (1991) (citing P.R. LAWS ANN. tit. 31, § 3471). “If the words should appear contrary to the evident intention of the contracting parties, the intention shall prevail.” Id. But, if there is an ambiguity in the contract, the interpretation must not favor the party occasioning the ambiguity. See P.R. LAWS ANN. tit. 31, § 3478; see also Grifols, Inc. v. Caribe RX Serv., Inc., 2016 TSPR 147, at *7–8 (P.R. 2016) (Rodrı´guez, J., concurring).
14. Usually, contract claims that are covered by the Commerce Code, but are not designated for specific prescriptive treatment, fall under the Civil Code’s fifteen-year catchall provision. See Caribbean Mushroom Co., Inc. v. Gov’t Dev. Bank of P.R., 102 F.3d 1307, 1312 (1st Cir. 1996). Although Law 75 is part of the Commerce Code, it specifically designates a three-year statute of limitations for termination and impairment claims. See Inst. of Innovative Med., Inc. v. Lab. Unidos, 613 F. Supp. 2d 181 (D.P.R. 2009); see also P.R. LAWS ANN. tit. 10 § 279h.
15. 820 F.3d 490 (1st Cir. 2016).
tation of Puerto Rico law regarding when such claims for impairment of con-
tract accrue and, hence, when the three-year statute of limitation begins to 
run.16 This holding is likely to spawn litigation.17

In sum, a risk assessment of dealer disputes in Puerto Rico may require an 
overview of not only the text of those two special laws applying to Puerto 
Rico dealers and sales representatives, but also the Civil Code; the Com-
merce Code; the writings of learned commentators; and interpretive judicial 
decisions of the Supreme Court of Puerto Rico, the U.S. District Court for 
the District of Puerto Rico, the U.S. Court of Appeals for the First Circuit, 
the federal courts in other jurisdictions that have decided Law 75 or Law 21 
claims in diversity cases,18 the common law, and on occasion the Supreme 
Court of Spain.

B. Procedural Considerations of Litigating Dealer Disputes in Puerto Rico

Procedurally, litigation of dealer disputes in Puerto Rico involves impor-
tant differences from litigation in the United States. As in many states, 
Puerto Rico has a three-tier judicial system: a unified court of first instance 
with general jurisdiction, an intermediate appellate court, and a supreme 
court with review of final decisions by the U.S. Supreme Court.19 However, 
unlike many states, local court judges are not elected, but appointed to their 
positions. Those appointments, including to the Puerto Rico Supreme 
Court,20 are for definite terms—unlike Article III federal judges, who are

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16. Id. at 494–95. The plaintiff Trafon was a Puerto Rico-based wholesale food distributor 
that had acquired certain assets, including an existing distribution agreement with Butterball 
for whole bird and turkey products, from Packers Provisions Company of Puerto Rico. The 
asset purchase agreement did not reference an alleged exclusive distribution relationship be-
tween Packers Provisions and Butterball. Nor did Trafon secure the manufacturer’s consent, 
or a representation of exclusivity, prior to completing the asset purchase transaction. While Tra-
fon may have believed that the distribution rights it had acquired were exclusive, Butterball dis-
agreed and openly refuted the allegations of exclusivity in its counsel’s letter of October 2009 
and in disclaimers made in each subsequent invoice. Trafon sued Butterball in September 
2013 after Butterball had made sales to Costco and refused to pay commissions to Trafon on 
such direct sales made during 2011 and 2012. Essentially, the legal issue on appeal centered 
on when the Law 75 claim accrued to start the running of the three-year limitations period. 
Did it begin to run in October 2009, when Trafon was on notice of Butterball’s repudiation 
of the exclusivity allegation, or when the latter started to sell product directly in 2011? Applying 
Basic Controlex v. Klockner Moeller Corp., 202 F.3d 450 (1st Cir. 2000), the First Circuit held that 
the limitations period began to run from Butterball’s counsel’s letter in October 2009, resulting 
in the action filed in September 2013 being time-barred. See Trafon Grp., 820 F.3d at 494–95.

17. The First Circuit’s holding in Trafon Group that a Law 75 impairment claim accrues when 
the dealer is on notice that the principal does not intend to respect an alleged exclusive distribution 
right, and not when the principal acts on it by selling product directly or through a com-
petitor, see id., puts a premium on the dealer to sue first and negotiate later or else face the risk of 
waiving the right to sue. This predicament is likely to strain business relations between dealers 
and manufacturers and put both sides on the offensive.

18. See, e.g., Whirlpool Corp. v. U.M.C.O Int’l, 748 F. Supp. 1557 (S.D. Fla. 1990); Carib-


appointed for life. Further, litigation in the local courts is primarily conducted in Spanish, although the Puerto Rico Rules of Civil Procedure allow for proceedings and filings to be in Spanish or English.

More importantly, there is no right to trial by jury in civil cases in the local Puerto Rico courts. This reality influences the strategic decision of whether to initiate litigation in the local versus federal court or to remove a case to the federal court where there is a right to trial by jury. Further, unlike a state, Puerto Rico is a territory under the plenary authority of the U.S. Congress. Regardless, just as in the United States, federal laws apply to Puerto Rico unless locally inapplicable.

As an example relevant here, the Federal Arbitration Act applies to Puerto Rico. There is also a Puerto Rico arbitration statute, and a strong public policy exists favoring arbitration of dealer disputes.

C. Litigation of Dealer Disputes in Federal Versus Local Court

Litigation of dealer disputes also has different implications in Puerto Rico’s local courts versus federal courts. Although the federal district court in diversity cases is bound to apply Puerto Rico’s substantive law as would a local court, the choice of forum (federal or local) can influence the outcome of a dealer dispute in some cases. In particular, divergent judicial interpretations or standards exist between the two courts in Law 75 cases when motions seek-

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22. Rule 8.7 of the Puerto Rico Rules of Civil Procedure (2010), P.R. LAWS ANN. tit. 32, App. V; see also P.R. LAWS ANN. tit. 1, § 59 (“Spanish and English are established as official languages of the Government of Puerto Rico.”). Nevertheless, as a practical matter, business in Puerto Rico is conducted largely in Spanish, and the language barrier can be of serious monetary consequence for litigants, even in the federal court. See, e.g., Torres-Serrant v. Dep’t of Educ. of P.R., 100 F. Supp. 3d 138, 139 (D.P.R. 2015) (noting that “although officially a bilingual jurisdiction with Spanish and English as its official languages, [Puerto Rico’s] population is largely Spanish-speaking. Given said cultural reality, judicial and administrative proceedings in the Commonwealth courts and agencies are conducted in the language of Cervantes rather than that of Shakespeare, while those at the federal level are officiated in the latter tongue”; and holding that costs of translating administrative record would be borne by defendant) (internal footnotes omitted).
23. See Vera-Lozano v. Int’l Broad., 50 F.3d 67, 71 (1st Cir. 1995) (“It is well accepted that the Seventh Amendment affords litigants in federal courts in Puerto Rico the right to trial by jury, notwithstanding the fact that the Constitution of Puerto Rico does not allow for juries in civil cases.”) (citing cases). Judicial attempts to establish that the Seventh Amendment right to a civil trial applies in the local Puerto Rico courts have not been successful. See González-Oyarzun v. Caribbean City Builders, Inc., 27 F. Supp. 3d 265, 275–81 (D.P.R. 2014), rev’d 798 F.3d 26 (1st Cir. 2015).
24. Vera-Lozano, 50 F.3d at 71.
27. 9 U.S.C. § 1 (applies to interstate commerce involving a territory).
ing to enforce forum selection clauses or requesting preliminary injunctions are at issue.

1. Does the Enforcement of a Forum Selection Clause Depend on the Court Deciding Its Validity?

Generally, as a matter of federal law, mandatory forum selection agreements are *prima facie* valid and enforceable.\(^{30}\) However, the U.S. Supreme Court held in *Bremen v. Zapata* that the question whether a forum selection clause offends a forum state’s public policy can be one of a number of grounds for invalidation of such a clause.\(^{31}\) To that end, Law 75 has a provision at Section 278b-2 specifically providing that a forum selection clause mandating litigation or arbitration outside of Puerto Rico is null and void as against public policy.\(^{32}\) Unlike Law 75, Law 21 does not expressly forbid the enforcement of a choice of forum clause.\(^{33}\)

Despite the language of Law 75’s Section 278b-2, decisions from the U.S. District Court for the District of Puerto Rico have for the most

31. Id. at 15–16.
32. P.R. LAWS ANN. tit. 10, § 278b-2 (“Any stipulation that obligates a dealer to adjust, arbitrate or litigate any controversy that comes up regarding his dealer contract outside of Puerto Rico, or under foreign law or rule of law, shall be likewise considered as violating the public policy set forth by this chapter and is therefore null and void.”). As for the prohibition against celebrating arbitration of dealer disputes outside of Puerto Rico, the Federal Arbitration Act has been found to preempt Section 278b-2 in that regard. See Medika Int’l, Inc. v. Scanlan Int’l, Inc., 830 F. Supp. 81, 84 (D.P.R. 1993). Concerning the validity of a choice of law clause providing for another state law to apply to a dealer contract governed by Law 75, the U.S. District Court for the Southern District of New York has generally held those clauses to be unenforceable as contrary to Puerto Rico’s public policy. See, e.g., Caribbean Wholesales & Serv. Corp. v. US JVC Corp., 855 F. Supp. 627 (S.D.N.Y. 1994) (applying New York choice of law rules, Law 75 held to govern despite choice of law clause specifying New York law); S. Int’l Sales Co. v. Potter & Brumfield Div. of AMF Inc., 410 F. Supp. 1339, 1342 (S.D.N.Y. 1976) (same, where choice of law clause specified Indiana law). It is an open question whether the outcome in those cases would have been the same under the choice of law rules of another state or had the clause in the Law 75 or Law 21 contract provided that state law governed without regard to conflict of law rules.
33. Law 21 provides in pertinent part that “[t]he sales representation contracts referred to in this chapter shall be construed pursuant to, and shall be governed by the laws of the Commonwealth of Puerto Rico, and any stipulation to the contrary shall be null. However, this nullity shall not include any arbitration clause agreed upon.” P.R. LAWS ANN. tit. 10, § 279F. In *Barril v. Combraco Industries*, 619 F.3d 90 (1st Cir. 2010), the principal terminated a Law 21 agreement. After removal of the dealer’s complaint to federal court, the district court enforced the choice of forum clause granting a Federal Rule of Civil Procedure 12(b)(6) motion and dismissed the action without prejudice. The First Circuit affirmed. The court followed the federal standard in *Bremen v. Zapata* and skirted the issue whether enforcement of a forum selection clause is procedural or substantive, noting that both Puerto Rico and North Carolina follow the *Bremen* standard. The appellant had argued that enforcement of the clause under *Bremen*’s fourth prong was invalid because it contravened the strong public policy of the forum behind Law 21. The court disagreed. The court noted that Law 21 does not by its terms forbid the enforcement of a choice of forum clause, but only a choice of law clause insofar as it “would prevent Law 21’s substantive protections from being given effect.” Id. at 94. The court rejected the argument that North Carolina law precludes courts from giving effect to the laws of another state or territory, so that North Carolina courts are just as capable of enforcing Law 21 to the extent that it otherwise applies, despite the choice of law clause. Id. at 94–95.
part enforced forum selection clauses in dealers’ contracts governed by the statute. Federal courts have reasoned that important federal interests of respecting liberty of contract and freedom of commerce outweigh parochial provisions in legislation, such as Law 75, requiring litigation of dealer disputes in home courts. Further, in those cases, federal courts have predicted that the Puerto Rico Supreme Court would follow a series of decisions adopting federal law on the enforcement of forum selection clauses, disregard the prohibition in Law 75, and give more weight to federal policy interests.

Notwithstanding, a panel of the intermediate appellate court in Puerto Rico recently went the other way on this issue. In *Caribe RX Service, Inc. v. Grifols Inc.*, the Puerto Rico appellate court held that Section 278b-2 of Law 75 required finding that a clause in a distributor agreement providing for mandatory litigation in North Carolina was illegal and unenforceable.

34. Choice of forum clauses have not always been enforced by the U.S. District Court for the District of Puerto Rico on federal law grounds. In *Victory Management Solutions, Inc. v. Grohe America, Inc.*, 103 F. Supp. 3d 191 (D.P.R. 2015), rev’d, No. 14-1818, 2015 WL 10662841 (D.P.R. July 8, 2015) (reversed on reconsideration based on new evidence), the supplier Grohe moved to dismiss on grounds of *forum non conveniens* (not for failure to state a claim under Federal Rule of Civil Procedure 12(b)(6)). Grohe alleged that the Law 21 claim for alleged wrongful termination of contract fell under a mandatory forum selection clause providing for litigation in Illinois. The district court found many problems with the chosen venue that made the clause unreasonable and unenforceable under the court’s *Bremen* analysis. The district court determined that the clause had no connection to the parties, the agreement, or the dispute. *Id.* at 197. Grohe’s lease of a third party warehouse for storage, logistics, distribution, and service support was insufficient and made it unfair for the agent to litigate in Illinois. *Id.* However, the court did give weight to the fact that an Illinois court would most probably apply Puerto Rico law despite a contrary choice of law clause in the agreement. *Id.* The court also held that the clause was not invalid under Law 21’s public policy. *Id.* at 196. While this part of the court’s decision is *dicta*, it opines on an issue previously left unresolved by the First Circuit in the *Barril* case but is consistent with other decisions validating forum selection clauses in distribution agreements governed by Law 75.


36. See *Caribbean Rest.*, 23 F. Supp. 3d at 78; *Marpor Corp.*, 2010 WL 4922693, at *5.

37. See *P.R. Surgical Tech.*, 2010 WL 4237927, at *3 (citing cases).


39. *Id.* at *3–5. In the *Grifols* case, the appeals court validated the trial court’s order denying a motion to dismiss for lack of jurisdiction based on a North Carolina forum selection clause in the distribution agreement. The appeals court denied certiorari review from the trial court’s order. *Id.* at *5–6. Although this decision is not precedent in other cases, see García v. Padro, 165 P.R. Dec. 324, 336 (2005); see also Núñez Borges v. Pauneto Rivera, 130 P.R. Dec. 749, 755–56 (1992) (same as to a Puerto Rico Supreme Court denial of certiorari), the opinion still reached and rejected the merits of the arguments raised by *Grifols*. *Id.* at *2–5. Unlike the U.S. Supreme Court when it denies discretionary review without reaching the merits, Puerto Rico’s appellate courts tend to reach merit issues in orders denying certiorari review. Those determinations may be considered persuasive, though not binding, by the lower trial court or sister panels of the intermediate appellate court. See, e.g., Cadiz Gomez v. E.L.A. de Puerto Rico, HSCI201500189, 2016 WL 6989560, at *10 (P.R. Ct. App. Oct. 31, 2016); see also Rivera Maldonado v. E.L.A., 119 P.R. Dec. 74, 79–80 (1987) (judgments issued without opinion by the Puerto Rico Supreme Court also do not have res judicata effect, but may be cited as persuasive). Another difference
Further appeal to the Puerto Rico Supreme Court as to the forum selection clause issue was not taken in that case. To date, the Puerto Rico Supreme Court has not decided the validity of a forum selection clause specifically in a Law 75 or Law 21 contract. As the law now stands, given the long line of cases deciding precisely this question in the federal forum, the latter appears to be more receptive to the enforcement of choice of forum clauses in Law 75 or Law 21 cases than the local Puerto Rico court, where the issue is unsettled.

2. Does It Make a Difference Where the Request for a Preliminary Injunction Under Laws 75 or 21 Is Made?

Deciding whether a case requires moving for a preliminary injunction may influence a dealer-plaintiff on its choice of forum. Under Federal Rule of Civil Procedure 65, a federal court may not issue a preliminary injunction without proof that the traditional requirements for injunctive relief, including proof of irreparable harm and likelihood of success on the merits, have been satisfied. However, in Law 75 cases filed in local Puerto Rico courts, the traditional requirements for injunctive relief are permissive and relaxed, and this may influence a plaintiff’s choice of forum or the outcome pending a final judgment.

between Puerto Rico and federal appellate practice that should be relevant to the distribution law practitioner is that Puerto Rico appellate courts, unlike the First Circuit, rarely if ever hold oral argument in pending cases. See Rule 80 of the Puerto Rico Court of Appeals, P.R. LAWS ANN. 4, App. XXII-B.

40. But see Grifols, Inc. v. Caribe RX Serv., Inc., 2016 TSPR 147 (P.R. 2016) (Rodrı ´guez, J., concurring) (reversing and modifying preliminary injunction that was subsequently granted to plaintiff; published concurring opinion discusses preliminary injunction factors in Law 75 context and Puerto Rico law of contracts applied to verbal agreement vis-à-vis integration clause included in distribution contract).


42. As the First Circuit has pointed out, Law 75’s “statutory provision for preliminary injunctive relief neither specifies nor forbids that the dealer show a likelihood of success on the merits, [ ] P.R. LAWS ANN. [tit. 10,] § 278b-1, and the case law appears to be divided on whether there is such a requirement.” V. Suarez & Co., Inc. v. Dow Brands, Inc., 337 F.3d 1, 8 n.10 (1st Cir. 2003) (citing Luis Rosario, Inc. v. Amana Refrigeration, Inc., 733 F.2d 172, 173 (1st Cir. 1984)); Cobos Liccia v. DeJean Packing Co., 24 P.R. Offic. Trans. 896 (1989); Systema de Puerto Rico, Inc. v. Interface Int'l, Inc., 23 P.R. Offic. Trans 347 (1989)). In the federal context, this question of whether “the likelihood of success” requirement applies would present a direct conflict with the Hanna holding, requiring the federal procedural standard to govern (in this case, Federal Rule of Civil Procedure 65), when in conflict with state substantive law. See Ricardo F. Casellas-Sánchez & Manuel Pietrantoni, When a Substantive Rule of Puerto Rico Law
In *Next Step I*, the Puerto Rico Supreme Court held that the issuance of a Law 75 preliminary injunction to a qualified dealer required weighing the policies served by the statute and balancing all the relevant interests. The court reiterated its prior statements to the effect that traditional standards for preliminary injunctions are relevant, but do not necessarily apply in this context, although traditional defenses to equitable relief, such as laches and estoppel, still apply. The sequel case, *Next Step II*, involved the principal’s termination of a Law 75 contract after the dealer’s distribution rights had been expressly assumed by the principal’s successor. After the trial court scheduled a preliminary injunction hearing, the principal admitted lack of just cause and argued that the request for a preliminary injunction had become moot because all that remained was a prompt hearing on damages. The trial court agreed with the principal. The intermediate appellate court not only reversed but, concluding that the principal had admitted lack of just cause, also entered a preliminary injunction on appeal and without a hearing.

This procedural imbroglio came before the Puerto Rico Supreme Court on two issues: first, whether the principal’s admission of liability mooted the preliminary injunction remedy (it did not), and second, whether the appellate court erred by granting a preliminary injunction on appeal (it did). The court held that the preliminary injunction was not moot. The purpose of the Law 75 provisional remedy was to lessen the impact to the dealer from its loss of the dealer contract until a final judgment on the merits. Because the case was not over with only an admission of lack of just cause, the provisional remedy was not moot. However, the intermediate appellate court did err in granting the preliminary injunction without a hearing because the dealer still had the burden of proving the reality of its damages and that the balancing of the relevant factors justified injunctive relief under *Next Step I*. The case was remanded for further proceedings.

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44. *Id.* at 496–500.
45. *Id.* at 499.
47. *Id.* at 742.
48. *Id.* at 744–45.
49. *Id.* at 744–46.
50. *Id.* at 746.
51. *Id.* at 755–57.
52. *Id.* at 757.
II. Overview of Puerto Rico’s Special Laws Protecting Dealers and Sales Representatives

Puerto Rico has no law regulating disclosures by franchisors to franchisees, dealers, or prospective investors prior to the sale of a franchise.53 The only special relationship laws that apply specifically in the franchise context are Law 75 governing dealers (including franchisees, distributors, wholesalers, and other resellers)54 and Law 21 for exclusive sales representatives.55 Law 75 is a special law passed in 1964 that embodies a public policy in Puerto Rico to “remedy the abusive practices of suppliers who arbitrarily eliminated distributors after they had invested in the business and had successfully established a market for the supplier’s product or service.”56 One of the main purposes of Law 75 is to “level the contractual conditions between two groups that are economically unequal,” recognizing that the supplier, typically a more powerful company, has leverage over the Puerto Rico dealer that lacks bargaining power when entering into contracts.57 The statute traces its origins to similar laws in the Dominican Republic, Cuba, and the United States.58 Law 75 has survived federal constitutional and statutory challenges.59

Law 75 prohibits the termination, non-renewal, or impairment of the dealer contract without just cause. As such, it applies to prevent arbitrary ter-

54. P.R. LAWS ANN. tit. 10, §§ 278 et. seq.
55. P.R. LAWS ANN. tit. 10, §§ 279 et. seq.
56. Re-Ace, Inc v Wheeled Coach Indus., Inc., 363 F.3d 51 (1st Cir. 2004) (citation omitted); Newell Puerto Rico, Ltd. v. Rubbermaid, Inc., 20 F.3d 15, 22 (1st Cir.1994). “[Law 75] regulates the termination of a supplier’s relationship with a dealer providing that, regardless of any unilateral right to terminate present in a contract, ‘no principal or grantor may directly or indirectly perform any act detrimental to the established relationship . . . , without just cause.” Newell Puerto Rico, 20 F.3d at 54 (quoting P.R. LAWS ANN. tit. 10, § 278a). “Law 75’s main interest is to prevent unfair usurpation by the supplier of the distributor’s hard won clientele and goodwill.” V. Suarez & Co. v. Dow Brands, Inc., 337 F.3d 1, 7 (1st Cir. 2003).
58. Foreign jurisdictions that can be persuasive in the interpretation of Laws 75 and 21 include Spain, Cuba, and the Dominican Republic, of which the last two have similar statutes that predate Puerto Rico’s. See COMMONWEALTH OF P.R., CHAMBER OF COMMERCE, Estudio Sobre la Ley 75 de 24 de junio de 1964 que Reglamenta los Contratos de Distribución [Report on Law 75 of June 24, 1964 That Regulates Distribution Contracts], at 80 (undated). But common law jurisdictions that have also shaped many of the amendments to Law 75 relating to the presumption of lack of just cause include California, Colorado, Florida, Georgia, Illinois, Indiana, Kentucky, Maine, Massachusetts, Mississippi, North Carolina, Nevada, New Hampshire, New Jersey, New Mexico, Ohio, Rhode Island, South Carolina, Tennessee, Texas, Vermont, and possibly, Wisconsin. See id. at 61–77. Delaware enacted a “Franchise Security Law” on July 8, 1970, protecting certain franchisees with a place of business within the state from unjustified terminations. Damages include lost profits and loss of goodwill. “[Delaware law], within the ambit of legislation in the United States, is closest in its focus to Law 75.” See id. at 67–68.
minations or other abusive conduct by the principal or grantor.\textsuperscript{60} The statute provides that “no principal or grantor may directly or indirectly perform any act detrimental to the established relationship or refuse to renew said contract on its expiration except for just cause.”\textsuperscript{61} Impairment is conduct by the manufacturer that does not terminate the contract, but is considered to be detrimental to the established relationship.\textsuperscript{62} Termination of a Law 75 contract must be done in good faith and with due prior notice to the dealer considering the nature and characteristics of the relationship.\textsuperscript{63}

A. \textit{How Do Puerto Rico’s Relationship Statutes Depart from Their Common Law Counterparts?}

In its most basic formulation, Law 75 departs from civil and common law principles governing commercial contracts in significant ways. First, Law 75 superimposes in every dealer contract a requirement of “just cause” for the principal to terminate, impair, or refuse to renew the agreement and establishes presumptions of lack of just cause in specified circumstances.\textsuperscript{64} A Law 75 contract is not terminable at will, or on its own terms, since it requires just cause.\textsuperscript{65} Public policy does not permit provisions of Law 75 to be contracted away and the distributor’s rights cannot be waived.\textsuperscript{66} This

\textsuperscript{60} R.W. Int’l Corp. v. Welch Food, Inc., 13 F.3d 478, 485 (1st Cir. 1994); San Juan Mery- cantile v. Canadian Transport Co., 8 P.R. Offic. Trans. 218, 222 (1978); Ileana Irvine, IRG Research Grp., Inc. v. Murad Skin Research Labs., Inc., 194 F.3d 313, 317 (1st Cir. 1999).


\textsuperscript{62} In the context of what constitutes a detrimental act, Law 75 does not create rights where none exist by contract. See Medina & Medina v. Hormel Foods Corp., 840 F.3d 26, 41–42 (1st Cir. 2016). Law 75 protects contractually acquired rights. Id. For example, where the contract is non-exclusive, a dealer cannot claim an impairment of contract or damages from the supplier’s sales of products to a competing distributor or for selling products directly, nor can the dealer convert an expressly non-exclusive contract into an exclusive contract. Id.; see also Grifols, Inc. v. Caribe RX Serv., Inc., 2016 TSPR 147, at *11–12 (P.R. 2016) (Rodríguez, J., concurring) (dealer held to content of signed written agreement, executed after extensive negotiation and containing an integration clause, that limited exclusivity to specific lines of product; dealer’s one-sided contention that implied agreement was for exclusivity over all products did not trump actual agreement reached in writing with distributor).

\textsuperscript{63} Medina & Medina v. Country Pride Foods, Ltd., 858 F.2d 817 (1st Cir. 1988).

\textsuperscript{64} P.R. LAWS ANN. tit. 10, § 278a–1(c)

\textsuperscript{65} Under Puerto Rico law, contracts not governed by Law 75 and that have no fixed term or duration are terminable at will by either party. See Quality Const. Chems. v. Sika Corp., 389 F. Supp. 2d 246 (D.P.R. 2005).

\textsuperscript{66} P.R. LAWS ANN. tit. 31, § 3372 (1991); P.R. LAWS ANN. tit. 10, § 278c. For that reason, “[the] just cause limitation applies even where a contract includes a clause providing for termination under specified circumstances.” Casas Office Machines, Inc. v. Mita Copystar Am., Inc., 42 F.3d 668, 679 (1st Cir. 1994). Similarly, provisions fixing any rules or standards of conduct or goals are invalid to prove just cause through non-compliance, unless those provisions are reasonable and adjust to the realities of the Puerto Rico market at the time of the non-performance or the alleged contract violation. P.R. LAWS ANN. tit. 10, § 278a–1(c). The burden of proof to show the reasonableness of the rule of conduct or goal rests with the principal or grantor. See Casas Office Machines, 42 F.3d at 679. As an exception, a non-renewal of a Law 75 dealer contract without just cause is valid where the dealer fails to comply with a contractual provision requiring ad-
principle is consistent with the Civil Code, in that contracts are enforceable unless contrary to law, morals, or public policy.67

Under Law 75, the principal or grantor has the “the burden of persuasion to prove the factual elements of the just cause inquiry.”68 There is just cause if the dealer commits a violation of an essential provision in the agreement or engages in conduct that substantially and adversely affects the interests of the principal or grantor in Puerto Rico.69 What is an essential obligation (or not) depends on the terms of the agreement or the course of dealings between the parties.70 If the principal or grantor fails to prove just cause, it “shall have

vance notice of intent to renew the agreement prior to its expiration date. See Nike Int’l v. Athletic Sales, Inc., 689 F. Supp. 1235 (D.P.R. 1988). In that narrow situation, the contract expires on its own terms without any liability. Id.

On an issue of Law 75 damages and waiver of rights, a panel of the American Arbitration Association issued a partial award in July 2011, holding that a provision in an exclusive sub-distribution agreement (analogous to a liquidated damages provision), allowing an offset of the value of the distribution rights granted by the principal (the owner of the trademarks) from the amount of Law 75 damages that would accrue from an unjustified termination, did not constitute a waiver of Law 75 rights. See V. Suárez & Co., Inc. v. Bacardi Corp., No. KLCE201201176, 2013 WL 4037215, at *2 (P.R. Ct. App. June 25, 2013) (confirming trial court decision that confirmed partial award). The purpose of that provision had been to compensate the dealer, which did not pay a franchise fee as consideration for the grant of exclusivity, for the excess value of the line at the time of termination over and above the distribution value. See Bacardi Int’l Ltd. v. V. Suárez & Co., Inc., 719 F.3d 1, 4–6 (1st Cir. 2013) (related federal case). The authors represented Bacardí in that case and in the arbitration.

67. P.R. LAWS ANN. tit. 10, § 278c.
69. “Just cause” requires the principal to prove that the dealer violated an essential obligation specified in the agreement or that it committed a serious or egregious action or omission that has adversely and substantially affected the interests of the principal or grantor in promoting the marketing or distribution of the merchandise or service in Puerto Rico. See P.R. LAWS ANN. Tit. 10, § 278(d); cf. R.W. Int’l Corp. v. Welch Foods, 88 F.3d 49, 51–52 (1st Cir. 1996) (non-breaching actions or omissions by dealer must be “sufficiently egregious” and must be shown to have adversely and substantially affected the manufacturer’s interests). Depending on the facts of each case, “resolving whether a breach [of an essential obligation] occurred requires assessing the adequacy or reasonableness of [the dealer’s] performances and course of conduct . . .”); Casco Inc. v. John Deere, No. 13-1325, 2014 WL 4233241, at *6 (D.P.R. Aug. 24, 2014) (decided in context of supplier’s contention that failure to pay on time breached an essential obligation, although distribution agreement, with an integration clause, listed all the essential obligations and did not include payment terms in such list).
70. An “essential obligation” is one that must be complied with by a party because it is the other party’s true motive for entering into the contract. See Ramírez v. Club Cala de Palmas, 123 P.R. Dec. 339, 347–48 (1989). Some obligations are not essential because they are accessory or complementary and do not justify the termination of a contract, either because the parties did not specify that they were essential in their agreement or because complying with that obligation was not the true motive for entering into the agreement. Where the breach concerns an accessory or supplemental provision, e.g., one that clarifies the understanding of the parties, it does not justify the termination of a contract. See Necia Mortg. Corp. v. A&W Dev., 137 P.R. Dec. 860, 875–76 (1995). Minor contract violations or violations of non-essential provisions do not, without more, provide just cause for termination. See R.W. Int’l Corp., 88 F.3d at 51–52; see, e.g., La Playa Santa Marina, Inc. v. Chris-Craft Corp., 597 F.2d 1, 3–4 (1st Cir. 1979) (not posting the manufacturer’s signs or having no inventory).
executed a tortious act against the dealer and shall indemnify it to the extent of the damages caused him.\textsuperscript{71}

Another important difference from the common law is that, in case of an unjustified termination, refusal to renew, or detrimental act, Law 75 codifies a measure of damages for five years of the dealer’s lost profits\textsuperscript{72} or, if less than five years, five times the average annual profits, plus a separate amount for loss of goodwill, among other provisions for recovery.\textsuperscript{73} Under this statutory formula, the amount of the potential indemnity is not insubstantial.\textsuperscript{74}

\footnotesize

72. In computing lost profits, there should be a deduction of the costs incurred by the dealer that are directly related to its volume of sales of the product line in question from the gross profits. This generally means deducting the costs that the dealer would necessarily have had to incur had the manufacturer not terminated the contract. See Ballester Hermanos, Inc. v. Campbell Soup Co., No. 92-1096, 1993 WL 269656, at *6 (D.P.R. 1993). Puerto Rico law does not allow recovery of gross profits, see El Coqui Landfill v. Mun. de Gurabo, 186 P.R. Dec. 688, 701 (2012), and recovery is pre-tax, see Casas Office Machines v. Mita Copystar Am., Inc., 961 F. Supp. 353, 359 (D.P.R. 1997).


74. Law 75 provides that the amount of such indemnity shall be fixed on the basis of the following factors:

(a) The actual value of the amount expended by the dealer in the acquisition and fitting of premises, equipment, installations, furniture and utensils, to the extent that these are not easily and reasonably useful to any other activity in which the dealer is normally engaged.

(b) The cost of the goods, parts, pieces, accessories and utensils that the dealer may have in stock, and from whose sale or exploitation he is unable to benefit.

(c) The good will of the business, or such part thereof attributable to the distribution of the merchandise or to the rendering of the pertinent services, said good will to be determined by taking into consideration the following factors:

(1) Number of years the dealer has had charge of the distribution;

(2) Actual volume of the distribution of the merchandise or the rendering of the pertinent services and the proportion it represents in the dealer’s business;

(3) Proportion of the Puerto Rican market said volume represents;

(4) Any other factor that may help establish equitably the amount of said good will.

(d) The amount of the profit obtained in the distribution of the merchandise or in the rendering of the services, as the case may be, during the last five (5) years, or if less than five (5), five (5) times the average of the annual profit obtained during the last years, whatever they may be. P.R. LAWS ANN. tit. 10, § 278b. It is important to note that the factors enumerated in Law 75 are not mandatory or exclusive of other factors. See Marina Indus., Inc. v. Brown Boveri Corp., 14 P.R. Offic. Trans. 86, 118 (1983). Rather, they constitute guidelines to be utilized contingent upon the presentation of adequate proof in each case. See Ileana Irvine, IRG Research Grp., Inc. v. Murad Skin Research Labs., Inc., 194 F.3d 313, 319–20 (1st Cir. 1999). Adequate proof means that the party claiming damages must prove “their existence, their relationship to the act complained of and their value.” Computec Sys. Corp. v. Gen. Automation, Inc., 599 F. Supp. 819, 825 (D.P.R. 1984). Once the existence of damages and the relation to the act complained of has been established, the amount of damages can be estimated on a reasonable basis and there is no need for mathematical certainty. Id. at 825. “The Act provides for a liberal interpretation in furtherance of the remedial considerations behind it.” Id. (citing P.R. LAWS ANN. tit. 31, § 278c).
Pursuant to Law 75 case law, the termination of a distribution contract produces two wrongs: (1) the loss of the profits that the line yields and (2) the loss of the value (good will) that the line gave to the business. As explained in Ballester Hermanos, Inc. v. Campbell Soup Co.:

[Law 75] actually provides one recovery for profits (or benefits . . .) which are lost as a result of the termination of an average distributor while it also provides a separate recovery which, at least in part, is for profits to be lost after the termination of a distributor who generated good will in the product. This is a crucial distinction because it reflects the reason why Law 75 does not provide duplicative or punitive damages.75

That is to say, “[t]he dealer must be indemnified to the extent that profits which are attributable to its efforts and that it had expected to enjoy will be enjoyed by another company after the dealer is terminated.”76

Law 75 also allows separate recovery for impairment damages, short of termination. If the fact-finder concludes that the principal or grantor impaired the agreement without just cause, damages for any lost profits are to be determined based on the benefits that the dealer would have made in distributing the products had the impairment not occurred, or the amount that the dealer would have realized under the contract if it had been dutifully carried out, plus out of pocket expenses incurred, less the direct costs of making that profit.77 Again, damages must be proven by the dealer.78

Law 75 codifies the remedy of a preliminary injunction, available to preserve the status quo ante, pending a final judgment in the litigation.79 It also has a fee-shifting provision allowing recovery of attorney fees, expert witness fees, and costs by the prevailing party.80 Finally, another important difference is that Law 75 is a remedial statute and should be interpreted liberally in order to guarantee “the most effective protection” of the dealer’s rights.81

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77. Casas Office Machines, 961 F. Supp. at 359.
78. Sun Blinds, Inc. v. S.A. Recasens, 111 F. App’x 617, 619 (1st Cir. 2004); Draft-Line Corp. v. Hon Co., 781 F. Supp. 841, 846–47 (D.P.R. 1991) (noting that Law 75 damages are not automatic upon proof of a violation of the statute; actual damages must be proven by the dealer).
79. P.R. LAWS ANN. tit. 10, § 278b-1. There is no permanent injunction remedy in the text of Law 75 to compel the principal to do business with the dealer because damages are the sole remedy. A permanent injunction would raise constitutional objections of involuntary servitude. See Ricardo F. Casellas-Sánchez, Like Oil and Water: Puerto Rico Dealerships and Permanent Injunctions Do Not Mix, 32 REV. JUR. UPR 67 (1997).
80. On September 1, 2000, Law 75 was amended to add a provision for recovery of attorney and expert witness fees by the prevailing party. P.R. LAWS ANN. tit. 10, § 278e. The Statement of Motives for Act No. 288 of September 1, 2000 (Puerto Rico Senate Bill 1371) behind this amendment states that the “Legislature deem[ed] it necessary to allow the granting of attorney’s fees to the prevailing party under parameters similar to those under Title VII of the Civil Rights Act of 1964, as amended.” Act No. 288 of Sept. 1, 2000, S.B. 1371, at 1 (2000). However, Law 21 has no provision allowing recovery of fees.
81. P.R. LAWS ANN. tit. 10, § 278e.
B. Threshold Questions in Law 75 Cases

There are threshold questions that come to bear in most Law 75 cases. First, as a general rule, Law 75 does not apply retroactively to contracts or relationships existing before the statute’s enactment in 1964. An exception to this rule is when there has been an extinctive novation, as determined under Civil Code principles, of the original relationship or agreement predating the enactment of Law 75, and the substitution of that relationship with the creation of a new relationship or agreement.

Second, Law 75 applies only to a “person actually interested in a dealer contract because of his having effectively in his charge in Puerto Rico the distribution, agency, concession or representation of a given merchandise or service.” A dealer contract is defined by the statute as a “relationship established between a dealer and a principal or grantor whereby and irrespectively of the manner in which the parties may call, characterize or execute such relationship, the former actually and effectively takes charge of the distribution of a merchandise, or of the rendering of a service, by concession or franchise, on the market of Puerto Rico.” The multi-factor test to determine who qualifies as a Law 75 dealer is fact intensive. As expounded in Roberco, Inc. v. Colón v. Oxford Industries, Inc., those factors include:

. . . if the “dealer” actively promotes the product and/or concludes contracts; if he keeps an inventory; if he has a say on price fixing; if he has discretion to fix the sales terms; if he has delivery and billing responsibilities and authority to extend credit; if he independently or jointly embarks on advertising campaigns; if he has assumed the risks and responsibilities for the activities undertaken; if he buys the product; and if he has facilities and offers product-related services to his clients. More could be added inasmuch as a complete list is not intended.

84. 10 P.R. LAWS ANN. § 278(a).
85. 10 P.R. LAWS ANN. § 278(b).
87. Id. at 122; see Cobos Liccia v. De Jean Packing Co, Inc., 24 PR Offic. Trans. 641, 652 (1989) (quoting Roberco and noting that this list of factors is not exhaustive); Cruz Marcano v. Sanchez Tarazona, 172 P.R. Dec. 526, 540 (2007) (same); see also Triangle Trading Co., Inc. v. Robroy Indus., Inc., 200 F.3d 1, 2 (1st Cir. 1999) (same). In certain circumstances, the sale of generic or private label products—whether or not the brand is registered—may qualify for Law 75 protection, as it would for trademarked or brand name goods. See Jorge Rivera Surillo & Co. Inc., v. Cerro Copper Products Co., 885 F. Supp. 358 (D.P.R. 1995) (“Act 75 does not define dealer in terms of the merchandise but in terms of the person’s activities in relation to the merchandise or service.”).
Regarding what a Law 75 dealer is not, the following analysis by the Puerto Rico Supreme Court in *Lorenzana v. General Accident Insurance Company* is instructive:

"[I]n *Roberco* . . . we established a key distinction between two (2) fundamentally different trade auxiliaries: the distributor and the traveling salesman. The traveling salesman assists the businessman in a stable and continuous manner, and his business is deployed outside the place of business. “The traveling salesman extends the clientele of the merchant, giving the public that is distant from the business place information about the merchandise (by samples usually) or services obtained therein. The prosperity of the business often depends on the skill and competence of traveling salesman.” J. Garrigues, *Curso de Derecho Mercantil* [Commercial Law Course], 7th ed., Madrid, Imp. Aguirre, 1976, p. 674.

However, it is also true that “[t]he powers of the traveling salesman vary in practice: sometimes his power extends to the conclusion of the sales contract (authorized or not to receive the payment); other times he is only authorized to transmit contract offers to the principal; others, finally, he may contract, but subject to the approval of the principal.” Garrigues, op. cit. On the other hand, the distributor “assumes [a risk that] outweighs the commercial risk issuing from a simple commission clause.” *Medina & Medina v. Country Pride Foods*, supra, p. [822]. This level of risk and entrepreneurial independence creates a fundamental difference between the traveling salesman and the distributor. Therefore, although “he constantly widens the circle of business operations of the enterprise, maintaining, renewing and increasing the clientele as possible” (R. Uría, *Derecho Mercantil* [Commercial Law], 11th ed. Madrid, Imp. Aguirre, 1976, p. 52), “the travelling salesman is not protected by [Law] No. 75.” (Emphasis supplied). *Roberco, Inc. y Colón v. Oxford Inds., Inc.*, supra, at [121].

Third, Law 75 applies only to qualified Puerto Rico dealers, that is, a dealer that is located in, a resident of, or authorized to do business in Puerto Rico. The statute does not apply to stateside corporations or foreign companies that, without more, export products or services to Puerto Rico. Moreover, it is settled that Laws 75 and 21 do not apply extraterritorially. However, it has not been resolved if sales to customers within federal military installations in Puerto Rico are covered by these relationship statutes.

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89. Id. at 554–55 (authors’ translation).
90. See A.M. Capen's Co. Inc. v. Am. Trading and Prod. Co., 202 F.3d 469, 474–75 (1st Cir. 2000) (holding that “legislature sought to protect the interests of commercial distributors working in Puerto Rico,” and noting that courts interpreting the statute and its legislative history have uniformly held as such) (quoting *Draft–Line Corp. v. Hon Co.*, 781 F. Supp. 841, 843–44 (D.P.R.1991), aff’d, 983 F.2d 1046 (1st Cir.1993), and citing Puerto Rico Supreme Court jurisprudence).
91. Id. (finding that New Jersey corporation exporting products to Puerto Rico is not a Law 75 dealer).
Importantly, Law 75 protects both exclusive and non-exclusive dealers. Further, commercial agreements, such as those covered under Laws 21 and 75, are not required to be written for them to be enforceable, and extrinsic evidence is unnecessary to corroborate their existence. These special laws apply to written contracts as well as to verbal agreements or relationships established by a course of dealings. Finally, Law 75 is directed against only the principal or grantor in the existing relationship or agreement. There is no joint liability by non-contracting parties under Law 75.

C. Law 21 Is Patterned After Law 75

Law 75 and its interpretive jurisprudence are persuasive when ruling on Law 21 issues. In 1990, the Legislature enacted Law 21 to protect exclusive sales representatives who were providing services on a commission or remuneration basis and did not qualify for protection as dealers under Law 75. This is the figure of the manufacturer’s representative who has been assigned a specific market or territory in Puerto Rico.

A significant difference between these statutes is the exclusivity requirement. Unlike Law 75, which requires no exclusivity as an element of a claim, Law 21 requires the agent to be an exclusive manufacturer’s representative in order to gain the statute’s protections. Despite this requirement,

94. See Vulcan Tools of Puerto Rico v. Makita U.S.A., Inc., 23 F.3d 564, 569 (1st Cir. 1994); see also Medina & Medina v. Hormel Foods Corp., 840 F.3d 26, 41 (1st Cir. 2016). There is a misconception that Law 75 requires exclusivity, but that is not so. An exclusive right arises from the principal’s grant of exclusivity in a contract, verbal or written, or in the absence of a contract, from a course of dealings by both parties where, over time a de facto exclusive distribution arrangement could, but not necessarily, create exclusive rights under Law 75. According to precedent, exclusivity “constitutes . . . a contractual limitation—obligation to abstain from doing—on the principal. It enjoins said principal or grantor from providing—either directly or indirectly—services of the same nature as those included in the contract in areas designated as exclusive.” Systema de P.R. v. Interface, 23 P.R. Offic. Trans. 347 (1989) (citing treatises). Nonetheless, definitional problems remain on the meaning and scope of exclusivity. Law 75 does not define exclusivity. Hormel Foods aptly illustrates the problems that develop when a claim of exclusivity arises from a verbal appointment without a meeting of the minds as to the scope and reach of the alleged exclusive rights. There, the dealer failed to prove that the supplier had agreed to grant “airtight” exclusive distribution rights over sales of all products to a club store in Puerto Rico or over new products or that in fact the dealer was exclusive. Hormel Foods, 840 F.3d at 36–37.


96. Id.; see also Homemedical Inc. v. Sarns/3M Health Care Inc., 875 F. Supp. 947, 951 (D.P.R. 1995) (course of dealings evidence may be relevant to prove exclusivity at least absent a written non-exclusive agreement).

97. See Romero v. ITE Imperial Corp., 332 F. Supp. 523, 525 (D.P.R. 1971) (finding that, pursuant to Puerto Rico legislative intent, “a claim for damages under [Law 75] can only be directed against the principal or grantor” and all defendants other than the principal or grantor were improper parties to claims under the Act).


99. P.R. LAWS ANN. tit. 10 § 279(a)-(c).

100. P.R. LAWS ANN. tit. 10 § 279(a).

101. Id.; see also Gonzalez v. Hurley Int’l LLC, 920 F. Supp. 2d 243, 249 (D.P.R. 2013) (noting this distinction between the two laws).
Law 21 does not define the meaning of exclusivity. The case law has seized on the apparent ambiguity of the statute and suggests that exclusivity, in the context of Law 21, has two potential meanings: (1) exclusivity in the sense that the principal agreed not to sell or distribute the products directly in Puerto Rico or appoint another competing agent in the territory or (2) that the agent agreed not to compete and is bound to represent the products or services of its principal or grantor exclusively.

Like Law 75, Law 21 has a just cause requirement and establishes rebuttable presumptions of lack of just cause. Regarding the measure of damages, Law 21 has a similar provision to Law 75’s allowing recovery of lost profits, actual value of investments and expenses for the line, and loss of goodwill. However, Law 21 has an additional provision allowing for an alternative compensation formula, based on a maximum of 5 percent of the total sales volume for the number of years of the representation, if it does not cause an unjust enrichment of the dealer.

III. Jury Trials of Dealer Termination Cases in U.S. District Court

Not surprisingly, jury trials of dealer termination claims in the U.S. District Court for the District of Puerto Rico are few and far between. Even fewer jury verdicts are reported. With the overwhelming majority of federal civil cases resulting in settlements, voluntary dismissals, referrals to

102. *Hurley Int’l*, 920 F. Supp. 2d at 254–56 (in dictum, noting but not deciding the issue). The legislative history of Law 21 sheds no light about the meaning of exclusivity or the reasons for making it a requirement. It is clear, however, that non-exclusive sales representatives that do not otherwise qualify for protection under Law 75 will have no right of action under these special relationship laws.

103. *P.R. LAWS ANN.* tit. 10, §§ 279a (c) & 279b(b).

104. *P.R. LAWS ANN.* tit. 10, § 279c.

105. *P.R. LAWS ANN.* tit. 10, § 279d.

106. *Sun Blinds, Inc.* v. S.A. Recasens, 111 F. App’x 617, 619–20 (1st Cir. 2004) (jury’s verdict for dealer vacated for lack of proof of damages); *Sheils Title Co.* Inc. v. Commw. Land Title Ins. Co., 184 F.3d 10, 15–18 (1st Cir. 1999) (vacated jury’s Law 75 liability verdict for dealer on the ground that contract permitted only one reasonable interpretation of its terms and it proved just cause); Ileana Irvine, IRG Research Grp., Inc. v. Murad Skin Research Labs., Inc., 194 F.3d 313, 319–20 (1st Cir. 1999) (vacated jury’s verdict for dealer and ordered a new trial where expert’s opinion on damages was flawed); *Newell Puerto Rico, Ltd.* v. Rubbermaid, Inc., 20 F.3d 15, 22–23 (1st Cir.1994) (upheld jury’s verdict for dealer of lack of just cause and damages because principal had known for many years that dealer had been marketing competing products; jury awarded an amount of damages that was approximately an average of the sums of the opinions of the experts for both sides and an independent expert appointed by the court). Bench trials of Law 75 or Law 21 cases are more common, but the judgments and opinions are rarely published. See, e.g., *La Playa Santa Marina, Inc.* v. Chris-Craft Corp., 597 F.2d 1, 4–5 (1st Cir. 1979) (construing § 278(d) and affirming district court’s verdict of damages for Law 75 dealer after finding sufficient evidence that supplier failed to prove just cause because “any alleged violations of the agreements” did not in any way adversely and substantially affect its interests in promoting the marketing or distribution of the products). There is one reported and recent arbitration award on the merits favoring a Puerto Rico dealer, which was enforced under the FAA. See *Thomas Díaz v. Colombina, S.A.*, 831 F. Supp. 528 (D.P.R. 2011).
binding arbitration, or summary disposition before trial, it is no wonder that
the art of trying a commercial civil case before a jury is vanishing.107 In the
few civil cases that are tried, the jury selection process can be perplexing. In
particular, lawyers in the District of Puerto Rico are allowed no direct par-
ticipation in the voir dire to question the venire,108 meaning that jurors who
actually get picked are more of a lucky draw than a conscientious or scientific
effort at jury selection.

A. Case Study of a Law 75 Jury Trial: Casco, Inc. v. John Deere
Construction Co. and Forestry Co.109

On March 11, 2016, a jury in the U.S. District Court for the District of
Puerto Rico found defendant John Deere Construction & Forestry Com-
pany liable for termination of a twenty-seven year-old dealer contract with-
out just cause under Law 75 and awarded the plaintiff Casco Sales, Inc., the
Puerto Rico distributor, impairment and termination damages totaling
$1,763,934.110 Casco was a Puerto Rican distributor of construction equip-
ment, which claimed that John Deere, one of the leading manufacturers of
construction equipment in the United States, impaired the contract by can-
celing in 2012 a purchase order for the sale of a John Deere excavator worth
$268,000 and unilaterally terminated its contract in 2013 without just
cause.111 Only the separate claims for impairment and termination of con-
tract under Law 75 reached the jury. At trial, the court dismissed the
dolus (fraud) claim, holding that the alleged predicate for fraud or construc-
tive termination of the contract in 2009 was not actionable under Puerto
Rico Law 75. Mid-trial, as noted, the court granted John Deere’s motion
under Federal Rule of Procedure 50 to dismiss the dolus claim for fraudulent
inducement and fraudulent performance of contract, entered judgment for

107. See D. Brock Hornby, Imagined Conversations: A Series, The Decline in Federal Civil Trials,
100:1 JUDICATURE (Spring 2016).
108. See U.S. District Court for the District of Puerto Rico Local Civil Rule 47(a) (“Unless
otherwise ordered by the Court, the presiding judge will personally conduct the initial examina-
tion of prospective jurors requesting that each juror address the court orally, stating his or her
name, address, occupation, and previous jury service. At the close of the examination, the Court
will afford counsel an opportunity, at the bench, to request that the Court ask additional ques-
tions.”), U.S. District Court for the District of Puerto Rico Local Civil Rule 47(b) (“Challenges
for cause of individual prospective jurors shall be made at the bench, at the conclusion of the
Court’s examination.”).
109. Mr. Casellas is lead counsel for Casco in this case. More details about the facts and the
court’s pretrial rulings can be found at Casco, Inc. v. John Deere Construction Co. and Forestry Co.,
No. 13-1325, 2004 WL 4233241 (D.P.R. Aug. 26, 2014) (opinion and order denying cross-
motions for summary judgment) and Casco, Inc. v. John Deere Construction Co. and Forestry Co.,
No. 13-1325, 2015 WL 4132278 (D.P.R. July 8, 2015) (opinion and order on motions in
limine).
110. See U.S. District Court for the District of Puerto Rico, Civil No. 13-1325, Docket
Nos. 243 & 249.
John Deere on its counterclaim for collection of a debt of roughly $200,000, and denied the latter’s motion to dismiss the Law 75 termination claim. The jury pool in the Casco v. John Deere case was composed of roughly thirty-six candidates. Some were excused for cause, either for medical reasons or because of prior travel arrangements or commitments, or because they knew the lawyers or their law firms. For example, one of the potential jurors worked as a clerk for the external auditors of the plaintiff’s counsel’s law firm and was stricken for cause. The jury, which was initially composed of four men and four women, was selected from those who remained after three peremptory challenges per side. After a number of back-to-back recesses called by the judge mid-trial, a middle-aged female juror became sick and was excused for cause. The remaining jury of four men and three women was representative of all walks of life. There was an administrative assistant of a multinational corporation, two engineers, an attendant of an auto parts store, a public school physical education teacher, an accounts receivable clerk in a newspaper, and a housewife. There were no accountants or financial analysts in the jury, except perhaps for the accounts receivable clerk who may have known basic accounting, and the engineers who likely had a fuller understanding of science and mathematics. These individuals did not appear to have post-graduate degrees. Although their ages were not disclosed, one could speculate that most were between the ages of thirty and fifty-five. All lived in different municipalities across Puerto Rico, except for one juror from the capital, San Juan. As expected, fluency in English was mixed.

The judge required the second venire (the second pool of jurors who are left after others from the first batch are excused for cause) to read out loud and on the record, their responses to a short set of boilerplate questions, such as, where they live and work and what their family members do for a living. Most of the jurors were naturally so soft-spoken in the intimidating courtroom environment that one could barely hear what they said. From what may have been a twenty second narrative by each of roughly twenty persons, the lawyers were supposed to discern all the facts to make an informed judgment to select the jury. No interrogation by counsel was allowed, nor is it typically allowed in the Puerto Rico district. In this case, jurors clearly spoke and understood English, but not as a first language. The only common denominator, that may or may not have been relevant, is that none of the jurors had served before in any other case, civil or criminal, implying that all had an open mind and were not contaminated by experiences in other cases.
Regarding Casco’s success on the Law 75 claims, the jury had sufficient admissible evidence from which to find that John Deere’s ostensible reasons for the impairment and subsequent termination, as stated in two letters, were false or a pretext and that Casco had not breached an essential obligation in the contract. The jury credited Casco’s version of the events that John Deere retaliated or discriminated against its Puerto Rican dealer over many years as a vendetta for the dealer’s owner’s business affiliation with Volvo Construction, a competitor. Casco introduced substantial evidence at trial that John Deere treated its Puerto Rican distributor differently than other construction equipment dealers in Latin America and the United States. Those other dealers received grace periods to comply with John Deere’s requirements and were invited to attend important dealer conferences. Casco received no breaks and was the only dealer excluded from the dealer conferences. John Deere executives admitted to being upset at Casco for standing up for its rights on many commercial issues in their relationship and more so for Casco’s business dealings with Volvo. Importantly, the John Deere dealer agreement with Casco did not have a non-compete obligation, as do many of John Deere’s newer dealer contracts with other distributors.

After a two-week trial and over two hours of deliberations, the jury awarded Casco impairment damages of $323,440 and termination damages of $1,440,494, fully compensating Casco for 100 percent of its Law 75 claims. As discussed previously, Law 75 has a cost-shifting provision requiring the court to award reasonable attorney and expert witness fees in the dealer’s favor as the prevailing party.116 As of this writing, the judgment is not final.117

B. Insights Gleaned from Jury Trials in Dealer Termination Cases

In the highly improbable scenario that a case gets to a jury, how do juries see and decide dealer termination cases in Puerto Rico? Do they decide dealer versus manufacturer commercial cases any differently than other cases? It is hard to tell in the District of Puerto Rico because jury exit polling after a verdict is prohibited,118 and the authors have found no published studies on this subject. Two decades ago, informal statistical research con-
ducted based on the federal court’s public electronic database for a Law 75 case about to go to trial showed that, of all the docketed jury verdicts in commercial diversity cases in the U.S. District Court for the District of Puerto Rico, plaintiffs prevailed roughly 75 percent of the time. Of course, it is hard to validate those numbers or extrapolate any concrete data to reach conclusions about jury trials today from what was a non-empirical study. Nonetheless, impressions about how juries decide dealer termination cases can be formed from the presentation of the evidence in each case and the isolated instances during trial when lawyers can see a juror “connecting” with or being turned off by a witness, or paying particular attention to one exhibit and not to others. From experience and practice, one can try to make a few generalizations in these cases. First, juries generally favor the underdog. In these cases, the underdog is almost always the Puerto Rico dealer or representative, who is up against the more economically powerful manufacturer or supplier. Second, an underdog status, without more, will not win the case for the dealer. Third, juries give more weight to a credible witness testifying about an exhibit and the totality of the evidence than to an exhibit without a credible witness backing it up. Fourth, jurors turn to their own life experiences, knowledge, and backgrounds in applying the court’s instructions to the admissible evidence. A keen lawyer will be mindful of this during closing. Fifth, as previously discussed, Laws 75 and 21 cases require juries by law to decide whether a termination was just and whether there was cause. This inquiry may open up at trial relevant considerations of the terms of the contract; the conduct of the parties; and what was fair, just, and reasonable. For example, was the termination based on true and legitimate business justifications or was there an ulterior motive behind it? Sixth, assuming everything else equal, a direct relationship often exists between a strong liability case for the principal and a low award of damages and a strong liability case for the dealer and a high award of damages. Finally, sometimes, as in the Newell Puerto Rico, Ltd. v. Rubbermaid, Inc. case, juries may “split the difference” when it comes to determining damages. In that case, the court appointed an independent expert on damages and each side had its own Law 75 expert. The amount awarded by the jury amounted to an average of the admissible evidence of the amounts of damages of all three experts.

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119. See, e.g., R.W. Int’l Corp. v. Welch Foods, 88 F.3d 49, 51–52 (1st Cir. 1996) (existence of “just cause” under Law 75 is a question of fact for the jury to decide); Newell Puerto Rico, Ltd. v. Rubbermaid, Inc., 20 F.3d 15, 22 (1st Cir. 1994) (affirming district court decision not to disturb jury’s finding that defendant failed to establish just cause).

120. See Newell Puerto Rico, 20 F.3d at 19–20.

121. Id. at 18 (amount awarded by jury totaled $1.4 million) & 19 n.2, n.4, n.5 (amounts estimated by defendant’s expert, plaintiff’s expert, and court appointed expert, were $269,431, (max.), $3,954,749 (max.), and $585,951, respectively).
IV. Conclusion

Dealer termination cases are challenging to litigate and try for manufacturers or suppliers in Puerto Rico, particularly for those with wholly stateside operations. Laws 75 and 21 are designed as remedial statutes and provide not only preliminary injunctive relief, but also compensatory damages to qualified dealers or sales representatives upon proof of damages stemming from an unjustified termination or impairment of the existing relationship or contract. Like the federal Civil Rights Act, Puerto Rico’s Law 75 (but not Law 21) also provides for recovery by the prevailing party of reasonable attorney and expert witness fees. Importantly, these relationship laws start with the presumption (which can be disproved) that the local qualified dealer or exclusive sales representative has created a favorable market or clientele for the principal’s products or services in Puerto Rico and that the principal has acted to take that market away without paying just compensation. With this in mind, lawyers can and should give proactive counseling to clients and carefully draft contracts before clients do business with a Puerto Rico dealer or agent to prevent disputes from reaching litigation.

There is truth to the anecdotal evidence that plaintiffs that survive summary judgment and reach trial prevail most of the time in civil jury cases tried in the federal court in Puerto Rico. Dealer termination cases are no exception. Therefore, if representing a supplier or manufacturer about to enter into a relationship potentially governed by Puerto Rico law, one should carefully craft an integrated agreement to minimize the risk of having a federal jury or a local court decide the case on the merits. This means including enforceable forum selection and arbitration provisions as well as reasonable performance standards or goals that should be spelled out clearly and completely in the agreement. As Medina v. Hormel Corporation122 illustrates, doing business on a handshake, without a written contract, spells trouble ahead for the supplier or manufacturer, creates uncertainty for both parties, and invites costly and protracted litigation.

If litigation is imminent or pending in the local court, a practitioner should also decide whether to file a declaratory judgment action in a stateside forum with personal jurisdiction and venue or whether to remove the case to an appropriate federal district court. The filing by the dealer of a motion for preliminary injunctive relief or the existence of a stateside forum selection clause may influence a practitioner’s decision whether to remove the case. Other relevant considerations on the choice of forum issue include the federal court’s familiarity with Law 75 and Law 21 precedents, the feasibility of summary judgment resolution, any differences in the application of substantive law by the federal courts and the local courts, as well as the likelihood of success or failure of an appeal from a final judgment to the First Circuit or to the local appellate courts.

For franchisee counsel, although a federal jury may seem like the obvious choice, the local trial courts are as familiar with Law 75 and Law 21 issues as the federal court and have proved to be expeditious in scheduling preliminary injunction hearings in those cases. Finally, it is hard to say whether arbitration is a more favorable forum for one side or the other in dealer disputes in Puerto Rico because so few of the awards are reported unless they involve a court proceeding to confirm or vacate the award.

Analyzing all of the above factors will be critical to early decisions made when drafting franchise and distribution agreements and to the later decisions that shape litigation proceedings.
Constructive termination is a legal theory, first developed in the context of employment law, under which a plaintiff is permitted to pursue a claim that the defendant has “constructively terminated” the employee by making working conditions so intolerable that continued performance of the job is extremely difficult or impossible. A key legal question under this theory is whether plaintiffs are required as an essential element of the claim to show that they had ended the contractual or employment relationship, or alternatively whether it was sufficient to demonstrate something short of an actual end to the relationship, such as intolerable working conditions or severe hindrance to continued contractual performance.

In *Mac’s Shell Service, Inc. v. Shell Oil Products Co.*, the U.S. Supreme Court held that a franchisee of a petroleum marketing franchise could not state a claim under the Petroleum Marketing Practices Act (PMPA) for constructive termination unless and until it went out of business or was denied the right to use the franchisor’s trademarks, buy its fuel, or occupy station premises it owned. The decision reversed a First Circuit opinion that had affirmed a jury verdict on a PMPA claim in favor of Shell franchisees that had objected to the termination of a rent subsidy program. The franchisees continued to operate their stations, but asserted claims for constructive termination and constructive nonrenewal based on Shell’s unilateral termination of the rent subsidy.2 The decision overruled lower federal court decisions that allowed

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1. 559 U.S. 175 (2010).

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petroleum franchisees to bring constructive termination or constructive non-renewal claims under the PMPA even when they continued to operate their franchises.3

This article examines the impact that Mac’s Shell has had on constructive termination claims in franchise litigation. Part I begins by examining cases brought under the PMPA that have asserted constructive termination claims after Mac’s Shell was decided and finds no surprises in the lower federal courts’ decisions enforcing the Supreme Court’s strict interpretation of a claim for constructive termination. In Part II, the article discusses franchise cases that apply Mac’s Shell outside the context of PMPA litigation, finding some decisions under state statutes and common law that have enforced the Mac’s Shell requirement that a constructive termination plaintiff must cease doing business in order to bring a claim, but noting that many cases interpreting state law constructive termination claims in franchising do not mention Mac’s Shell at all. Finally, Part III of this article discusses possible future issues dealing with the decision, including the possibility of the Supreme Court deciding whether the PMPA permits constructive termination claims at all and provides a suggested analytical framework to guide resolution of that issue.

I. Constructive Termination Claims Under the Petroleum Marketing Practices Act After Mac’s Shell

The Supreme Court has not addressed the issue left unresolved in Mac’s Shell: whether constructive termination is a proper ground for a violation of the PMPA. Despite this, the Court did express skepticism as to whether Congress intended to authorize such a claim. Relying on the “well-recognized” doctrine of constructive discharge in employment discrimination law, the Seventh Circuit, in an opinion written by Judge Richard Posner, challenged that skepticism in Al’s Service Center v. BP Products North America, Inc., suggesting that “without a doctrine of constructive termination, there would be . . . a big loophole in the Petroleum Marketing Practices Act.”4 Nevertheless, the Seventh Circuit acknowledged in one of the first decisions after Mac’s Shell that it could not “ignore the Court’s ruling that ‘a necessary element of any constructive termination claim under the Act is that the franchisor’s conduct forced an end to the franchisee’s use of the franchisor’s trademark, purchase of the franchisor’s fuel, or occupation of the franchisor’s service station.’”5 Concluding that none of those things occurred, the Seventh Circuit had little trouble disposing of the plaintiff’s claim.

3. E.g., Barnes v. Gulf Oil Corp., 795 F.2d 358 (4th Cir. 1986); Pro Sales, Inc. v. Texaco, U.S.A., 792 F.2d 1394 (9th Cir. 1986).
4. 599 F.3d 720, 726 (7th Cir. 2010).
5. Id. at 726–27 (emphasis added).
Few courts seem willing to flout the Supreme Court’s conclusion in *Mac’s Shell* “that a necessary element of any constructive termination claim under the Act is that the franchisor’s conduct forced an end to the use of the franchisor’s trademark, purchase of the franchisor’s fuel, or occupation of the franchisor’s service station.”⁶ In *Duncan Services, Inc. v. ExxonMobil Oil Corporation*, for example, the U.S. District Court for the District of Maryland examined the claims of sixty-five ExxonMobil franchisees that challenged the franchisor’s assignment of their franchise agreements to a third-party distributor, which in turn sold the agreements to third-party GTY MD Leasing (Getty).⁷ Finding that the assignment did not violate the PMPA, the court in *Duncan Services* explained that *Mac’s Shell* compelled the conclusion that a franchisee seeking protection under the statute must allege a “violation of a statutory element of a franchise” in order to state a claim.⁸ In lockstep with the Supreme Court’s conclusion, the court affirmed that “[c]onduct that does not force an end to the franchise . . . is not prohibited by the Act’s plain terms.”⁹ For this reason, the franchisees subjected to the assignment could not assert a claim for actual or constructive termination under the PMPA.¹⁰

Similarly, in *Poquez v. Suncor Holdings-COPII, LLC*, the U.S. District Court for the Northern District of California refused to extend the PMPA to protect a gas station owner from various actions that the franchisee claimed amounted to a termination under the statute.¹¹ The case involved a company that had rights to purchase the property housing the gas station, which was being leased by the franchisee as part of its relationship with Suncor.¹² Specifically, the plaintiff claimed that the defendants violated the PMPA by:

1. failing to provide Plaintiff with forty-five days to exercise her right of first refusal to purchase the property;
2. denying Plaintiff’s alleged right of first refusal to purchase the property and selling it to [third-party] Forest City;
3. issuing Plaintiff a sham three-year lease; and
4. selling the property to Forest City, allegedly knowing that the developer [would] terminate the underlying lease and evict the Plaintiff.¹³

Clearly cognizant of *Mac’s Shell’s* admonitions against extending the PMPA beyond its plain meaning, the franchisee argued that its case was not one for constructive termination or non-renewal but rather “an actual severance of the relevant legal relationship.”¹⁴ But none of this mattered to the district court in disposing of the PMPA claim. In a straightforward application of *Mac’s Shell*, the court in *Poquez* concluded that the plaintiff’s

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⁶ *Mac’s Shell*, 559 U.S. at 182 (emphasis added).
⁸ *Id.*
⁹ *Id.* at 645 (quoting *Mac’s Shell*, 599 U.S. at 175).
¹⁰ *Id.* at 645.
¹² *Id.* at *1.
¹³ *Id.* at *2.
¹⁴ *Id.* at *4.
failure to allege “any facts showing that the franchise agreement has been
terminated or that Defendants have in any way interfered with Plaintiff’s
use of the Union 76 trademark, purchase of fuel, or occupation of the subject
property” doomed the claim under the PMPA.15 In so deciding, the district
court ruled it wholly irrelevant what the defendants intended in relation to the
lease transaction; what counted was whether the defendants “actually termi-
inated or failed to renew the franchise.”16 In short, the trend after Mac’s Shell
is to strictly apply its holding in PMPA cases, likely explaining the limited
number of decisions published after Mac’s Shell was decided. After all, a fran-
chisee is not likely to assert a claim under the PMPA if the claim does not
meet the Supreme Court’s construction of the statute.

Although some may consider the Mac’s Shell decision too restrictive and
unnecessarily narrow (see Judge Posner’s musings in Al’s Service Center, for
example), all is not lost for those seeking protection under the statute. For
example, in GTO Investments, Inc. v. Buchanan Energy, the U.S. District
Court for the Northern District of Illinois granted a preliminary injunction
to a franchisee seeking protection under the PMPA when faced with what it
deemed a “take it or leave it” lease renewal proposal from the franchisor.17
GTO operated an ExxonMobil franchise and, by all accounts, was in com-
pliance with its obligations under the lease agreement that ExxonMobil as-
signed to defendant Buchanan, which assumed ExxonMobil’s rights under
the agreement.18 When its franchise agreement was up for renewal, GTO
refused to sign Buchanan’s proposed new lease because of various terms pertaining
to rent, gasoline pricing, and other aspects of the franchisor-franchisee re-
lationship.19 Buchanan responded to the refusal harshly: it chose not to renew
the franchise relationship “because GTO refused to sign the Proposed Lease.”20

The district court took issue with Buchanan’s refusal to renew and con-
cluded that GTO had a reasonable likelihood of succeeding on the merits
of its claim that the defendants had violated the PMPA.21 Judge Gottschall
was particularly troubled by the absence of “rent amounts” in the second and
third years of the proposed lease (they were left entirely blank and for future
determination) as well as the “discriminatory gasoline pricing” contained in
the contract submitted to GTO.22 On these facts, the court determined that
Buchanan was likely acting in bad faith under the PMPA by subjecting all of
its franchisees to the oppressive lease while at the same time exempting those

15. Id. at *4–5.
16. Id. at *4 (emphasis added).
18. Id. at *1.
19. Id.
20. Id. at *2.
21. Id. at *6.
22. Id. at *3–4.
ExxonMobil gas stations run by Buchanan itself. GTO was not the only franchisee affected.

Critical to understanding how the district court reached this decision is its analysis of Buchanan’s arguments against the PMPA claim. Buchanan, the franchisor, argued that GTO’s claim under the PMPA should fail because it resembled the contract claims asserted by the plaintiff in Mac’s Shell, and the Supreme Court, in that case, had refused to turn state law contract claims into a violation of the PMPA in the absence of an actual termination, abandonment, or non-renewal. It also asserted that it could not be bad faith under the statute to impose the new lease on GTO because Buchanan had rolled out the new lease to all franchisees (even though it had reserved distinct rights for its own corporate stores). The district court rejected this argument, relying on Mac’s Shell itself:

[The Supreme Court] understood that inquiries into reasonableness of contractual provisions would sometimes be necessary under the PMPA. As the Court stated, “Under the balance struck by the plain text of the [PMPA], a franchisee faced with objectionable new terms must decide whether challenging those terms is worth risking nonrenewal of the franchise relationship; if the franchisee rejects the terms and the franchisor seeks nonrenewal, the franchisee runs the risk that a court will ultimately determine that the proposed terms were lawful under the PMPA.” (Citations omitted.) Here, GTO has chosen to take that risk, believing that Buchanan has “imposed[] arbitrary and unreasonable new terms . . . that are designed to force an end to the petroleum franchise relationship. (Citation omitted.) As discussed above, some of these terms may give rise to a viable PMPA claim. If GTO loses its PMPA claim, however, it will also lose its franchise.

GTO is a good example of how to structure successful constructive termination claims under the PMPA after Mac’s Shell. The district court suggests that not all claims looking like “constructive termination” are dead on arrival. Rather, the case demonstrates that franchisees must choose their path carefully and be willing to take the risk of a course of action that, if not validated by a court at the preliminary injunction stage, will result in the loss of their franchise. If the franchisee does what some of the plaintiffs in Mac’s Shell did—sign the renewal papers and then assert that it was constructively non-renewed by the franchisor—its claim under the PMPA will fail. If, on the other hand, the franchisee holds out and accepts the possible consequences of not signing the renewal agreements, the franchisee will earn the right to a determination of whether the franchisor’s actions violated the PMPA. As seen throughout decisions made since the Supreme Court’s ruling in Mac’s Shell, at the core of this analysis remains the idea that if a franchisee

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23. Id.
24. Id. at *4–5.
25. Id.
26. Id. at *4.
cannot establish that the fundamental elements of its franchise are under attack from the franchisor, there is no PMPA claim under *Mac’s Shell*.27

II. Constructive Termination Claims Under State Common Law and Dealer Protection Statutes: The Impact of *Mac’s Shell* Outside the Context of PMPA Claims

Shortly after *Mac’s Shell* was decided, some commentators posited that the decision would have a broad impact outside of claims under the PMPA and would be used by franchisors and courts to limit claims under state franchise and dealer protection statutes.28 It was even suggested that *Mac’s Shell* would constrain state franchise and dealer protection statute claims to only those situations in which a franchisor’s conduct forced an end to the franchise.29 Overall, this has not been the case. Below we highlight some of the main constructive termination cases brought outside the context of the PMPA, which were decided after the Supreme Court’s decision in *Mac’s Shell* and that relied on *Mac’s Shell* as authority. We also summarize the numerous cases that have resolved constructive termination claims without invoking *Mac’s Shell* at all.

A little over two years after *Mac’s Shell* was decided, a court extended its reach to the non-PMPA distribution context. The U.S. District Court for the Northern District of Illinois in *Bell v. Bimbo Foods Bakeries Distribution, Inc.* held that, if there exists a claim for constructive termination under the Illinois Franchise Disclosure Act, to state a claim, one must allege “that his [or her] distributorship or franchise has actually terminated.”30 Bell was a distributor for Bimbo Foods Bakeries Distribution Inc. who had purchased the right to deliver and stock Bimbo products at bakeries in a certain geographic area.31 When Bimbo purchased Sara Lee Corporation, it began selling and distributing these “competing” products in Bell’s distribution area.32 Bell brought a claim for wrongful termination under the Illinois

29. Id.
31. Id.
32. Id. at *1.
33. Id.
Franchise Disclosure Act because Bimbo’s actions “seriously and materially and directly undermine[d]’ his franchise agreement and ‘abrogate[d] the sine qua non of the ‘Distributor Agreement[ ],’ thus ‘effectively terminat[ing] the franchise agreement’ without good cause.”

The court was not persuaded. Without deciding whether claims for constructive termination were cognizable at all under the Act, it determined that Bell had failed to adequately allege one. Relying on *Mac’s Shell* as analogous case law, it explained:

the Supreme Court noted in *Mac’s Shell*, “a plaintiff must actually sever a particular legal relationship to maintain a claim for constructive termination.” 130 S. Ct. at 1258. To recover for constructive discharge in the employment context, an employee generally is required to quit his or her job; to claim constructive eviction in the landlord-tenant context, the “general rule . . . is that a tenant must actually move out.”

Because Bell continued operating his distributorship and did not allege that Bimbo Foods had “effectively forced him out” of business, the court concluded that he had failed to state a claim and dismissed his cause of action.

A little less than two years later, the U.S. District Court for the District of New Jersey cited the *Bell* decision and made a similar ruling under the New Jersey Franchise Practices Act (NJFPA).

In *Pai v. DRX Urgent Care, LLC*, the court acknowledged that a claim for constructive termination exists under the NJFPA, but interpreted the contours of such a claim according to those outlined in *Mac’s Shell*: “The Supreme Court recently has made clear that a claim for constructive termination by a franchisee requires that a franchisee no longer be in operation.”

The *Mac’s Shell* Court reasoned that requiring franchisees to abandon their franchise before claiming constructive termination was consistent with the general understanding of the doctrine of constructive termination, where “a plaintiff must actually sever a particular legal relationship” to state a claim. (Citation omitted.) After all, termination is considered “constructive” not because there is no end to the relationship, but because it is the plaintiff who formally puts an end to the legal relationship, as opposed to the defendant.

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34. 815 ILL. COMP. STAT. 705/19.
36. *Id.*
37. *Id.*
40. *Id.* at *8. The court pointed out that a claim for constructive termination had been recognized by the New Jersey Superior Court in *Maintainco, Inc. v. Mitsubishi Caterpillar Forklift America, Inc.*, 975 A.2d 510, 518 (N.J. App. Div. 2009). Permitting claims for constructive termination had been “necessary under the NJFPA because any other conclusion ‘would undercut the remedial purposes of the Act by allowing a franchisor to engage in such blatant attempts to ‘ditch,’ or constructively terminate, a franchisee, but escape liability under the Act because it did not entirely succeed.’” *Id.* at *8.
41. *Id.* at *7.
42. *Id.*
Because the plaintiffs were still operating their franchises and “continue[d] to generate revenue” using defendants’ marks, the court dismissed their claim with prejudice.43

The plaintiffs in *Pai* argued that *Mac’s Shell* was inapplicable because it involved the interpretation of a federal statute.44 The court did not agree: “Plaintiffs have asserted no reason why the statutes should be interpreted or applied differently, particularly where both statutes share the same purpose of protecting franchisees from termination without cause.”45 Additionally, the court cited *Bell* for the proposition that “at least one other federal court has held that the reasoning of *Mac’s Shell* applies to a state statute, almost identical to the NJFPA, aiming to protect franchisees.”46 Thus, because the plaintiffs were still operating their franchises, they could not state a claim for constructive termination under the NJFPA. The Third Circuit affirmed on other grounds in *Fabbro v. DRX Urgent Care, LLC*47 and noted that “the Supreme Court’s decision regarding the federal Petroleum Marketing Practices Act (PMPA) in *Mac’s Shell* . . . is not controlling authority for interpreting the New Jersey Franchise Practices Act.”

New Jersey has proven to be a fertile ground for litigation of this issue. Shortly after *Pai* was decided, but before the Third Circuit’s decision in *Fabbro*, the U.S. District Court for the District of New Jersey was again confronted with a constructive termination claim under the NJFPA. In *Naik v. 7-Eleven, Inc.*, the court “agree[d] with the reasoning set forth [by the New Jersey District Court] in *Pai,*” which had largely adopted the reasoning of the court in *Mac’s Shell*.48 The *Naik* court dismissed the constructive termination claim “[b]ecause the Plaintiffs [we]re still operating their franchises and [we]re still gaining a profit from their stores (albeit a profit they allege[d] ha[d] been diminished through Defendant’s conduct[)].”49 Therefore, without an actual “termination,” they could not state a claim.50

In the context of common law claims for constructive termination as opposed to statutory claims, both courts and litigants have also relied on *Mac’s Shell*. In *Bedford Nissan, Inc. v. Nissan North America, Inc.*, the defendant manufacturer cited *Mac’s Shell* in support of a motion to dismiss a common law state breach of contract claim.51 Although ultimately not mentioned by the court in its decision, the U.S. District Court for the Northern District of

43. Id. at *7, *9.
44. Id. at *8.
45. Id.
46. Id.
47. 616 F. App’x 485, 489 (3d Cir. 2015).
49. Id.
50. See id.
51. No. 1:16 CV 423, 2016 WL 6395799, at *10 (N.D. Ohio Oct. 28, 2016). Notably, the plaintiffs did not allege constructive termination under the Ohio Motor Vehicle Franchise Act, which prohibits termination without good cause. It provides, in relevant part: “Notwithstanding the terms, provisions, or conditions of an existing franchise, no franchisor shall terminate, cancel, or fail to continue or renew a franchise except for good cause. This section governs
Ohio employed reasoning similar to that of the court in *Mac’s Shell*. The plaintiffs, owners of several Nissan dealerships, asserted that defendant Nissan North America breached the parties’ dealers sale and service agreement by constructively terminating them in a manner not authorized by the agreement’s termination provision. Despite claiming their agreements had been constructively terminated, the plaintiffs’ dealerships remained in business.

Nissan NA referenced *Mac’s Shell* and argued that “[a] valid claim for constructive termination requires that Plaintiffs’ Dealerships and their Dealer Agreements have, in fact, been terminated, and Plaintiffs do not (and cannot in good faith) allege Nissan [NA] has actually or effectively done so.” The district court agreed. Although essentially relying on the same principle espoused in *Mac’s Shell*—that constructive termination requires an actual termination of the agreement—the court did not cite the case, instead relying on two district court cases cited in Nissan NA’s brief, which supported the proposition.

Similarly, *Mac’s Shell* was referenced in the context of a common law application of the doctrine of constructive termination in *Tilstra v. Bou-Matic, LLC*. Plaintiffs Sid Tilstra and Tilstra Dairy Equipment, Ltd. alleged that Defendant Bou-Matic breached their dealership agreement by constructively terminating it without ninety days’ notice and good cause, which were required by the terms of the agreement itself. Bou-Matic had informed Tilstra that it “was going to remove their entire trade territory if they did not any action or intent to terminate, cancel, discontinue, or not renew a franchise . . . .” 

52. See Bedford Nissan, 2016 WL 6395799, at *10.
53. Id. Essentially, the plaintiffs claimed that Nissan NA had selected a preferred dealer in Northeast Ohio, entered into secret agreements under which he was given “secret cash and quarterly incentive payments,” id. at *1, with the intent of “eliminat[ing] intrabrand competition among its dealers in Northeast Ohio, reconfigur[ing] its dealer network in Northeast Ohio, and ‘drown[ing] the Plaintiffs,’” id. at *10.
54. Id. at *10.
55. Id.
58. 1 F. Supp. 3d 900, 913 (W.D. Wis. 2014).
59. Id. at 910.
agree to sell their assets and dealership to [a neighboring competing dealer]” by a date certain. When Sid Tilstra failed to execute the sale within the required time frame, Bou-Matic sent him a letter saying that its decision to re-assign Tilstra’s territory was final and that Bou-Matic would “proceed with or without [their] cooperation.” Fearing that his dealership would soon be rendered worthless without his territory if he did not complete the sale, Tilstra sold to the competing dealer at a fire sale price.

Tilstra was located in Canada and thus not entitled to the protections of the Wisconsin Fair Dealership Law. However, Tilstra alleged that the contract had been constructively terminated under common law contract principles. The U.S. District Court for the Western District of Wisconsin cited Mac’s Shell for an explanation of the doctrine in the context of employment law and noted that “a termination is deemed ‘constructive’ because it is the plaintiff rather than the defendant that formally puts an end to the particular legal relationship, not because there has been no actual end to the relationship.” In this case, Tilstra had effectively ended the relationship by executing the sale. The court concluded that Tilstra’s claim survived summary judgment, and ultimately, the jury ruled in Tilstra’s favor, finding that Bou-Matic had breached the covenant of good faith and fair dealing implied in the contract by constructively terminating the agreement.

The contours of constructive termination claims outside the PMPA—and whether they exist at all in certain cases—are still being determined. More interesting, this process appears to be relatively unaffected by Mac’s Shell. Some courts have left the question still unanswered as to whether these claims may be recognized at all. Other courts have refused to entertain

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60. Id. at 909–10.
61. Id. at 908.
62. Id. at 906–07.
63. Id. at 914.
64. Id.
65. Id. (citing Mac’s Shell, 559 U.S. at 185).
66. Id. at 914.
68. For example, in Estes Automotive Group, Inc. v. Hyundai Motor America, No. 8:10-CV-00287-JST, 2011 WL 1153371, at *4 (C.D. Cal. Mar. 25, 2011), the court left open the question of whether a claim for constructive termination is recognized under the Automobile Dealers Day in Court Act (ADDCA), 15 U.S.C. §§ 1221–25, which provides a cause of action “for the failure of [an] automobile manufacturer to act in good faith in performing or complying with any of the terms of provisions of the franchise or in terminating, canceling, or not renewing the dealer’s franchise.” (quoting Autohaus Brugger, Inc. v. Saab Motors, Inc., 567 F.2d 901, 910 (9th Cir. 1978)). The court noted that “[t]he Ninth Circuit ha[d] not [yet] addressed whether constructive termination is actionable under the ADDCA,” but pointed out that even if such a claim was permitted, the plaintiffs’ allegations were insufficient. Estes, 2011 WL 1153371 at *4.
69. In Grimes Buick-GMC, Inc. v. GMAC, LLC, No. CV 12-73-H-CCL, 2013 WL 5348103, at *5 (D. Mont. Sept. 23, 2013), the U.S. District Court for the District of Montana addressed a claim for constructive termination under the Montana Motor Vehicle Dealer Act, which mandates that “a franchisor may not cancel, terminate or refuse to continue a franchise unless the franchisor has cause for termination or noncontinuance.” MONT. CODE ANN. §§ 61-4-205. Noting that
constructive termination claims under state franchise statutes in the absence of a specific legislative pronouncement that such claims are cognizable under the statute at issue.69 Post-Mac’s Shell, use of the doctrine continues under various statutes70 and the common law of contracts.71

The large majority of cases show that the doctrine of constructive termination in the franchise context is alive and well, untouched by the holding in Mac’s Shell. Indeed, Mac’s Shell is not cited as authority by courts (or parties,

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| 69. In Casco Inc. v. John Deere Construction Co. and Forestry Co., the U.S. District Court for the District of Puerto Rico noted that “[t]he issue of whether Law 75 [Puerto Rico Dealers Act] affords relief for constructive termination is . . . an undeveloped question of Puerto Rico law”; as a federal court sitting in diversity, it declined to “[r]ead[] constructive termination into Law 75’s potential causes of action.” No. CIV. 13-1325 GAG, 2014 WL 4233241, at *3 n.2 (D.P.R. Aug. 26, 2014). However, in a subsequent ruling by a different judge, the district court characterized the earlier ruling as deciding that claims were not recognized under the statute: “the court previously ruled that constructive termination is not actionable under Law 75.” Casco, Inc. v. John Deere Const. & Forestry Co., No. CIV. 13-1325 PAD, 2015 WL 4132278, at *4 (D.P.R. July 8, 2015) (citing Casco, 2014 WL 4233241, at *3 n.2 (No. Civ. 13-1325 GAG, Doc. 117, at p. 6)). Neither opinion cited the Supreme Court’s ruling in Mac’s Shell.

70. For example, in Jay Automotive Group, Inc. v. American Suzuki Motor Corporation, No. 4:11-CV-129 CDL, 2012 WL 425984, at *7 (M.D. Ga. Feb. 9, 2012), the U.S. District Court for the Middle District of Georgia ruled that constructive termination is actionable under the Georgia Motor Vehicle Franchise Practices Act. The plaintiff in Jay alleged that it had been constructively terminated in violation of both GA. CODE ANN. §§ 10-1-631 (2010) (Motor Vehicle Dealer’s Day in Court Act) and 10-1-651 (2010) (Motor Vehicle Franchise Continuation and Succession Act), which require “good faith in ‘termination’ of a franchise” and notice and good cause for termination, respectively. Id. at *6–7. It is unclear, however, under the court’s ruling whether the limitation in Mac’s Shell—that the franchise actually have terminated—will be applied to claims under the Act. The defendant argued that the plaintiff’s claim could not succeed in part “because the Franchise continue[d] to operate.” Id. at *6. However, the court underscored that the plaintiff had in fact alleged that the franchise had stopped operating “due to [the defendant’s] actions.” Id.

71. See HRCC, Ltd. v. Hard Rock Cafe Int’l (USA), Inc., No. 6:14-CV-2004-ORL-40, 2015 WL 3498610, at *9 (M.D. Fla. June 2, 2015) (stating, in response to “Defendants[]’ claim that a cause of action for constructive termination require[d] an express or implied mandate via legislation which governs the relevant franchise relationship,” that de facto or constructive termination “applies where one party unilaterally modifies the terms of a contractual relationship in a manner that ‘substantially interferes with the other party’s ability to obtain the benefits of the contract’”) (citations omitted).
as far as we can tell after reviewing publicly available briefs) in most decisions interpreting constructive termination claims under dealer protection and franchise statutes.72 Despite Mac’s Shell’s limitation on PMPA claims, courts have continued to embrace franchisees’ use of constructive termination under state franchise statutes and the common law as a key way to equalize the power imbalance that exists between franchisors and franchisees and manufacturers and dealers—the very purpose of much state and federal franchise legislation in the first place.73

III. Where We’ve Been and Where We (Should) Go from Here: The Past and Future of Mac’s Shell

The Supreme Court issued its decision in Mac’s Shell on March 2, 2010, so the decision is now more than seven years old. During that seven-year period, three principal topics of interest have emerged in the decision’s wake.

First, courts faced with constructive termination claims under the PMPA have not hesitated to apply Mac’s Shell and bar claims by franchisees that fail to allege they have gone out of business or been deprived of the right to use the franchisor’s trademarks, buy its fuel, or use its business premises. This is, on the most basic level, unsurprising because the lower federal courts are not ordinarily known for open defiance of U.S. Supreme Court decisions. Over and above this basic truth, the lower courts have resisted franchisee efforts to

72. Girl Scouts of Manitou Council, Inc. v. Girl Scouts of U.S. of Am., Inc., 646 F.3d 983, 990 (7th Cir. 2011), aff’d in part and rev’d in part Girl Scouts of Manitou Council Inc. v. Girl Scouts of U.S. of Am. Inc., 700 F. Supp. 2d 1055, 1079 (E.D. Wis. 2010) (noting that the U.S. District Court for the Eastern District of Wisconsin had accurately “described the transfer [of a local Girl Scout council’s northern territory to another council] as amounting to “constructive termination” of [that council’s dealership]”); Budget Blinds Inc. v. LeClair, No. SACV 12-1101 DOC, 2013 WL 183935, at *3 (C.D. Cal. Jan. 16, 2013) (upholding arbitrator’s finding that Budget Blinds constructively terminated the franchise agreement because under the Wisconsin Fair Dealership Law, constructive termination “can occur when the grantor takes actions that amount to an ‘effective end to the commercially meaningful aspects of the [dealership] relationship,’ regardless of whether the formal contractual relationship between the parties continues in force”); Kaeser Compressors, Inc. v. Compressor & Pump Repair Servs., Inc., 781 F. Supp. 2d 819, 827 (E.D. Wis. 2011) (manufacturer’s proposal of dealership agreement with new, less favorable terms was not yet enough to amount to a constructive termination); Sandhu v. 7-Eleven, Inc., 45 F. Supp. 3d 426, 430 (D. Del. 2014) (plaintiff not entitled to preliminary injunction under Delaware Franchise Security Law because she had failed to show “that it [was] more likely so than not that 7–Eleven [was] constructively terminating the franchise in bad faith”); Kejzar Motors, 334 S.W.3d at 356 (denying preliminary injunction under Texas Business Opportunities and Agreements Act because of conflicting evidence offered regarding dealer’s probable performance after new dealer allowed to open in territory).

73. See e.g., Grimes Buick, 2013 WL 5348103, at *5 (noting that one of the purposes of the Montana Motor Vehicle Dealer Act “is to protect the dealer in a circumstance where the manufacturer might be viewed as taking an unfair advantage of its economic leverage”); Sandbu, 45 F. Supp. 3d at 430 (noting that the “general purpose” of the Delaware Franchise Security Law “is to remedy the imbalance of power in the franchise relationship by adding a few statutory pounds to the franchisee’s side of the scales” (citations omitted)); Girl Scouts of Manitou, 700 F. Supp. 2d at 1073 (explaining that “the Wisconsin legislature enacted the WFDL [Wisconsin Fair Dealership Law] in order ‘to protect dealers against unfair treatment by grantors’”) (quoting Eisencorp, Inc. v. Rocky Mountain Radar, Inc., 398 F.3d 962, 965 (7th Cir. 2005)).
recharacterize their PMPA-based claims as something other than a constructive termination. For example, in *Poquez*, the franchisee disclaimed it was relying on a constructive termination theory and instead asserted that the franchisor’s alleged failure to grant the franchisee its right of first refusal and the franchisor’s subsequent sale of the station’s underlying real estate to the developer effected a “severance” of the legal relationship. The franchisee’s PMPA claim, however, was still dismissed.

Second, the Supreme Court has declined to address the question it left open in *Mac’s Shell*, namely, whether constructive termination claims invoking the PMPA are valid at all. Despite the Court’s apparent skepticism about such claims, there is good reason to recognize a constructive termination theory for PMPA claims—and, by extension, under other franchisee-protection statutes—when the franchisor does not formally force an end to a petroleum franchise, stemming from Judge Posner’s dictum that without a constructive termination claim, there would be “a big loophole” in the Act.

Because this analysis has been criticized, however, we next look at the Seventh Circuit’s analysis using concepts from that court’s decisions interpreting the Wisconsin Fair Dealership Law (WFDL). The WFDL covers a wider range of business relationships than most franchisee-protection statutes, and courts have often had to decide whether a plaintiff met the WFDL’s requirement that a party seeking protected “dealer” status shared a “community of interest” with the manufacturer or putative “grantor.” After having been confronted with the question many times over the first few decades of the WFDL’s existence, and under the influence of the law-and-economics approach brought to the court by Judge Posner and Judge Frank Easterbrook, the Seventh Circuit began viewing the “community of interest” issue through the lens of the economic concept of opportunistic behavior. This approach came to light for the first time in a case against Radio Shack in 1987:

Suppose that, as is common in franchise arrangements, Moore had been authorized or required to invest his own money in modifying the store premises to Radio Shack’s specifications, and had done so; and suppose that the premises would not be suitable for any other use without additional modifications that would be expensive. Then Moore would be at Radio Shack’s mercy, for if Radio Shack terminated the franchise, Moore would lose the investment he had made in modifying the premises to Radio Shack’s specifications. This would be a concrete example of “taking unfair advantage of the relative economic weakness of the franchisee.” . . . Moore could protect himself in advance against such opportunistic behavior on Radio Shack’s part by negotiating for a long-term dealership contract; in effect (and this is the irreducibly protectionist aspect of the statute) the

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75. Id. at *4–5.
76. *Al’s Serv. Ctr.*, 599 F.3d at 726.
77. See, e.g., Kry, *supra* note 28, at 69–70.
78. Wis. Stat. §§ 135.01 et seq.
79. See Wis. Stat. §§ 135.02(1)–(3).
Wisconsin Fair Dealership Law forces on the parties the equivalent of such a contract, in the form of a nonwaivable prohibition against the franchisor’s terminating the dealership without cause.80

In a later case, the Seventh Circuit succinctly explained its reasoning: “We have deduced from the structure and history of the statute a central function: preventing suppliers from behaving opportunistically once franchisees or other dealers have sunk substantial resources into tailoring their business around, and promoting, a brand.”81

Of course, protection of the party with less economic power, the party that is effectively “over a barrel”82 because of its unrecoverable financial commitments to a supplier’s brand and products, is the “central function” of all franchisee-protection statutes, including the PMPA. One way for a petroleum franchisor to behave opportunistically in its dealings with a franchisee would be to impose conditions or requirements on the franchisee that fell short of the PMPA’s limited allowed reasons for termination and that induced the franchisee to give up the franchise voluntarily by making it too burdensome or expensive to continue. If the franchisor could accomplish this without formally taking action to terminate the franchisee’s status, it would be accomplishing indirectly what the PMPA forbade it from doing directly—exactly the “loophole” referenced by the Seventh Circuit in Al’s Service Center discussed above. And if it is legitimate for Congress to attack franchisors’ opportunistic behavior by enacting the PMPA’s prohibitions forbidding direct terminations for reasons not specified in the statute, there is no logical reason for courts to allow franchisors to run around those prohibitions by creatively devising ways to make the franchisee’s continued existence so intolerable that it gives up the business without receiving formal notice of termination.

Third, it is noteworthy that Mac’s Shell appears to have had a limited impact outside the context of PMPA litigation. The decision received extensive attention and discussion from the franchise bar when it was issued, and counsel for franchisees and franchisors alike expressed the belief that future litigants and courts would use the reasoning of Mac’s Shell to try to limit the scope of constructive termination claims.83 Although a number of non-PMPA decisions have applied Mac’s Shell, more cases proceed with their analysis of constructive termination claims in franchising without ever mentioning the decision. It is probably safe to say that if the reasoning of Mac’s Shell has not taken over the field of constructive termination claims in franchising outside the context of the PMPA in the seven years since the decision was handed down, the day when Mac’s Shell universally governs non-PMPA claims is unlikely to arrive at all.

80. Moore v. Tandy Corp., 819 F.2d 820, 822 (7th Cir. 1987).
82. Home Protective Servs., Inc. v. ADT Sec. Servs., Inc., 438 F.3d 716, 720 (7th Cir. 2006).
83. Kry, supra note 28, at 69; Carmen D. Caruso, Franchisee Claims for Constructive Termination Under the PMPA After Mac’s Shell, 30 Franchise L.J. 139, 143 (2011).
IV. Conclusion

Because the U.S. Supreme Court has the last word on matters of federal law, it is not surprising that the lower federal courts have fallen into step with the decision in *Mac’s Shell* and dismissed constructive termination claims under the PMPA when the plaintiff has not actually stopped operating the franchise. And because the Supreme Court will often allow legal issues to develop in the district courts and courts of appeals before granting certiorari and resolving the issue, it is also not surprising that even seven years after the *Mac’s Shell* decision, the Court has yet to resolve whether the PMPA allows a claim for constructive termination in the first instance. The most surprising fact in the wake of *Mac’s Shell* may be the limited relevance its reasoning has had in the resolution of claims for constructive termination asserted by franchisees under common law and state relationship statutes. Although a few cases have relied on the reasoning of *Mac’s Shell*, many more such claims have been resolved without even a reference to the opinion. As a result, it is likely that the full impact of *Mac’s Shell* on franchise litigation has already been absorbed.
Succession Planning for Franchisees

Bruce S. Schaeffer and K. Eli Akhavan

Succession planning for franchisees is a current imperative because there is a demographic onslaught approaching the franchise sector; it’s coming at a time when there is a stark lack of foreseeability with respect to estate and gift taxes. Baby boomers are reaching retirement age in staggering numbers and the new president has promised to repeal the estate tax.

At a minimum, franchisees must consider the topics below that apply to them and devise and implement appropriate plans and solutions—complete with the required documents and procedures.

1. **Succession Plan**—This is a business contingency plan. The question to be asked is what happens if the principal leaves his or her business for lunch and is killed by a bus or a stray bullet? What, if any, are the restrictions in the franchise agreement that apply to transferees?

2. **Estate Plan**—This is a dispositive scheme that first must consider a possible sale and, after that, is generally accomplished by wills, trusts, LLC agreements, shareholders agreements, family partnership agreements, life insurance trusts and/or other revocable and irrevocable trusts.

3. **Estate Tax Plan**—This is a consideration only where the estates are worth more than $5.49 million under the current estate tax scheme. But who knows what the situation will be under the new administration? Currently many franchise owners have assets worth far more than the threshold for estate taxation. With combined federal and state estate tax rates exceeding 40 percent, advance planning is essen-

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tial. People with these types of success problems must consider valuation discounts for lack of marketability and other discounts and must consider how any such estate tax liability will be met to avoid a forced liquidation.

(4) **Valuation**—If a franchise owner is going to sell, or die and dispose of his or her franchise company by bequest, the value of the business must be determined. It is not only an essential element in any estate tax planning to know the value of the franchise on which the tax is potentially to be levied, but valuation is a key factor in all exit strategy planning.

I. Getting Started on a Succession Plan

A succession plan is a set of directions that may not be properly part of a franchise owner’s estate plan and, therefore, would not be included in documents such as a will or revocable trust. But it is equally as important. The key considerations in formulating the succession plan are:

1. Who will run the franchise business if the principal is incapacitated or dies?
2. Should the business be sold, continued, or liquidated?
3. If there are questions about 1 and 2 above, who should be consulted? What adviser will have all the facts, and hopefully answers?

Because most franchise owners are novice sellers, many may make mistakes, including:

- They often lack preparation. Sellers should have a plan/strategy to sell well in advance of making the sale. For most franchises, this should be at least three years out.
- They often will fail to have an accurate valuation done on their business by a qualified third party expert. This in turn, may give sellers an inflated view of the value of their business.
- They fail to organize the books and records.
- Customer/vendor/employee issues are not dealt with properly prior to sale.
- They lose their motivation, passion, commitment, and momentum when they consider sale or retirement. Instead, if they want to sell the business, they should try to increase revenue because increasing sales are important to buyers as they analyze trends.
- They fail to de-emphasize the owner’s personal role in the business.¹

A. Demographics

Here are some statistics: there are approximately seventy-five million baby boomers in the United States and more than five million similarly situated in Canada. Most are on the verge of retirement. For the next few decades, an average of 10,000 people each day will reach age sixty-five (one every eight seconds), which has historically been the retirement age. Between 2000 and 2010, the number of people age sixty-five to eighty-four in the U.S. grew by 3.3 million. Although a little more than 13 percent of Americans are currently age sixty-five or older, that proportion will jump to 18 percent by 2030. The current forty million senior citizens will balloon to eighty-nine million by 2050. In the case of franchise owners approaching retirement age, generally the most valuable asset they own—indeed often far more than 50 percent of their net worth—is tied up in their franchise companies. Additionally, many who have not been involved in franchises previously may have retired from other work and bought franchises as part of the “new retirement work scape,” according to a 2014 Merrill Lynch Retirement Study.

Boomers are currently starting their own businesses in record numbers. According to the Kauffman Index of Entrepreneurial Activity, 23.4 percent of new entrepreneurs in 2013 were aged fifty-five to sixty-four. Part of the reason is that when older workers are downsized, it can take nearly twice as long for them to find new jobs so it makes sense to many boomers to start their own companies. Franchises are deemed safer than pure start-ups.

Selling-Your-Chain-168026046.html#ixzz25apUF5Ln (quoting Meg Schmitz, senior franchise consultant, FranChoice).


6. Id.


B. Exit Planning—Sale or Other Pre-Death Disposition Options

It has been argued that when planning a disposition, a franchisee (or any business owner) has only nine options to consider:

1. Sell or give your company to a family member;
2. Sell your business to one or more key employees;
3. Sell to your employees through an employee stock ownership plan (ESOP);
4. Sell your business to other shareholders;
5. Sell to an outside third party;
6. Bring in an outside investor and keep a minority interest;
7. Go public;
8. Hire a management team to take over and become a passive owner; or
9. Liquidate your business.¹⁰

According to Venture Resources, there are “12 Fatal Mistakes to Avoid When Selling Your Business”:

1. Lack of deal structure expertise;
2. Failure to adjust the net owner benefit;
3. Failure to maintain confidentiality;
4. Failure to secure qualified buyers;
5. Failure to continue to run your business;
6. Failure to properly adjust for economic conditions and owner’s ability;
7. Failure to provide credible information;
8. Poor negotiating techniques;
9. Failure to place the proper value on your business;
10. Failure to consider alternative investments;
11. Failure to prepare for proper due diligence; and
12. Failure to seek professional assistance and consultation.¹¹

Owners of franchises, dealerships, or distributorships must be aware of the legal, financial, marketing, timing, and other vital considerations, most of which should not be made without the advice of the right professionals, that must be addressed in the selling process.

¹⁰ Richard Jackim, JD, MBA, CEPA, an attorney and investment banker on the Board of Governors of the Exit Planning Institute.
II. Franchise Agreement Restrictions and Transfer Procedures

If there is an intent to leave the franchise as a bequest at death, practitioners have to be aware that practically every franchise agreement grants the franchisor a right of approval and often a right of first refusal (ROFR) with respect to any transfer, whether by sale or devise. The franchisee really owns only a contract right, leaving the franchisor in complete control of all transfers, bequests, or both. Thus, the best laid estate and succession plan for a franchisee is worthless if it does not meet the franchisor’s requirements.

A synopsis of several sample franchise agreements shows the following:

A. Planet Fitness (2015) Section 13

(1) Transfer without prior approval prohibited.

(2) “The proposed transferee and its direct and indirect owners must be individuals of good moral character and otherwise meet our then applicable standards for PLANET FITNESS business franchisees.” (emphasis added).

(3) If the proposed transfer is for estate planning, transferor (a) must be up to date on royalties; (b) must reimburse franchisor for costs it incurs with respect to the transfer; (c) transferor must execute general release in favor of franchisor; (d) franchisor must give approval; and (e) transferee must sign additional required agreements.

(4) If the transfer is of substantially all the franchise’s assets, transferee (a) must have appropriate moral character; (b) transferor must be up to date on royalty payments; (c) transferee and its managers must have completed required training; (d) transferee must agree to be bound by all terms of franchise agreement; (e) transferor must pay $25,000 transfer fee; (f) transferor must deliver general release; (g) franchisor must give approval and have “determined that the price and terms of payment will not adversely affect the transferee’s operation of the Business”; (h) if the transfer is seller-financed, transferor must agree that purchase payments are subordinated to royalties and other payments to franchisor; and (i) transferee must agree to be bound by franchise agreement.

(5) Transfer upon death or disability: Owner’s executor must transfer the interest in the franchise to a third party; transfer must be “completed within a reasonable time not to exceed 6 months from the date of death and a failure to do so constitutes a breach of the franchise agreement.”

(6) Franchisor has right of first refusal (ROFR) on any transfer for 30 days after receiving notice.
B. Burger King’s (BKC) Franchise Agreement (2014) Section 15

(1) “Any purported assignment or transfer not in full compliance with this Section 15 shall be null and void and shall constitute a material breach of this agreement for which BKC may immediately terminate without opportunity to cure.” (emphasis added)

(2) Prohibits transfer of the franchise agreement, an ownership interest, or equity securities; also prohibits pledging of the franchise agreement.

(3) Has requirement that transferor be up to date with all obligations, sign a release, and remain liable for at least a year for unpaid royalties and advertising contributions; the franchisor (BKC) has a ROFR and will not answer request for consent to transfer for two to three months. Therefore, there can be no immediate disposition at death. In addition, BKC has right to veto transfer if it impairs cash flow (i.e., if price too high).

(4) Death—must get consent to transfer, subject to ROFR, and must transfer within twenty-four months or BKC can buy at fair market value.

C. Service Master (2014) Section 12

(1) Transfer to competitor prohibited.

(2) Transfer to entity—franchisee must retain at least 66 percent of such entity.

(3) Upon the death or permanent incapacity of the franchisee, the executor shall transfer to an approved party within a reasonable time.

(4) If heirs are not accepted as transferees, the personal representative shall have a reasonable time to dispose of decedent’s interest.

Thus, these provisions make clear that estate and succession planners cannot just devise a plan that seems to make sense. They must come up with a plan that makes sense and will pass muster with the franchisor.

III. Valuation

Valuation is a major consideration in succession planning for franchise owners for two reasons: (1) it allows owners to figure out the total of their estates, permitting them to allocate to recipients according to value (e.g., to all children equally); and (2) it puts a value on the assets and the total estate for estate tax purposes. This is important for tax planning and for computing the basis on which depreciation or amortization is available (income tax considerations) to a successor in interest.

The specialized vocabulary of appraisals and valuations is stultifying and filled with technical terms. Also, some legal and accounting definitions tend
to overlap the appraisers’ usage although others do not. For example, in fixing the “value” of a business, a practitioner must deal with a whole host of specialized terms, such as discounted cash flows and modified discounted cash flows, price-to-earnings ratios, and price-to-sales ratios, “cap” rates and growth rates, and disputes over whether one business is “comparable” to another.

The major terms used in business valuations are “fair market value,” which is a legal term, and “fair value,” which is an accounting term. They both generally mean the same thing. Three (and really only three) general methods are acceptable for determining business value. In legal terms, these are book value, capitalization of earnings, and comparable sales. In accounting terms, these methods are known as (1) cost (book value), (2) income (capitalization of earnings), and (3) market (comparable sales). Calculations using other methods or comparisons should be treated with great caution.

- **Book value** is the net worth of a company determined by either its balance sheet assets or the replacement cost of its balance sheet assets minus liabilities.

- **Capitalization of earnings**: This method assumes that the earnings of a business either constitute an annual percentage return on the value of the business or, more accurately, that the present discounted value of all of the business’s earnings into the future is the current business value. Thus using that method, once the discount rate and the earnings are determined, a value is computed. For example, a 5 percent capitalization rate (sometimes called a discount rate) applied to $100,000 of earnings would yield a business value of $2 million ($100,000 divided by .05 = $2,000,000). This is the same result as a 20:1 price/earnings ratio.

- **“Comparable” sales** are recent sales of similarly situated businesses. Because those prices are not estimates but actualities, the comparable sales method is generally preferred as the most realistic proof of fair market value.

**Business goodwill vs. personal goodwill**—Valuation analysts are often asked to identify and quantify the company-owned entity’s goodwill, separately from the shareholder-owned personal goodwill, in the valuation of a closely held company such as a franchise. These goodwill valuations may be relevant for gift and estate tax, company sale proceeds allocation, and family law and other litigation purposes. Therefore, estate planners should be aware of the factors to be considered when allocating goodwill between the entity and the owner.

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IV. Nuts and Bolts of Succession Planning

Succession planning should be a tailored and personal process. The succession plan must incorporate the unique features of every situation. However, there are certain common themes that run through succession planning:

A. Ownership and Management

A basic consideration in business succession planning is whether ownership will be segregated from the management of the business. Some franchisees may have children who will remain or become owners in the business, and the question becomes whether they have the requisite experience and skills necessary to manage and operate the franchise. Other considerations include whether the children have the respect of the franchisee’s key employees. Additionally, the children should articulate a vision for the future of the business and should be onboard with the timing for the succession of the business.

Whether or not the children are fit to succeed as managers of the business, the franchise owner must ensure that a proper compensation plan is in place to retain the key employees of the business to ensure its future success.

B. Advisory Team

In designing and formulating a business succession plan, a franchisee should be supported by a team of specialists. An advisory team should include a CPA; financial advisor; valuation specialist; and, of course, a tax and estate planning attorney. Navigating the succession process requires both technical skill as well as judgment calls. The business owner needs to be informed as much as possible.

C. Conflict Between Passive and Active Owners

A common source of dispute in family-owned businesses is when there are both active as well as passive owners. Generally, family members who are not active in the business would like to receive tax-advantaged dividend distributions or even proceeds from the sale of the company. Additionally, non-active family members may feel that the active owners are receiving excessive salary and other benefits from the business. In the event the company does not issue any dividends, the family conflict may become even more pronounced.

Active owners in the family business generally believe that their efforts and work on behalf of the company is what allows the enterprise to profit, and therefore dividend distributions are unwarranted. Active owners may also be resentful that passive owners benefit from their labor.

The economic strain that the passive family owners may place on the business operations through distribution or buy-out demands may have an
adverse effect on business operations. It is always recommended that the active family owners provide financial transparency into the books and records of the business to minimize conflict and even consider a buyout to eliminate the “distraction” the tension may cause.

D. Senior Generation versus Junior Generation Control

Often founding members and owners of an operating business are not willing to abdicate responsibilities, even if they have children who are willing to take up the mantle of leadership. The senior generation risks having the younger generation leave the business in search of other opportunities. The younger generation may even set up a competing company to implement their vision.

One possible solution is to recapitalize the interests in the business to give the older generation a preferred class of stock and the younger generation non-preferred equity. This would allow the senior generation to retain substantial control of the business while incentivizing the younger generation to remain in the company. Sometimes, however, the franchise agreement does not allow such solutions.

E. No One Qualified to Succeed

Oftentimes, a business owner may not have children interested in taking the helm of an operating business. Even if the children are interested in the business, they may not have the skills to manage it. In either case, the founder is not out of options. He or she can still arrange to have the company sold upon death or retirement. But if such a plan is not in place, there is a risk of incompetent successors running the business into the ground; that injures to no one’s benefit.

F. Employee Succession

An employee stock ownership plan or ESOP is a qualified retirement plan that allows employees to purchase and own stock of the employer. The ESOP can be funded either by the company by issuing new shares of its own stock or cash to buy its existing shares for which it can sometimes also use leverage. The company can make a tax-deductible contribution to the ESOP to buy out the owner’s shares, which often can be accomplished on a tax-deferred basis. An attractive feature of the ESOP sale is that control of the company can remain in the hands of the owner/founder.

The drawback of an ESOP plan is that its administration can be somewhat costly and complicated. And, if it’s not done right, there could be adverse tax and business consequences.

G. Life Insurance as Succession Planning Tool

Life insurance can be an integral part of a business succession plan. First, the death benefit from a policy can mitigate the estate tax impact. Second, life insurance proceeds can provide estate equalization for children who
are either not active or not involved in the family business. Generally, the policy should be owned by an irrevocable life insurance trust (ILIT) so that the death benefit proceeds are not includible in the insured’s estate and not subject to income tax.

V. Estate Planning

A formal estate plan is generally made up of legal documents that are a blueprint for the disposition of assets upon the death of a franchise owner. The documents most often used, particularly for owners of franchises, dealerships or distributorships who may be subject to estate taxes, are:

1. Pour-Over will
2. Revocable Trust
3. Durable Power of Attorney (Financial)
4. Durable Power of Attorney (Health Care)—a/k/a “living will” or “health care proxy”
5. HIPAA Form
6. Irrevocable Life Insurance Trust
7. Grandchildren’s Trust
8. GRIT, GRAT or GRUT
9. Charitable Lead Trust or Charitable Remainder Trust

We will comment briefly on the first four of these documents. A discussion of the rest is beyond the scope of this article.

A. Will versus Revocable Trust

A last will and testament disposes of a decedent’s probate assets, which are assets that do not pass by operation of law, while non-probate assets pass by operation of law. Examples of non-probate property include jointly held property as well as annuities, life insurance policies, and retirement accounts that do not list an estate as the designated beneficiary. A “pour over” will is generally used to leave assets to a revocable living trust when that is used as the main dispositive instrument.

A revocable living trust is a trust agreement that can be amended or revoked by the settlor at any time. A revocable living trust does not serve any estate tax or asset protection purpose. The primary purpose of a revocable living trust is to avoid probate court. In states in which probate fees are based on the value of the probate estate, avoiding probate can save significant amounts of money. It can also avoid the delays and vagaries of dealing with probate courts and their judges.

Neither method can be deemed the superior option for bequeathing assets. It all depends on the facts and circumstances. The one drawback with
A revocable living trust is that it must be funded to operate as designed. In other words, to avoid probate on what would generally be considered probate assets, the assets must be titled in the name of the trust before death. Individuals who set up revocable living trusts but fail to comply with this administrative requirement may therefore defeat the purpose of the living trust.

Franchise owners who desire to avoid probate should consult their franchise agreements to see if interests in the franchise can be transferred to a revocable living trust.

B. Durable Power of Attorney

A durable power of attorney is a legal directive that gives an agent the legal authority to act on a principal’s behalf while the principal is alive. The authority can be effective either immediately (durable power of attorney) or upon the occurrence of a future event (springing power of attorney). The future event is usually the incapacity of the principal. However, practically all powers of attorney cease to be effective upon the death of the principal, revocation by the principal, or the incapacity of the agent.

The powers of an agent can be as broad or as limited as the principal directs. Many states have an official form for power of attorney and the applicable state statute must be consulted. Franchisees should have a duly executed financial power of attorney so that in the event of incapacity someone is authorized to handle their business affairs to ensure the continuity of business operations.

C. Health Care Proxy/Living Will

A health care proxy (also known as a durable power of attorney for health care, medical power of attorney, or appointment of a healthcare agent) lets an individual appoint another person to make health care decisions in the event of incapacity. Appointing a health care agent is one of the most important things one can do to ensure that one’s health care wishes are complied with.

Typically, the health care proxy goes into effect when a person is unable to communicate his or her wishes due to a temporary or permanent injury or illness. A living will, which generally provides a statement of the patient’s wishes rather than simply empowering an agent, differs from a health care proxy. Both documents should be in place.

D. Transfers to Trusts

A trust is a tripartite instrument whereby the original owner’s (grantor, trustor, settlor) interest in the ownership and title to assets are transferred to a legal owner (trustee) for the benefit of a beneficial owner (beneficiary). The trustee manages the trust for the benefit of the beneficiaries. A transfer to an irrevocable trust during the franchisee’s lifetime will remove any appreciation in the asset from the franchisee’s estate and generally protect the asset from the franchisee’s creditors (assuming no fraudulent transfer).
If franchisees transfer their interest in the business to a trust during life or via a will, sometimes one or two important considerations will arise: (1) appointment of trustee and (2) appointment of trust protector.

1. Who Should Serve as Trustee?

If franchisees deem it prudent to transfer their interest in the franchise to a trust, either while they are alive or upon death, they must carefully consider who should serve as trustee. If the transfer is to an irrevocable trust and is being made for estate tax or asset protection purposes, the franchisee should not serve as trustee.

Although trustees have the fiduciary duties of faith and loyalty to the beneficiaries of the trust, they will have voting, distribution, and investment decision-making powers. Accordingly, whoever the franchise owner appoints as trustee of either an inter-vivos or testamentary trust should be someone that the franchisee believes will look out for the best interest of the beneficiaries and also possesses the business skill and acumen to make the right decisions or hire the right advisors if he or she does not have those skills.

2. Trust Protector

Often, clients feel more comfortable transferring or bequeathing assets to a trust in which there is oversight over the trustee. One vehicle through which trustee oversight can be accomplished is through the position of a “trust protector.” A trust protector can be given many different powers, including the powers to add or change beneficiaries, change trust situs, and the power to hire and fire trustees. Some states explicitly provide for the position of trust protector by statute and some are silent on the matter. Additionally, some states provide that that a trust protector acts under a fiduciary duty although other states do not explicitly provide either way—the trust agreement can specify.

3. Asset Protection Considerations

We live in an extremely litigious society; franchisees can find themselves being hauled into court for claims arising from the franchisee’s business operations (inside liabilities) and claims unrelated to the business operations (outside liabilities). If a customer gets ill or is injured from a franchisee’s product (e.g., fast food, cars, vitamins, etc.), the franchisee will likely be listed as a defendant in the personal injury or wrongful death lawsuit. On a personal level, franchisees are exposed to liabilities arising from tort, family disputes, and personal relationships. Accordingly, franchisees should proactively protect their assets from both inside and outside liabilities.

First, franchisees must ensure that they operate the franchise through a business entity, such as a corporation, a trust, or a limited liability company, that offers limited liability. Franchisees must also ensure that their ownership interests in the franchise as well as their other assets are protected from non-business creditors. Asset protection tools range from umbrella in-
surance to transferring assets to asset protection trusts in both domestic and foreign jurisdictions that have enacted self-settled trust legislation (whereby the grantor can possibly also be a beneficiary of the trust).

4. Limited Liability Companies

The most common entity used for franchised business operations currently is the limited liability company (LLC). An LLC offers two significant benefits: (1) only one layer of tax (as opposed to a corporation that is classified as a C corporation under the Internal Revenue Code which imposes two layers of tax)\(^ \text{14} \); and (2) limited liability to the business owners. However, the LLC primarily shields the franchisee from the inside liabilities.

Some things estate and succession planners should know about pass-through entities,\(^ \text{15} \) such as LLCs, are:

- More than 93 percent of businesses in America are pass-through enterprises. In 2014, 28.3 million out of 30.8 million business establishments were pass-through enterprises.

- Pass-through firms account for more than half of U.S. private sector employment. In 2014, the number of workers at these firms totaled 73 million, compared with 54 million at C corporations.

- The total profits of pass-through firms have surpassed the profits of C corporations. In 2012, the net income was $1.6 trillion for pass-through firms and $1.1 trillion for C corporations.\(^ \text{16} \)

VI. Estate and Gift Tax Considerations

A. Estate Tax

Currently, a 40 percent federal estate tax is imposed on the estate of individuals. Every individual has a lifetime exemption (currently, $5.49 million, indexed for inflation) so the 40 percent tax rate is imposed when the estate is valued at over $5.49 million. Additionally, for married couples, if one spouse predeceases the other, the surviving spouse can utilize the unused ex-

\(^{14}\) Contrast with a corporation classified as a C corporation under the Internal Revenue Code under which two levels of income tax are imposed—one at the corporation level and then a second level at the shareholder level.

\(^{15}\) Pass-through businesses come in three varieties: sole proprietorships (firms with one owner); partnerships (which includes LLCs for tax purposes); and S corporations, which are corporations receiving pass-through tax treatment. Their number has grown rapidly. In 1980, according to the Tax Foundation, there were more C corporation tax returns filed than the combined total of sole proprietorships, partnerships, and S corporations. By 2012, the number of pass-through returns was more than four times greater than the returns from C corporations. See Scott Greenberg, *Pass-Through Businesses: Data and Policy*, TAX FOUND. (Jan. 17, 2017), https://taxfoundation.org/pass-through-businesses-data-and-policy/.

emption of the decedent spouse. Effectively, a married couple has $10.98 million in exemption. No estate tax is imposed for transfers between spouses that qualify for the marital deduction.

Franchisees, especially multiple unit owners, may have assets that exceed this $10.98 million threshold. In order to evaluate and plan for estate tax exposure, a franchisee should obtain an appraisal of all assets, including franchise interests.

It should be noted that under the current law, if a beneficiary inherits an asset from a decedent, the beneficiary receives an income tax basis in the asset equal to the fair market value of the asset on the date of death of the decedent (step-up in basis). Accordingly, if the beneficiary sells the asset and there was no appreciation in value since the date of death, the beneficiary will not recognize any taxable gain for income tax purposes.

In contrast, if a beneficiary receives an asset as a gift during the donor’s lifetime, the beneficiary will take the same basis as the donor (carryover basis). Accordingly, if the beneficiary sells the asset for more than the donor’s basis, the beneficiary will have taxable gain.

B. Gift Tax

In addition to the estate tax that covers a decedent’s assets upon death, there is a gift tax (the two combined are referred to as the unified transfer tax) for transfers made during lifetime for less than fair market value in money or money’s worth. For example, if a franchisee gifts part of his interest to a child or to a trust for the benefit of a child, that is a taxable gift. As with the estate tax, there is a $5.49 million lifetime exemption. The estate and gift taxes work in tandem—if an individual makes lifetime gifts, the individual lowers his or her estate tax exemption by the same amount.

Additionally, there is an exemption for the “annual exclusion amount,” which is currently $14,000. The annual exclusion allows donors to make gifts up to $14,000 to any individual without using up their lifetime exemption. In other words, donors can gift up to $14,000 to every single person on the planet and not use up their $5.49 million exemption. A husband and wife can gift $28,000 each year to as many people as they wish by “gift-splitting.”

C. Valuation Discounts

For purposes of the estate and gift taxes, the fair market value of the property being transferred to a decedent’s beneficiary, or to a donee while the franchisee is alive, is generally:

[T]he price at which the property would change hands between a willing buyer and a willing seller, when the former is not under any compulsion to buy and the latter is not under any compulsion to sell, both parties having reasonable knowledge of the relevant facts.17

For purposes of valuing a business interest, the IRS allows, inter alia, discounts for lack of marketability and lack of control. A discount for lack of marketability is warranted because privately held business interests are not traded on public markets and are therefore less liquid. Additionally, if there are restrictions on transfer or control imposed by the franchise agreement or other corporate governance documents, additional discounts may be applied.

In prior years, estate planning advisors made heavy use of these discounts to transfer wealth in the form of family-held business interests to the next generation at a gift and estate tax value, which was often lower than the value of the underlying assets. However, on August 2, 2016, the Treasury issued proposed regulations that would essentially eliminate discounts for minority interests in the family business context. Although this initially caused great panic among estate planning practitioners, it remains to be seen whether the proposed regulations will come to fruition. For tax purposes, the whole issue may become moot if the estate tax is repealed but such discounts would still be relevant for the purpose of buyouts and M&A transactions.

D. Use of 754 Election for Basis Adjustments

As a general rule, upon the passing of an individual, all his or her assets receive a “step-up” in basis. A step-up in basis means that the income tax basis of the individual’s property gets stepped-up to the property’s fair market value as of the date of death. If the decedent’s beneficiaries sell that property, they use the fair market value at the date of death as their basis in the asset.

However, in the business entity tax context, two income tax bases must be considered: (1) inside basis and (2) outside basis. Inside basis refers to the basis the entity holds in its individual assets and how that basis is reflected in the entity’s capital accounts. Outside basis refers to an owner’s income tax basis in the entity itself (e.g., stock, partnership, or LLC interest). Although the technical details are outside the scope of this article, it is possible for a discrepancy to exist between the inside and outside bases of an ownership interest. Upon the death of an owner, the owner’s successor-in-interest receives a basis in the entity equal to the date of death fair market value. However, there is no effect on the underlying asset in the hands of the entity.

Accordingly, if the enterprise sells an asset immediately after an owner dies, there is no basis adjustment and the owner’s successor-in-interest will report a gain. However, if the entity is a partnership or an LLC and makes a Section 754 election, the successor can adjust his or her share of the inside basis of the assets so that it equals the outside basis. This will allow the successor to recognize a smaller share of gain, if any, than his or her fellow partners if and when the entity sells assets.

A franchisee’s advisor should be aware of this election in the event the franchisee owns the franchise interest thorough a partnership or LLC and the entity’s assets are worth more than the tax basis on the date of transfer. For example, a Section 754 election would not be desirable if the value of the
enterprise had decreased over time and valuation discounts would reduce the decedent’s share of inside basis of partnership assets to below cost basis.

E. *Succession Planning Attributes of Various Entities*

The following table shows which attributes are characteristic of the various types of entities:

<table>
<thead>
<tr>
<th>Attribute</th>
<th>C Corp</th>
<th>S Corp</th>
<th>LLC</th>
<th>Individual Ownership</th>
</tr>
</thead>
<tbody>
<tr>
<td>Management Control</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Limited Liability</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>No</td>
</tr>
<tr>
<td>Step Up Inside Basis</td>
<td>No</td>
<td>No</td>
<td>Yes, if 754 election</td>
<td>Yes</td>
</tr>
<tr>
<td>Step Up Outside Basis</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Discount–Lack of Marketability</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
<tr>
<td>Discount–Minority</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
<td>Yes</td>
</tr>
</tbody>
</table>

F. *Trump Estate Tax Proposals*

The current Trump estate tax proposal (as enunciated during the presidential campaign) provides for a complete repeal of the federal estate tax.18 There is no mention of the gift tax although many practitioners believe that the gift tax will not be repealed because it serves as a backstop to income shifting to lower brackets. Additionally, under the announced proposals, unrealized capital gains exceeding $10 million will be subject to tax.

However, Trump’s estate tax proposal does not address whether the current law mandating a step-up in basis in a decedent’s assets would be maintained or whether a carryover basis regime would be adopted.

VII. *International Operations Considerations*

In an increasingly global world where U.S. persons will own franchise interests abroad and where foreigners will own interests in the United States, some familiarity with international tax concepts is warranted. A complete analysis of the international tax rules pertaining to cross-border franchisees is outside the scope of this article. However, the following highlights issues that cross-border franchisees should be aware of.

A. U.S. Owners of Foreign Franchises (Outbound Planning)

An individual who is considered a U.S. citizen or “resident” is subject to federal income taxation of his or her worldwide income even if the income is not “produced” in the United States. For example, if a U.S. citizen or resident owns a franchise that operates in a foreign country (e.g., a French chocolate franchise operating in Paris) he or she is subject to taxation on that income in the United States. Of course, the franchisee will be entitled to a U.S. tax credit (subject to certain limitations) for taxes paid to a foreign jurisdiction.

United States franchisees with foreign interests should also be aware of the “controlled foreign corporation” (CFC) and passive foreign investment company (PFIC) regimes. The CFC and PFIC regimes are anti-deferral regimes designed to ensure that income earned abroad is not deferred indefinitely. Finally, U.S. persons should consult the applicable income tax and/or estate tax treaties to determine what, if any, exemptions or reduced income tax rates are available.

B. Foreign Owners of U.S. Franchises (Inbound Planning)

Non-U.S. citizens and residents who own franchise interests in the United States face a complex variety of issues—the character and source of income derived from the franchise agreement, whether the income is effectively connected with the operation of the U.S. trade or business, and whether or not there is a flat 30 percent withholding tax as opposed to taxation based on the income tax rates in effect. And, as with outbound planning, the applicable income tax treaty must be consulted to determine whether reduced tax rates are available.

On the estate planning side, the U.S. imposes an estate tax on the U.S. situs assets of a non-domiciliary with only a $60,000 exemption. Whether one is domiciled in the United States for purposes of the $60,000 exemption is a question of facts and circumstances. And once more, the applicable estate tax treaty must be consulted to determine the estate tax exposure.
Are Material Changes to Renewal Franchise Agreements Subject to the Implied Covenant of Good Faith and Fair Dealing?

Keith J. Kanouse, Evan M. Goldman, and Scott D. Salmon

Despite the almost limitless variety of franchise agreements, the conditions to renew the franchise relationship at the end of the initial term usually include the following: “The Franchisee will sign the Franchisor’s then current form of Franchise Agreement, which agreement may contain terms materially different than the terms of this Agreement.”

If the franchise agreement merely states that the franchisee has a right to renew, a court may presume that the terms of the renewal franchise agreement are the same as the existing agreement except for the extended term.1 If the franchise agreement does not contain an explicit right to renew, courts will not imply one.2

The conditions to the right to renew are included in a boilerplate franchise agreement that is offered by a franchisor on a take-it-or-leave-it basis. The parties rarely negotiate these conditions. Because many, if not most, franchisees

1. See, e.g., Carlos v. Philips Bus. Sys., 556 F. Supp. 769 (E.D.N.Y. 1983), aff’d, 742 F.2d 1432 (2d Cir. 1983) (holding that under New Jersey statute, a new agreement that changed the relationship of deal from exclusive to nonexclusive was effectively a refusal to renew or a termination); see also Kaeser Compressors, Inc. v. Compressor & Pump Repair Servs., Inc., 832 F. Supp. 2d 984 (E.D. Wis. 2011) (holding that a dealer’s refusal to sign renewal contract was not good cause to terminate relationship under Wisconsin Fair Dealership Act).

fail to retain franchise counsel at the time of purchase, the legal and business ramifications of these provisions are rarely fully explained to or understood by a prospective franchisee until five, ten, or even twenty years later, when a substantially different—and more onerous—franchise agreement that has been unilaterally changed by the franchisor is presented to the franchisee.

Many franchise agreements treat expiration and non-renewal in the same manner as termination due to the franchisee’s default. The post-termination or post-expiration provisions may allow the franchisor to take over the franchisee’s business by assuming franchisee’s lease, telephone numbers, directory listings, and customer list; terminate the franchisee’s web page and social media accounts; and give the franchisor the right to purchase the business assets for an often unreasonably low price, such as the business’ book value. In contrast, franchisees intend to create and build a business that creates equity for the future to be sold or transferred to heirs, not one that is a temporary “rent-a-business” that must be returned to the franchisor.

This is the franchisee’s dilemma. Accept the new onerous terms of the franchise agreement or walk away from the business the franchisee has spent years investing in and cultivating. So what is the franchisee to do?

I. What If the Franchisor Refuses to Negotiate?

After the franchisee tells the franchisor that he or she is not willing to agree to the terms of the proposed renewal franchise agreement, the franchisor may tell the franchisee to either sign it or close up shop and abide by the covenant not-to-compete. At this point, the franchisee’s only options are to accept the new terms, or refer to the dispute resolution, governing law, and venue provisions of the franchise agreement.

The franchisee may be required to jump over the following hurdles created by the franchisor:

A. Informal Dispute Resolution

The franchise agreement may have an informal dispute resolution procedure. If such a provision exists, it must be followed. This usually requires an individual franchisee spending time and money traveling to the franchisor’s home office and meeting to discuss the franchisee’s concerns. The International Franchise Association has an Ombudsman Program for its members to assist with the resolution of disputes arising from business issues. The expectation is that the ombudsman will assist franchisors and franchisees to resolve their disputes to their mutual satisfaction and avoid costly and time-consuming litigation. In an informal and confidential manner, the ombudsman, who operates as a neutral, independent third party, assists franchisees and franchisors in identifying the issues that require resolution and making use of various alternatives for managing conflict effectively.3 Of the forty-two complaints handled

through the Ombudsman Program, only three related to the renewal of a franchise. Because this is a confidential process, the exact nature of the complaints or their resolution is unknown. Assuming this process does not resolve the issue, the next hurdle is mediation.

B. Mediation

The franchisee may have to file a demand for mediation of the problem provisions of the renewal franchise agreement. The Center for Public Resources (CPR) Institute for Dispute Resolution has created the National Franchise Mediation Program (NFMP). Franchisors that join the program must agree for at least two years to attempt to resolve any dispute with any of its franchisees through mediation. Although either a franchisor or a franchisee can initiate a complaint, the most common use of the program is franchisee initiated as follows:

1. The franchisee completes a form letter briefly describing the complaint against the franchisor to the administrator of the program.
2. The franchisee agrees to meet within a specified time period with a senior representative of the franchisor at the franchisor’s home office to discuss the issues informally with the franchisor. Many times, this step can resolve the dispute because the franchisor and the franchisee are communicating directly about the problem. Various educational tools are available to the franchisor to assist in this important part of the process. Even if a resolution cannot be reached, a mutual respect and understanding of the issues can set the stage for a successful resolution at a later stage of the process.
3. If the dispute cannot be resolved through the initial negotiations of the parties, the administrator of the program will recommend up to five experienced franchise mediators for the parties to choose a mediator. If the parties cannot agree on a mediator, the administrator will select the mediator based upon a ranking order priority from both parties.
4. The mediator’s compensation rate is determined before appointment and each party pays one-half of the cost of the mediator along with an administrative fee of $1,500 to the administrator.
5. Mediation is scheduled within a specified time frame.
6. Each party delivers to the mediator a summary of the background of the dispute and other information to familiarize the mediator with the dispute.
7. Mediation is held and normally can be accomplished in a one-day session.
8. If the mediation does not result in a negotiated resolution the mediator will give both parties a written evaluation of the issues.

The NFMP claims a success rate of more than 90 percent in cases where the franchisee agreed to participate and in which a mediator was needed.

6. Id.
Many times the disputes are resolved before the need for a mediator’s intervention. However, there are no specific statistics available about the success rate when the issues involve material changes to the terms of the renewal franchise agreement. Mediation works only if both parties are open-minded and willing to understand the other party’s position as well as the costs and risks of arbitration or litigation.

Many of the larger franchisors that are members of the IFA have volunteered to participate in the NFMP. To find out if your franchisor has joined the NFMP, contact CPR at (212) 949-6490. Even if your franchisor has not joined, ask it to use the NFMP to mediate the terms of the renewal franchise agreement. If the franchise agreement is silent on mediation, ask the franchisor to mediate anyway. Mediation may avoid the cost of arbitration or litigation.

Unfortunately, the NFMP applies only to mediation between a single franchisee and the franchisor. Without the franchisor’s consent, mediation on a group, class, or collective basis cannot take place. If the franchisor does not consent, NFMP is not available. In the authors’ opinion, CPR should change its policy and allow collective mediation of similar disputes affecting more than one franchisee or systemic problems within the franchise network. This would ameliorate the “divide and conquer mentality” of many franchisors and be a more efficient and economical way to resolve such disputes.

If mediation is not successful, you are backed into a corner if your franchisor continues to stonewall you. You have three choices: (1) sign the renewal franchise agreement and related documents, including a general release, and worry about whether your business will continue to be successful; (2) do not sign the renewal franchise agreement and be subject to its post-expiration provisions, including de-identification and the covenant not to compete; or (3) arbitration or litigation.

C. Arbitration

If the franchise agreement contains an arbitration provision, do not waste your time and money challenging its enforceability. Numerous court decisions under the Federal Arbitration Act have stayed litigation (or dismissed the court action) and enforced an arbitration provision. The franchisee’s demand for arbitration should seek a declaratory judgment that certain terms of the renewal franchise agreement are either unconscionable or breach

the implied covenant of good faith and fair dealing. The franchisee should also request the appointment of a special arbitrator to issue an interim order directing the parties to continue to operate pursuant to the existing franchise agreement until the arbitrator issues an award. This prevents the franchisor from exercising its post-termination or expiration remedies under the franchise agreement. If the arbitration rules do not grant the arbitrator power to issue preliminary relief or the franchise agreement otherwise provides, you may have to file an action in court to request the preliminary injunction.

D. Litigation

If the franchise agreement requires that the franchisee file a complaint with a court having jurisdiction over the parties and the issues, the franchisee’s complaint should request a declaratory judgment asking the court to declare that certain terms of the renewal franchise agreement are either unconscionable or breach the implied covenant of good faith and fair dealing. The complaint should also ask for a preliminary injunction directing the parties to continue to operate pursuant to the existing franchise agreement until the court rules on the merits of the action and issues a declaratory judgment.

If litigation is the preferred or required strategy, because many franchisees are, or will soon to be, similarly faced with the terms of the renewal franchise agreement, ideally they should organize to challenge the terms of the renewal franchise agreement. This entails finding and funding a franchisee that is soon up for renewal that resides in, or whose franchise business operates in, a state having a franchise relationship law or a public policy that supersedes the choice of law provision in the franchise agreement and grants franchisees protections not afforded by federal law, or a state having no franchise relationship law.

For example, sixteen states and two U.S. territories have franchise relationship laws that regulate the franchisee’s right to renew to some extent: Arkansas, California, Connecticut, Delaware, Florida, Hawaii, Illinois,  

10. There is no federal franchise relationship law. The Amended Federal Trade Commission Franchise Rule (FTC Franchise Rule) does not regulate the terms of the franchise agreement. It is merely a presale disclosure requirement. 16 C.F.R. Part 436. The FTC Franchise Rule requires a franchisor to disclose in Items 17(b) and (c) the renewal or extension of the term of the franchise agreement and the requirement for the franchisee to renew or extend.
14. See Del. Code Ann. tit. 6, § 2552 (stating that the franchisor is not permitted to include provisions in the franchise agreement that permit unjust renewal because this would violate Delaware’s public policy and that a franchisor cannot unjustly refuse to deal with a franchisee with which the franchisor has been dealing for at least two years).
Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Puerto Rico, U.S. Virgin Islands, Washington, and Wisconsin. A number of these jurisdictions have franchise relationship laws that have “anti-discrimination” provisions requiring franchisors to treat franchisees in the same manner, including dealing with renewal. However, a survey of these state franchise relationship laws indicates that a renewal franchise agreement with materially different terms offered uniformly to all new and renewing franchisees may be permissible if commercially reasonable and made in good faith.

For franchisee attorneys, further research should be done on the franchise relationship law and public policy of the state where the franchisee resides, or where the franchise business operates, to determine whether that state affords the franchisee greater rights than the laws of the state designated in the franchise agreement.

II. Using Unconscionability and the Implied Covenant of Good Faith and Fair Dealing in Court Challenges

Although we are aware of no decision that specifically holds that the typical renewal provision is unenforceable as it is unconscionable, or that a franchisor that refuses to collectively negotiate the terms of a renewal franchise agreement violates the implied covenant of good faith and fair dealing, recent cases in favor of franchisees are trending in that direction. For example, in Vylene Enterprises, Inc. v. Naugles, Inc., the Ninth Circuit ruled that the franchisor failed to negotiate the renewal franchise agreement in good faith because it offered a new franchise agreement that was commercially unreasonable and the franchisor knew or should have known that the franchisee would reject its terms.30

Similarly, in Tatan Management v. Jacfran Corp., the U.S. District Court for the District of Puerto Rico ruled in favor of the franchisor, but stated concerns with unilateral changes to franchise agreements.31

9. See IOWA CODE § 237A.10(8).
10. See MICH. COMP. LAWS § 445.1527.
11. See MINN. STAT. § 80C.14.
12. See MISS. CODE § 75-24-53.
16. See 10 P.R. LAWS ANN. § 278a.
17. See 12A V.I. CODE § 132.
19. See WIS. STAT. § 135.03 (“No grantor, directly or through any officer, agent or employee, may terminate, cancel, fail to renew or substantially change the competitive circumstances of a dealership agreement without good cause. The burden of proving good cause is on the grantor.”).
30. 90 F.3d 1472 (9th Cir. 1996).
plaintiff, a former children’s clothing franchisee, sued its franchisor, claiming termination or nonrenewal of the franchise agreement in violation of Puerto Rico Dealers’ Contracts Act. 32 Puerto Rico law prohibits franchisors from refusing to renew a franchisee’s contract, except for just cause, so the franchisee moved for summary judgment to bar the termination. 33 The district court denied the franchisee’s motion because the franchisee failed to meet certain, express conditions of the franchise agreement’s renewal provision, but the court expressed grave concerns regarding the lawfulness of the “then current standard form” franchise renewal clause: 34

The Court has doubts as to the lawfulness of requiring the execution of the then current standard form of the franchise agreement and the execution of a release. The first condition potentially runs contrary to Law 75 by allowing the principal to unilaterally alter the terms of the agreement, 10 P.R. Laws Ann. § 278a, while the execution of the release seems to clash with Law 75’s provision that the rights provided under the statute cannot be waived, id. § 278c. 35

In a New York-based case, Bronx Auto Mall, Inc. v. American Honda Motor Co., Inc., a multi-line automobile dealer brought action to enjoin the manufacturer from terminating the franchisee’s dealership. 36 The U.S. District Court for the Southern District of New York granted injunctive relief and an appeal was taken to the Second Circuit. The dealer argued that it was unreasonable to demand that certain substantial renovations be made at the dealership as a prerequisite for renewal. The district court held, and the Second Circuit affirmed, 37 that the manufacturer could not use the franchisee’s noncompliance with conditions imposed on renewal of the franchise agreement as grounds for termination because the manufacturer failed to establish the reasonableness of the conditions.

Similarly, in Beilowitz v. General Motors Corp., Beilowitz, an automobile parts distributor, sued its manufacturer for violation of the New Jersey Franchise Practices Act (NJFPA). 38 In what the U.S. District Court for the District of New Jersey referred to as a “Hobson’s choice,” 39 Beilowitz was required “either to accede to [General Motors]’s new business plan, which would result in the loss of forty percent of Beilowitz’s revenue, or, after a twenty-three-year-long relationship with GM, to be cut out of doing any business with [General Motors] at all.” 40 In the suit, Beilowitz, seeking a preliminary injunction, claimed that General Motors’ actions violated the

32. Id.
33. Id.
34. Id. at 206.
35. Id.
37. Id.
39. Id. at 633 (“Thomas Hobson, an English liveryman who lived in the seventeenth century, required his customers to take the horse nearest to the stable door or none at all. Accordingly, a ‘Hobson’s choice’ refers to an apparently free choice that offers no real alternative.”).
40. Id.
NJFPA, which prohibits “a franchisor’s termination, cancellation, or failure to renew a franchise without good cause.”41 The court noted that: “[i]t is a violation of the NJFPA to cancel a franchise for any reason other than the franchisee’s substantial breach, even if the franchisor acts in good faith and for a bona fide reason.”42 In granting the preliminary injunction, the court took issue with the fact that “GM ha[d] not alleged that [Beilowitz] substantially breached” any agreement and, rather, “ha[d] generously lauded Beilowitz” in the past for his outstanding performance.43 Accordingly, the court held that, “[b]ecause GM ha[d] offered no reason, other than a change in its business strategy for its failure to renew the . . . franchise,” Beilowitz “ha[d] a likelihood of success on his claims under [the NJFPA].”44

On the other side of the issue are cases finding the “then current standard form” franchise renewal clause acceptable. In Meyer v. Kero-Sun, Inc.,45 the U.S. District Court for the Western District of Wisconsin, applied the Wisconsin Fair Dealership Law to a wholesale kerosene heater distribution franchise in determining whether the franchisor had properly terminated the franchisee.46 The court held that the franchisor’s actions to undermine the exclusivity provision of the franchise agreement did not constitute a “termination” of the franchise agreement.47 In fact, when discussing “treat[ing] a change in competitive circumstances48 as a termination or nonrenewal,” the court went so far as to say, “[a]lthough interesting and novel, the theory is nonsense.”49

In Ziegler Co., Inc. v. Rexnord, Inc., the Supreme Court of Wisconsin dealt with the issue of when a franchisor can change its policies and procedures in how it does business with its franchisees and, in consideration of the Wisconsin Fair Dealership Law, held: “The essential requirements of the statute allow a grantor to impose changes which must include those designed to accommodate the grantor’s own economic problems. Any contrary interpretation of the statute would place all risk of loss due to fundamental economic change on the grantor in perpetuity.”50

In Ziegler, the court noted a plethora of other cases—in Wisconsin and elsewhere—related to unilateral and system-wide changes of minor terms of the franchise agreement.51 Finding that the franchisee refused to substan-

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41. Id. at 644.
42. Id.
43. Id.
44. Id.
46. Id. at 404.
47. Id. at 406.
48. Under Wisconsin precedent, a “change in competitive circumstances” means that the franchisor used its superior bargaining power to change not merely the franchise agreement, but also the circumstances of the business itself. See Jungbluth v. Hometown, Inc., 548 N.W.2d 519, 524 (Wis. 1996).
50. 433 N.W.2d 8, 12 (Wis. 1988).
51. Id. at 12–13.
tially comply with essential, reasonable, and nondiscriminatory requirements sought to be imposed by the franchisor, the court held that there was good cause to terminate, cancel, or fail to renew the relationship at the expiration of the contractual term.\textsuperscript{52}

In \textit{Wisconsin Music Network, Inc. v. Muzak Ltd. Partnership},\textsuperscript{53} the licensee of a music subscription service sued the licensor seeking to prevent the licensor from terminating the license agreement. Before the U.S. District Court for the Eastern District of Wisconsin, the licensee sought a preliminary injunction to prevent modifications to the license agreement, namely, the inclusion of a program that enabled the franchisor to compete with the other biggest providers of subscription programmed music.\textsuperscript{54} The Seventh Circuit affirmed the denial of preliminary injunctive relief under the Wisconsin Fair Dealership Law, holding that “the new terms of the license agreement were essential and reasonable because they enabled [the franchisor] to offer a national service” and that there was a “competitive need to offer national customers national treatment.”\textsuperscript{55} Notably, however, the court in \textit{Wisconsin Music Network} found that, just because the licensor did not seek to impose the contractual change on other, unexpired agreements, this did not support the licensee’s argument that the terms were nonessential; rather, because all expired contracts contained the new terms and it was “not unreasonable for [the licensor] to rewrite its license agreements in an orderly fashion,” the court found no wrongdoing by the licensor.\textsuperscript{56}

In yet another case under the Wisconsin Fair Dealership Law, the Seventh Circuit in \textit{East Bay Running Store, Inc. v. NIKE, Inc.} affirmed the grant of summary judgment against the distributor and in favor of Nike.\textsuperscript{57} In \textit{East Bay}, the distributor “engaged in the business of retail sales of athletic shoes and . . . apparel,” including Nike products.\textsuperscript{58} Upon the launch of the Nike Air product brand, the distributor created a “flourishing mail-order business for NIKE products.”\textsuperscript{59} For the next six years, the distributor’s sales climbed to the point where Nike Air products “accounted for twenty-nine percent of [the distributor]’s total sales and fifty-five percent of [its] NIKE sales.”\textsuperscript{60} In October 1987, “NIKE notified all of its dealers in the United States” that it would no longer make Nike Air products “available for resale by mail, catalog, or electronic means.”\textsuperscript{61} The “purpose of imposing the restriction was to prevent ‘free-riding’ and to insure that the consumers of the Nike Air product line received personal individualized

\begin{footnotes}
\item[52.] Id. at 14.
\item[53.] 5 F.3d 218 (7th Cir. 1993).
\item[54.] Id.
\item[55.] Id. at 224.
\item[56.] Id.
\item[57.] 890 F.2d 996 (7th Cir. 1989).
\item[58.] Id. at 997.
\item[59.] Id. at 998.
\item[60.] Id.
\item[61.] Id.
\end{footnotes}
attention.’”\textsuperscript{62} Suit followed in the Circuit Court for Marathon County, Wisconsin, where, before removing the matter to federal court, the court entered an ex parte restraining order.\textsuperscript{63} In granting summary judgment, which was affirmed by the Seventh Circuit, the U.S. District Court for the Western District of Wisconsin “concluded that NIKE’s non-discriminatory, system-wide indirect sales limitation did not ‘substantially change the competitive circumstances’ of [the distributor] and, as such, did not implicate” the Wisconsin Fair Dealership Law.\textsuperscript{64} On appeal, the Seventh Circuit held, “[b]ased on the non-discriminatory nature of NIKE’s ‘no mail-order’ policy, we hold that the requirement of good cause was not triggered in this case.”\textsuperscript{65}

In \textit{Home Instead, Inc. v. Florance}, Florance, the franchisee, signed an addendum to the franchise agreement that he could maintain his territorial exclusivity if he met certain billing quotas, including a $30,000 per month quota “from the end of the fifth year of operation of the Franchise Business through the end of the term of this Agreement or any renewal terms of a renewal agreement.”\textsuperscript{66} Upon renewal, Home Instead attempted to impose a $70,000 billing quota.\textsuperscript{67} In denying Florance’s preliminary injunction application, the U.S. District Court for the District of Nebraska found that Florance had no likelihood of success on the merits, holding that Florance had agreed to sign the “then current franchise agreement upon any renewal,” which included an increased billing requirement.\textsuperscript{68} Ultimately, the Eighth Circuit reversed on appeal and remanded the matter back to the district court for the sole reason that the terms of the agreement were ambiguous on the issue of whether the $30,000 was a floor or ceiling.\textsuperscript{69} The Eighth Circuit’s decision did not change the ultimate opinion that Florance’s obligation to sign the then current franchise agreement permitted Home Instead to increase the billing requirement.\textsuperscript{70}

Similarly, in \textit{G.I. McDougal, Inc. v. Mail Boxes, Etc., Inc.}, the California Court of Appeal found “that the renewal [agreement] was not a breach of the implied covenant of good faith and fair dealing.”\textsuperscript{71} Under California law, “[t]he implied covenant has no existence independent of the express terms of the contract, and cannot impose substantive duties or limits on contracting parties beyond those in the specific terms of their agreements.”\textsuperscript{72} Accordingly, because the applicable renewal provision “contain[ed] no ex-
press contractual obligation to renew the franchise on the same terms as in the original franchise agreement,” there was no breach of the implied covenant of good faith and fair dealing.\textsuperscript{73} In a similar case applying California law, \textit{West L.A. Pizza, Inc. v. Domino’s Pizza, Inc.}, the U.S. District Court for the Central District of California found no violation of the implied covenant of good faith and fair dealing based on “Domino’s failure to offer ‘reasonable’ renewal terms.”\textsuperscript{74} In dismissing the franchisee’s implied covenant cause of action, the court stated: “Once again, the franchise agreement expressly permits Domino’s to condition renewal on materially different terms consistent with the ‘then current form’ of its standard agreement. In offering West L.A. store # 8306 a renewal franchise on those terms, Domino’s has not frustrated Plaintiffs’ rights to receive the benefits of the parties’ bargain.”\textsuperscript{75}

Although there are cases on both sides of these issues, most cases rejecting application of the implied covenant are based on Wisconsin and California law. The more recent cases in other jurisdictions have shifted away from this approach, leaving the door open for franchisees to argue that good faith and fair dealing requires that franchisors at least negotiate over renewal terms with their franchisees.

\textbf{III. Judicial Notice That Certain Franchise Agreement Provisions Are Unconscionable}

Numerous courts throughout the country have begun to take judicial notice of the fact that the typical franchise agreement is a “contract of adhesion” that contains many unconscionable terms.\textsuperscript{76} Parties having disproportionate bargaining power enter into the franchise agreement; its provisions are not subject to arm’s-length negotiation between parties of comparable bargaining power, notwithstanding the party line of the franchisor community that the typical franchise agreement is negotiated by knowledgeable franchisors and franchisees of equal bargaining power.\textsuperscript{77} Franchises are usually offered by a franchisor on a non-negotiable “take it or leave it” basis.\textsuperscript{78} Franchisees sign the franchise agreement containing provisions that are pat-

\textsuperscript{73} Id.
\textsuperscript{75} Id.
\textsuperscript{76} See, e.g., Indep. Ass’n of Mailbox Ctr. Owners, Inc. v. Super. Ct., 34 Cal. Rptr. 3d 659, 668 (Ct. App. 2005) (“Case law has recognized that franchise agreements can have some characteristics of contracts of adhesion.”).
\textsuperscript{77} See Brock v. Baskin-Robbins USA Co., 113 F. Supp. 2d 1078, 1087 (E.D. Tex. 2000) (stating that a franchisee, often composed of an individual or a small business, does not have equal bargaining power to a national franchisor with counsel when the form contract is not open to negotiation).
\textsuperscript{78} Id.
ently “commercially unreasonable.” Courts have begun to recognize that the most egregious terms, in which franchisees relinquish valuable rights without getting anything in return, may not be enforceable.

For example, in *Kubis & Perszyk Associates, Inc. v. Sun Microsystems Inc.*, a forum selection clause requiring a New Jersey franchisee to litigate a dispute with a California franchisor in California rather than in New Jersey was found by the Supreme Court of New Jersey to be “presumptively invalid because [it] fundamentally conflicted” with New Jersey’s public policy of “swift and effective judicial relief.” The court stated:

Though economic advantages to both parties exist in the franchise relationship, disparity in the bargaining power of the parties has led to some unconscionable provisions in the agreements. Franchisors have drafted contracts permitting them to terminate or to refuse renewal of franchises at will or for a wide variety of reasons, including failure to comply with unreasonable conditions. Some franchisors have terminated or refused to renew viable franchises, leaving franchisees with nothing in return for their investment. Others have threatened franchisees with termination to coerce them to stay open at unreasonable hours, purchase supplies only from the franchisor and at excessive rates or unduly expand their facilities.

**[W]e hold that forum-selection clauses in franchise agreements are presumptively invalid, and should not be enforced unless the franchisor can satisfy the burden of proving that such a clause was not imposed on the franchisee unfairly on the basis of its superior bargaining position. Evidence that the forum-selection clause was included as part of the standard franchise agreement, without more, is insufficient to overcome the presumption of invalidity. We anticipate that a franchisor could sustain its burden of proof by offering evidence of specific negotiations over the inclusion of the forum-selection clause and that it was included in exchange for specific concessions to the franchisee. Absent such proof, or other similarly persuasive proof demonstrating that the forum-selection clause was not imposed on the franchisee against its will, a trial court should conclude that the presumption against the enforceability of forum-selection clauses in franchise agreements subject to the [New Jersey Franchise Practices] Act has not been overcome.**

As such, the Supreme Court of New Jersey found that forum selection clauses in franchise agreements are presumptively invalid without additional evidence of additional consideration from the franchisee; simply put, they cannot be just included in the boilerplate language. If such a clause is automatically included, it is inherently unconscionable.

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79. See *In re Vylene Enters., Inc.*, 90 F.3d 1472, 1477 (9th Cir. 1996), as amended on denial of reb’g and reb’g en banc (Sept. 12, 1996) (stating that the proposed franchise agreement was commercially unreasonable).


82. *Id.*
IV. Expansion of Sun Microsystems to Other Material Changes and Jurisdictions

It is the authors’ opinion that the logic of Sun Microsystems should apply in all jurisdictions with greater force to a renewal provision in a franchise agreement that requires a franchisee to sign the franchisor’s then current form of franchise agreement. When such an agreement contains material changes unilaterally made by the franchisor without specific negotiation with the franchisees that are adverse to the economic and business interests of franchisees, there is substantial public interest in the fairness of those changes.

This is a far greater right a franchisee is relinquishing in giving the franchisor carte blanche to change the terms of the relationship than merely agreeing to litigate in the franchisor’s home state. This type of renewal provision, if it was not subject to specific negotiation in exchange for specific concessions to the franchisee, should be unenforceable as a matter of public policy. If courts refuse to recognize this argument, the alternative argument is that the franchisor is acting in bad faith in failing to negotiate with its franchisees concerning the material changes contained in the renewal franchise agreement.

VI. Use of the Implied Covenant in Achieving Sun Microsystems’ Goals

One of the newest arrows in a franchisee’s quiver when dealing with such clauses is the franchisor’s breach of the implied covenant of good faith and fair dealing. Courts in most states have recognized that the implied covenant of good faith and fair dealing applies to all parties to a contract, including parties to franchise agreements. A fair number of states recognize an independent cause of action for breach of this implied covenant of good faith and fair dealing.

83. See Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999).
However, some states hold that such a cause of action cannot exist wholly independent of the express terms of the contract. 85

Under the rationale established by a number of good faith franchise cases, if the renewal provision in the existing franchise agreement is specific as to what the changed terms will be on renewal, the court should uphold these changed terms. If these changed terms are not specified in the renewal provision of the existing franchise agreement, any changes made unilaterally by the franchisor ought to be measured against the implied covenant of good faith and fair dealing to determine their reasonableness.

Franchisors may argue that they cannot be acting in bad faith by unilaterally changing the terms of the franchise agreement upon renewal because the existing franchise agreement states that the terms of the renewal franchise agreement may contain materially different terms, including higher royalty fees, reduced exclusive territories, etc. The implied covenant of good faith and fair dealing cannot overrule the express terms of the franchise agreement. 86 However, the express terms of the renewal franchise agreement are not set forth in the renewal provision. Let’s assume the existing franchise agreement provides for a 5 percent royalty fee but also says that the franchisor reserves the right to increase the royalty fee up to 7 percent in the renewal franchise agreement. When the renewal franchise agreement containing a 7 percent royalty fee is submitted to the renewing franchisee, the franchisee has no ground for complaint. However, if the existing franchise agreement provides for a 5 percent royalty fee but the renewal provision says only that the renewal franchise agreement may contain a higher royalty fee, what if the renewal franchise agreement contains a 100 percent royalty fee? Of course, that is ludicrous, but it makes an important point.


86. See Life Plans, Inc. v. Sec. Life of Denver Ins. Co., 800 F.3d 343, 356 (7th Cir. 2015); see also Burger King Corp. v. Weaver, 169 F.3d 1310, 1318 (11th Cir. 1999).
Somewhere between 5 percent and 100 percent, the franchisor crossed a red line. That red line is created by the covenant of good faith and fair dealing.

Like many of the cases cited in this article, courts have been trending against requiring franchisees to sign a franchisor’s then current franchise agreement that contains material changes unilaterally made by the franchisor. The question then becomes at what point when the franchisor unilaterally makes increases in the royalty rate or other payments, or changes or eliminates another material term of the franchise agreement, such as significantly reducing or eliminating an exclusive territory, is the franchisor acting in bad faith? Any rational person would conclude that a franchisor must act in good faith in materially changing the terms of a renewal franchise agreement. Of course, the proper approach is to hold the exercise of discretion in check, preferably through negotiation with the franchisee, or through imposition of the implied covenant of good faith and fair dealing by an arbitrator or a court.

Although the franchisor may have the contractual right to condition the renewal of the franchise relationship, any material changes in the terms of the new franchise agreement that are commercially unreasonable and adverse to the legitimate economic and business interests of the franchisees should be subject to specific negotiation with its franchisees in good faith. For a franchisor to unilaterally make material adverse changes to the terms of the franchise relationship and impose these changes on its franchisees on a nonnegotiable “take it or leave it” basis, is an act of bad faith and an actionable breach of the covenant of good faith and fair dealing. This is particularly true if this action is coupled with the threat of termination of the franchise agreement and the automatic and immediate imposition of a restrictive and punitive covenant not to compete that may place a significant number of franchisees out of business and thousands of employees out of work.

VII. Conclusion

The franchise relationship should be a continuing “win-win” business arrangement for both sides. Where the franchisor gets greedy and imposes renewal terms that upset the franchise business model, franchisees should organize and first try to negotiate the issues on a system-wide basis. If the franchisor refuses to negotiate, the franchisee must go through the dispute resolution procedures. Franchisees should pick the ideal franchisee with a choice-of-law provision in a state that affords some protection against unilateral changes to file the declaratory judgment action. In such a scenario, the franchisee will be protected against the material changes to the terms of the renewal franchise agreement that are unconscionable or violate the covenant of good faith and fair dealing.

The Superior Court of North Carolina dismissed claims brought by a group of franchisees under the North Carolina antitrust law, alleging that their franchisor conspired with a supplier to require franchisees to purchase products solely from that supplier at inflated prices. The court reasoned that even if the franchisees were “locked in” to purchasing from a sole supplier, the lock-in was a result of the specific terms of the parties’ licensing agreements and not a result of the franchisor’s purported market power.

Defendant Window World, Inc. is a franchisor of businesses selling its own brand of vinyl replacement windows, doors, and related materials. The plaintiffs, comprised of various Window World franchisees, filed two actions, alleging that Window World knowingly and intentionally withheld information that the plaintiffs alleged they were entitled to receive under federal law. Specifically, the plaintiffs alleged that Window World misrepresented a key fact on which the franchise relationships were formed: that by becoming a licensee of the Window World marks, each plaintiff would gain access to the lowest available wholesale prices for the Window World windows, doors, and related materials that the plaintiffs sold and installed. The plaintiffs’ complaints alleged various claims against Window World including, as relevant here, violation of North Carolina’s
antitrust statute, N.C. GEN. STAT. §§ 75-1 and 75-1.1. The defendant filed a motion to dismiss the complaint, seeking dismissal of the antitrust claim and contending that the complainants failed to allege sufficient facts necessary to establish the required elements of Section 75-1, including (1) the identity of a relevant market, (2) whether Window World had sufficient market power in the relevant market, (3) whether Window World’s conduct had an anti-competitive effect, and (4) whether the plaintiffs suffered antitrust injury. Focusing on the first element, the court concluded that the plaintiffs failed to allege a valid relevant market over which Window World maintained marketing power sufficient to maintain a claim under Section 75-1. As a result, the court granted the motion to dismiss the antitrust claims.

The plaintiffs asserted a “lock-in” theory of antitrust liability under Section 75-1 (which, the court noted, is in all respects analogous to the federal Sherman Act). The plaintiffs’ claim was not that Window World exercised market power in the broad market for windows and related accessories by enjoying a dominant market share in particular geographic regions, but rather that Window World exercised market power over its franchisees by locking them into franchise agreements and unilaterally imposing a sole-supplier requirement that they could not have anticipated before entering into their franchise agreements.

After reviewing the U.S. Supreme Court’s decision in Eastman Kodak Co. v. Image Technical Services, 504 U.S. 451 (1992), generally regarded as the genesis of the “lock-in” antitrust theory, and subsequent cases applying Kodak in the franchise context, the court concluded that federal courts evaluating Kodak-type “lock-in” antitrust claims have looked to the specific language of the parties’ franchise agreement to determine whether the franchisor effected an unforeseen change in policy after the franchisee entered into the franchise agreement that prevented the franchisee from evaluating the economic costs and risks of the franchise prior to entry. If so, courts have generally allowed claims under the Sherman Act to survive; if not, federal courts have not hesitated to dismiss a franchisee’s claims under the Sherman Act.

In this case, the plaintiffs alleged that Window World’s arrangement with a key vendor as its sole source supplier locked in place a substantial volume of purchasers at a fixed price, preventing them from seeking alternative suppliers, and thus violated Section 75-1. Based upon the parties’ licensing agreements, the court disagreed. The applicable licensing agreement language expressly provided that “licensee expressly agrees that it will sell and install only and exclusively those products, goods, equipment, and parts from vendors approved by Window World.” The court found that this provision clearly put the franchisees on notice that the franchisor, Window World, retained the authority to require the franchisees to purchase products from only one vendor that Window World had approved. As such, the court was not persuaded that the plaintiffs were locked into an arrangement that would allow Window World to raise the prices of its Window World trademark windows to artificially high levels.
To the contrary, the court concluded that based on the language of the licensing agreements, the plaintiffs were able to anticipate that Window World might move, as it ultimately did, to a sole source supplier. If, as the plaintiffs contended, they were locked into purchasing from a sole supplier, the court concluded that this was the result of the specific terms of the licensing agreements, not because of Window World’s purported market power. On this basis, the court concluded that the plaintiffs had failed to allege a valid and relevant market over which Window World maintained market power sufficient to maintain a claim under Section 75-1 and, as a result, granted Window World’s motion to dismiss the antitrust claims. Finally, the court held that allowing the plaintiffs to amend and replead their antitrust claims would be futile and therefore dismissed the claims with prejudice.

ARBITRATION


Plaintiff Air-Con, Inc. brought an action in the Puerto Rico Court of First Instance against defendants Daikin Applied and Daikin North America, LLC for the alleged violation of the Puerto Rico Dealers’ Contract Act by impairing its exclusive distribution agreement to sell air conditioners and other related equipment marketed under the Daikin brand. The action also alleged that Technical Distributor, Inc. tortiously interfered with Air-Con’s contractual relations with Daikin. The defendants sought to remove the case to the U.S. District Court for the District of Puerto Rico on the grounds that the only non-diverse defendant, Technical Distributor, was fraudulently joined to destroy diversity jurisdiction and, in the alternative, based on federal question jurisdiction arising from the arbitration clause in the franchise agreement mandating that all disputes in relation to the commercial relationship be submitted to arbitration in Japan.

Daikin and Technical argued that Technical was fraudulently joined and there was no valid claim for tortious interference because (1) Air-Con failed to plead that Technical had knowledge of the distribution agreement between Air-Con and Daikin, an element of tortious interference; (2) Daikin had no commercial relationship with Technical, which obtained its products from a fourth party not privy to the contract; and (3) Daikin’s agreement with Air-Con was governed by a written contract that did not confer exclusive distribution rights of Daikin products in Puerto Rico and the Caribbean.

The case was remanded back to the Puerto Rico Court of First Instance because the District of Puerto Rico found that the defendants failed to prove that Technical Distributor was fraudulently joined and the case did not involve a federal question. Specifically, the court found that there was a reasonable basis that the Puerto Rico Supreme Court could find a cause of action
for tortious interference, regardless of whether the interference was accomplished through a relationship with a fourth party or with a party to the contract with which it interfered, and that a ruling on the issue of whether there was a nonexclusive contract was an issue of fact that required further discovery, despite the fact that the distribution contract in question had been signed by only one party.


Plaintiff Atlantic Pinstriping, LLC filed a motion for a temporary restraining order and preliminary injunction to enjoin (1) defendant Atlantic Pinstriping Triad, LLC from continuing to use the franchisor’s federally registered trademarks and (2) the franchisee from breaching its post-termination obligations, including a covenant not to compete and a requirement to cease all use of licensed equipment and any adaptations or copies and return leased equipment to the franchisor. The U.S. District Court for the Western District of North Carolina granted the franchisor’s motion for a preliminary injunction.

The franchisor and the franchisee entered into three franchise agreements between 2011 and 2015 that granted the franchisee the right to operate Atlantic Pinstriping franchises at various locations in South Carolina. The franchisor and the franchisee also entered into “owners agreements,” guaranteeing performance and payment under the franchise agreements, and an equipment lease, under which the franchisee leased certain pin striping applicators and heads for use in the franchised business. The franchisor alleged that in the one-year period from June 13, 2015, to June 13, 2016, the franchisee committed a combined forty-eight defaults of its respective franchise agreements. On June 16, 2016, the franchisor sent a written notice of termination of all three franchise agreements and equipment leases. In response, the franchisee sent a letter to the franchisor disputing the termination and stating it would not comply with the franchisor’s requests and demands.

The court granted the injunction based on a finding of likelihood of success on the merits for trademark infringement, breach of post-termination obligations, and validity of the noncompete covenant. The franchisor made a clear showing for likelihood of success on the merits for trademark infringement because (1) the marks were federally registered, which is prima facie evidence the franchisor owns a valid and protectable mark; (2) the franchisor expressly revoked the franchisee’s authorization to use the marks when it provided written notice of termination of the franchise agreements; and (3) there was reasonable expectation that the franchisee would continue to use the marks.

The franchisor made a clear showing for likelihood of success on the merits for breach of post-termination obligations because the franchise agreements, the owners’ agreements, and the lease agreements all constituted
valid and enforceable contracts and the franchisor demonstrated evidence of forty-eight separate defaults under the contracts.

The franchisor made a clear showing for likelihood of success on the merits for validity of covenant not to complete because the covenant was in writing, based on valuable consideration, reasonably necessary for the protection of legitimate business interests, reasonable as to time and territory, and not otherwise against public policy. Specifically, if the court allowed the franchisee to continue to provide vehicle pin striping services in violation of the covenant not to compete, the franchisee would be able to use the confidential and proprietary information it acquired from the franchisor to take business away from the franchisor and its franchisees.


The U.S. District Court for the District of Maryland granted franchisor and plaintiff Choice Hotels’ motion for default judgment, confirming an arbitrator’s award against Sheth for failure to pay franchise and related fees under its franchise agreement. After Choice Hotels obtained an arbitration award against Sheth, it filed an application to confirm the award with the district court. Sheth did not respond. The court, sitting in diversity jurisdiction, found that the franchise agreement’s arbitration clause covered the specific dispute arising from the agreement, i.e., unpaid fees, and stated that judgment on the award could be entered by any court having jurisdiction in accordance with the Federal Arbitration Act (FAA). In addition, Choice Hotels also met the requirements of the FAA because it filed its application to confirm the award within one year of the arbitrator’s decision and the arbitration hearing was consistent with the terms of the franchise agreement. Because Sheth was served and received notice of the motion, but failed to answer or make any showing of any grounds for vacating the arbitration award, the court granted Choice Hotels’ motion for default judgment to the extent it sought confirmation of the award.


This case presented an appeal following a bench trial. The District of Columbia Court of Appeals held that (1) the trial judge did not err in finding that the landlord was an intended third-party beneficiary of the franchise agreement, (2) the trial judge could decide whether the right to arbitration was waived, and (3) the tenant and its president both waived their right to arbitration. Following a bench trial, Profound Radiance, Inc. (PRI) and Abu Hossain were found liable for breach of commercial lease and a franchise agreement and for fraud. The issues on appeal were whether the landlord was an intended third-party beneficiary of the franchise agreement; whether the judge, rather than an arbitrator, could decide whether the con-
tractual right to arbitration was waived; and whether the tenant and president waived the right to arbitration.

Mickey Sood, as owner of JMU Properties, leased an office space to PRI, a company that performed tax preparation services, by and through PRI’s owner and president Abu Hossain. Later that month, Sood, as vice-president of JMU Tax & Preparation Services, entered into a franchise agreement with Hossain and PRI.

When PRI fell behind in its rental payments, JMU Properties/Sood changed the locks to the office. PRI filed a wrongful eviction claim against Sood, and JMU Properties, and Sood filed a counterclaim (and third-party complaint against Hossain individually) for breach of the lease and franchise agreements. JMU Tax was not a party to this litigation.

PRI moved to dismiss any franchise agreement claims because JMU Tax was the real party in interest and not a party to the litigation. JMU Properties and Sood filed a motion to stay the proceedings and compel arbitration. PRI claimed that its claims implicated only the lease and not the franchise agreement and the lease did not have an arbitration provision. The trial court denied both motions and proceeded with the bench trial. PRI then filed a motion to compel arbitration mid-trial, which the court later denied based on PRI having repeatedly waived any right to arbitration. Following the presentation of evidence and while the court had the matter under advisement, it did permit PRI and Hossain to file an answer to the third-party complaint.

The trial court found in favor of JMU Properties and Sood on their counterclaim and third-party complaint. PRI moved to amend the $391,640.82 judgment in favor of JMU Properties. PRI moved the trial court to amend the judgment, arguing that it did not waive its right to arbitration, but had instead only opposed JMU Properties/Sood’s motion to compel arbitration because there was no arbitration clause in the lease and because there was no relationship between the named parties—JMU Properties/Sood—and JMU Tax, the party to the franchise agreement. The trial court denied this motion, reiterating its original finding that Sood was the intended beneficiary of both the lease and the franchise agreement and that the two documents were intended to function together. It also found that under the totality of the circumstances that PRI’s behavior was inconsistent with a right to arbitrate, resulting in waiver.

The court held that the trial judge did not err in finding that the landlord was an intended third-party beneficiary of the franchise agreement; that the trial judge could decide whether the right to arbitration was waived; and that the tenant and president both waived their right to arbitration.

The court first addressed the relationship among Sood, JMU Properties, and JMU Tax. The court held that Sood was an intended beneficiary of the contract and that a beneficiary need not be named in the contract, as long as he is ascertainable from the contract and circumstances—“a third party to a contract may sue to enforce its provisions if the contracting parties intend...
the third party to benefit directly thereunder.” The court found that Sood, as sole owner of both JMU Properties and JMU Tax, clearly stood to benefit from any commercial arrangements involving those entities. Also Sood negotiated and signed both the lease and the franchise agreement in his capacity as owner of the respective companies. Further, Sood signed the franchise agreement using the title “Vice-President” of JMU Tax, making his involvement clearly ascertainable. Moreover, the franchise agreement referred back to the terms of the lease. The court thus held that Sood was an intended third party beneficiary because he was the sole owner of both JMU Properties and JMU Tax and because he negotiated and signed both the lease and the franchise agreement in his capacity as the owner of the respective companies.

The court next addressed the issue of whether the trial court erred in denying Hossain’s motion to compel arbitration. The court considered the U.S. Supreme Court’s mandate in Howsam v. Dean Witter Reynolds, Inc., 537 U.S. 79 (2002), that preliminary gateway disputes should be decided by the court and subsequent gateway matters and procedural issues such waiver are to be decided by the arbitrator. Here, however, the court found that the issue of waiver based on litigation conduct was significantly different. The court noted that the First, Third, Sixth, and Eleventh Circuits had carved out an exception to Howsam’s general presumption and required the courts to decide the issue of whether waiver had occurred based on litigation conduct. The D.C. Court of Appeals ultimately determined that totality of the circumstances in this case supported a finding that PRI and Hossain acted inconsistently with a right to arbitrate by actively participating in the litigation, by not moving to compel arbitration until after the trial had begun, and by previously opposing a motion to compel arbitration.

As part of the final judgment, the trial court did determine that JMU Tax should be a party and amended the counterclaim nunc pro tunc to add it as a party; the court also required that the judgment be amended to allocate damages between the breach of lease (and the appropriate parties) and the breach of the franchise agreement (and the appropriate parties). The appellate court found no prejudice or error in this late addition because it would not have altered the witnesses or evidence adduced at trial.


The Appellate Court of Illinois affirmed a trial court holding that a quick serve restaurant franchisee was contractually obligated to assert his claims against his franchisor and its principals in arbitration, even though the franchisor’s principals were not signatories to the franchise agreement containing the arbitration provision.

Franchisor SMK Franchising, Inc. (SMK), not a party to this action, grants franchises for quick service restaurants under the name Sarku Japan Grill & Sushi. Plaintiff Hyung Wook Kim attended a series of informational
seminars and other meetings with defendant Bruce Kim, who was acting on behalf of SMK, during which Bruce allegedly made a series of deceptive, false, misleading, and fraudulent misrepresentations concerning the operation of franchised Sarku restaurants and, in particular, regarding the operation of a particular restaurant that Bruce encouraged the plaintiff to purchase. Ultimately, the plaintiff signed a Sarku franchise agreement and, thereafter, purchased an existing franchised Sarku restaurant. The plaintiff almost immediately realized that the financial representations made to him by Bruce were false and demanded rescission of the sales contract and franchise agreement and return of all payments—all of which SMK and Bruce refused.

Thereafter, the plaintiff commenced this action alleging violation of the Illinois Franchise Disclosure Act, violation of the Illinois Consumer Fraud and Deceptive Business Practices Act, common law fraud, and fraudulent inducement as against Bruce. The plaintiff also asserted claims against defendant Gina Kim for common law fraud, fraudulent inducement, and aiding and abetting fraud. Defendants Bruce and Gina filed a motion to dismiss the complaint based on the arbitration provision in the franchise agreement, which the trial court denied, finding there was a question of fact concerning whether Bruce’s alleged misconduct was committed within the scope of his employment at SMK; this precluded the court from determining whether Bruce and Kim, as non-signatories to the franchise agreement, could compel arbitration. Defendants Bruce and Kim filed an answer containing a single affirmative defense that the plaintiffs’ claims were arbitrable and the parties engaged in discovery concerning the scope and applicability of the arbitration agreement. Thereafter, the defendants filed a renewed motion to dismiss or stay the action pending arbitration. The renewed motion was granted by the trial court, finding that the defendants did not waive their right to arbitrate through participation in the litigation and that the non-signatory defendants could compel the plaintiff to arbitrate his claims because the relationship between the parties and the issues raised in the plaintiff’s complaint were intertwined with the franchise agreement.

On appeal, the plaintiff contended that: (1) the defendants waived the right to arbitrate by answering the plaintiff’s complaint and participating in discovery; (2) the cost of arbitration would be prohibitively expensive; (3) the arbitration clause of the franchise agreement denied the plaintiff the right to seek punitive damages under the Illinois Consumer Fraud and Deceptive Practices Act; and (4) the defendants, as non-signatories, lacked standing to compel the plaintiff to arbitrate his claims.

The appellate court first undertook a choice of law analysis in order to consider whether the parties’ choice of Delaware law in the franchise agreement controlled. The plaintiff contended that the choice of law provision did not apply to the arbitration, but rather Illinois law applied. The court disagreed, finding that the questions of substantive law concerning arbitration must be determined by reference to Delaware law (except with regard to the procedural issue of waiver, which was governed by Illinois law).
Turning to the substantive and procedural issues, the plaintiff first argued that the defendants waived their right to arbitrate by filing an answer and participating in discovery. Because waiver is a procedural issue, the court applied Illinois law. Under Illinois law, to waive a right to arbitrate a party must act inconsistently with that right by, *inter alia*, submitting an arbitrable issue to the court for decision. The court noted that the defendants did not submit any arbitrable issues to the trial court for decision but, rather, they simply filed an answer (after the court denied their initial motion to dismiss/stay and refer the claims to arbitration), raising as their sole affirmative defense the contention that the plaintiff’s claims were subject to arbitration under the franchise agreement. The court concluded that these actions were clearly not inconsistent with their claimed right to arbitrate and therefore did not constitute a waiver.

The plaintiff next argued that he should not be forced to arbitrate because the cost of arbitration would exceed the cost of resolving the claims in court and the arbitration would deny him the ability to pursue punitive damages under the Illinois Consumer Fraud and Deceptive Business Practices Act. However, the court held that because the plaintiff failed to raise these issues in response to the renewed motion for arbitration, he had waived the issues.

The plaintiff next argued that the defendants could not compel arbitration because they were not signatories to the franchise agreement containing the arbitration provision. Applying Delaware law, the court noted that contract provisions generally can be enforced only by the parties and intended third-party beneficiaries of those contracts. However, there are a number of exceptions to this rule, including, as relevant here, equitable estoppel. Under the doctrine of equitable estoppel, non-signatories can compel arbitration in three circumstances: (1) where the signatory to the written agreement containing the arbitration clause must rely on terms in that agreement to make its claims against the non-signatory; (2) where the signatory raises allegations of substantially interdependent and concerted misconduct by both the non-signatory and one more of the signatories to the contract; and (3) where there is a close relationship between the entities involved, there is a close relationship between the alleged wrong and the non-signatory’s obligations and duties under the contract, and the claims are intimately founded in and intertwined with the contract requirements. Here, the plaintiff alleged that the defendants acted so as to wrongfully induce him into an agreement to purchase the franchised restaurant, thereby necessarily presuming the existence of the franchise agreement. As a result, the court held that the plaintiff was equitably estopped from avoiding arbitration.


In December 2006, Linglong and Horizon entered into a collaboration agreement under which Horizon was to be the sole distributor in the United
States for light-truck tires produced by Linglong. The agreement also contained an arbitration clause. When the agreement expired in 2011, the parties chose to not renew it. However, the companies repeatedly affirmed in correspondence that Horizon would remain the exclusive U.S. distributor for all the brands they had developed together. Eventually, the relationship deteriorated, and both parties filed suit against each other—actions that were consolidated into a single case before the U.S. District Court for the Northern District of Ohio.

Linglong filed a Federal Rule of Civil Procedure Rule 12(b)(1) motion to dismiss or stay Horizon’s amended counterclaims pending arbitration. The district court denied the motion, reasoning that Horizon’s claims were not based on the agreement, that the agreement had expired, and that Linglong had waived any right to arbitrate. Linglong appealed, and the Sixth Circuit affirmed the decision of the lower court.

The Sixth Circuit held that an arbitration clause survives the expiration of a contract only when the dispute at issue “arises under the contract”—first, if the “majority of the material facts and occurrences giving rise to the dispute occurred before the contract expired”; or second, if the contractual right at issue survives the expiration of the contract itself. Here, the vast majority of the events giving rise to litigation occurred in 2014 and 2015, long after the agreement had expired. The court further found that Horizon had expressly waived the second basis as theory to support its claims because Horizon’s claims were based on an alleged permanent right of exclusive distributorship under the agreement, but it unequivocally and irrevocably waived its rights to arbitration under the agreement.

The U.S. District Court for the Middle District of Tennessee stayed third party claims brought by a search engine optimization service against a cleanup and restoration services franchisee and referred those claims to arbitration pursuant to the arbitration agreement between the parties and further dismissed the fraud and breach of contract claims asserted against the principal of the franchisee.

Plaintiffs Servpro Intellectual Property, Inc. and Servpro Industries, Inc. (collectively, Servpro) provide cleanup and restoration services and license third parties to provide such services under the Servpro brand. In connection with those services, Servpro is the holder of several federal trademark registrations, including registrations for the mark “SERVPRO.” Third party defendant Anthony Oliverio is the president of third party defendant Olive Mill, Inc., an Arizona Servpro franchisee. In December 2013, Olive Mill and defendant Stellar Emarketing, Inc. entered into a contract pursuant to which Stellar agreed to perform search engine optimization (SEO) services intended to provide Olive Mill with preferential positioning in selected In-
ternet search engines. In the contract, Olive Mill represented that it owned, or had permission from the rightful owner to use, certain text, graphics, photos, designs, trademarks, and other artwork furnished to Stellar by Olive Mill and agreed to hold Stellar harmless from any claim or suits arising from the use of such content. Olive Mill further agreed to indemnify Stellar for any claim that Stellar’s use of the content infringed the intellectual property rights of a third party. Finally, the contract included an arbitration provision.

In connection with its services, Stellar created a website for Olive Mill. Servpro learned of and objected to the use of the content on that website, and Olive Mill informed Stellar of Servpro’s complaints and thereafter ceased using Stellar’s services. Approximately one year later, Servpro learned that the website using the content was still in operation and commenced this action against Stellar for trademark infringement and unfair competition arising out of its alleged use of SEO tactics to attract consumers searching for the word “Servpro” to its websites, including the website created for Olive Mill. Stellar answered the complaint and filed third party claims against Olive Mill and Oliverio under theories of indemnity and/or hold harmless. Olive Mill and Oliverio filed separate motions to dismiss and/or stay the third party claims. In response, Stellar filed a series of amended answers/counter-complaints, which caused Olive Mill and Oliverio to file a series of responsive motions to dismiss/stay.

Oliverio argued that because Olive Mill, not Oliverio, was the party to the contract with Stellar and because he signed the contract and took all other actions relating to Stellar purely in his professional capacity as a representative of Olive Mill, the claims against him, individually, should be dismissed. Stellar contended that Oliverio’s representation (presumably, outside of the contract) that he owned or was authorized to grant usage rights to the Servpro trademarks amounted to fraud and that, as a result, Stellar should be permitted to pierce the corporate veil and hold Oliverio liable in his personal capacity.

The court began its analysis by reviewing the parties’ contract, which was unambiguously directed only at Stellar and Olive Mill as corporate entities. Based on this analysis, the court concluded that all of the duties arising directly out of the contract were Olive Mill’s, not Oliverio’s. Thus, in order for Stellar to succeed on its breach of contract claims against Oliverio, it must pierce the corporate veil, which permits a court to attribute the actions of a corporation to its shareholders. After reviewing applicable Tennessee law, the court found that nothing in the third party complaint sufficiently alleged that disregarding the corporate form was necessary to achieve justice in this case, as required by applicable law. As a result, the court dismissed the breach of contract claims as against Oliverio.

Unlike the contractual claims, the court did not view the fraudulent inducement claims against Oliverio through the prism of piercing the corporate veil. Instead, the court noted the general principle that an agent cannot escape liability for tortious acts, including fraud or misrepresentation, against third persons simply because the agent was acting within the scope
of the agency or at the direction of an employer. Thus, the fraudulent inducement claims were properly directed at Oliverio in his individual capacity. However, Oliverio also contended that the fraudulent inducement claim was not sufficiently plead with particularity as required by Federal Rule of Civil Procedure 9(b). The court agreed, finding that Stellar failed to plead the content, context, time, or medium of Oliverio’s allegedly false representations. Without such detail, the court held that it was impossible to know whether Stellar relied on the alleged misrepresentations and if that reliance was reasonable. As a result, Stellar’s fraudulent inducement claim against Oliverio was also dismissed.

Olive Mill’s motion to stay and/or dismiss the third party claims against it was based upon the arbitration agreement in the parties’ contract. Stellar contended that Olive Mill had waived its right to invoke the arbitration provision by taking actions inconsistent with arbitration, in particular, by participating in this litigation.

The court began its analysis by finding that Stellar’s attempts to enforce its indemnification rights under the contract fell well within the scope of the arbitration provision. As a result, the claims were properly arbitrable unless the right to arbitrate was unenforceable or waived. Here, Stellar contended that even if its claims were at one time subject to the arbitration provision, Olive Mill had since waived those rights through its participation in this litigation. However, the court found that Olive Mill asserted its arbitration rights in its initial responsive motion and thereafter never took a position inconsistent with its assertion of those rights. The delays in litigation were attributable only to Stellar’s numerous amendments of its counter-complaint, not any action by Olive Mill. Stellar further contended that Olive Mill could have commenced the arbitration when it first learned of the possibility of a dispute between Servpro and either Olive Mill or Stellar concerning Stellar’s use of the Servpro trademarks on its website. However, the court found that Olive Mill’s failure to rush to arbitration as soon as the mere potential for dispute became apparent was in no way inconsistent with its later reliance on the arbitration provision. As a result, the court found that the third party claims against Olive Mill were properly arbitrated pursuant to the parties’ contract.

Finally, the court stayed, rather than dismissed, the third party claims against Olive Mill pending further developments in the underlying litigation between Servpro and Stellar.

BANKRUPTCY


In this dramatic bankruptcy case, a secured creditor and a franchisor (Bruegger’s) battled for control over the assets of a bankrupt multi-unit bagel bak-
ery franchisee/debtor, Flour City Bagels, LLC. However, due to multiple conflicts of interest, failed disclosures, and failures of proof, the U.S. Bankruptcy Court for the Western District of New York found that neither the secured creditor nor the franchisor was able to obtain immediate control and ownership of Flour City’s bagel bakeries and related assets.

Flour City operated thirty-two franchised Bruegger’s Bagel Bakeries, located in Rochester, Albany, and Syracuse. After Flour City defaulted on a series of payment obligations to its secured lenders, its junior secured lender, Canal Mezzanine Partners II, LP, exercised its contractual right to assume control over Flour City. After assuming control, however, Canal was unable to restore Flour City to profitability. Accordingly, Canal caused Flour City to file for bankruptcy protection, with the aim of selling substantially all of Flour City’s assets (its bagel bakeries) as a going concern. Critically, Kevin Coyne, the principal of Canal responsible for Flour City’s operations, acted on behalf of both Flour City and Canal in the bankruptcy process, with attendant fiduciary duties owing to both.

Canal sought to quickly purchase Flour City’s bagel bakeries from the bankruptcy estate through a court-approved bid process, thereby avoiding and negating certain post-termination assignment obligations owed by Flour City to its franchisor, Bruegger’s. In connection with the proposed sale, Bruegger’s and Flour City filed three motions: (1) Bruegger’s filed a motion seeking a determination that neither Canal nor the senior secured lender had any pre-petition liens on Flour City’s leases; (2) Bruegger’s filed a motion to compel Flour City to assign all of its leases and personal property to Bruegger’s under the terms of its franchise agreements with Flour City; and (3) Flour City filed a motion to approve the sale of substantially all of its assets, free and clear of all liens or interests, to Canal—the sole managing member of Flour City and the prevailing bidder at an auction held pursuant to bid procedures approved by the court.

Granting Bruegger’s first motion, the court held that Canal and the senior secured lender failed to properly perfect their security interests in Flour City’s leases in the manner required by Section 291 of New York’s Real Property Law and that Bruegger’s was not precluded from objecting to the purported liens due to its execution of an estoppel certificate. With respect to Bruegger’s second motion, the court held that Bruegger’s had failed to establish the requisite elements of specific performance under applicable New York law and thus denied Bruegger’s motion to compel assignment of the leases. Thus, through its determination of Bruegger’s two preliminary motions, the court denied Canal and Bruegger’s respective attempts to gain control over Flour City’s bakery leases outside of the court-approved bid process.

Finally, the court addressed Flour City’s motion to approve the sale of all of its assets under 11 U.S.C. § 363(b)(2), free and clear of all liens and interests, to Canal. Canal was the ostensible “highest and best” bidder, by virtue of its bid of $5 million (comprised of $1.3 million cash and $3.7 million in debt).
bid). Crucially, Flour City sought to sell the assets of its Bruegger’s bagel bakeries stripped of their franchise affiliation. Not surprisingly, Bruegger’s, which was the backup bidder by virtue of its all cash $4.75 million bid, objected to the Canal sale. Essential to the court’s analysis of the proposed sale was the fact that Canal, through its principal Kevin Coyne, acted on behalf of both the seller (through its operation and management of Flour City) and the buyer (itself) in connection with the proposed transaction. This inherent conflict of interest, combined with a number of inequitable terms of sale inevitably arising from this conflict, ultimately doomed the proposed sale. After conducting an extensive analysis, the court held that Flour City failed to carry its burden under a heightened scrutiny standard to show by a preponderance of evidence that the insider-purchaser acted in good faith and exercised sound business judgment in selecting Canal’s bid. In addition, the court held the Flour City had failed to demonstrate a business justification for selling its assets free and clear of liens, as required under 11 U.S.C. § 363(f)(2) or (3). As a result, the court denied Flour City’s motion to approve the sale of its assets, free and clear of all liens and interests, to Canal.

In addition to the numerous bankruptcy-specific issues addressed by the court, this case stands as a reminder that: (1) practitioners should be warned against the multiple conflicts of interest that are inherent in the sale of assets to a secured creditor, and (2) franchisors should be mindful of the attendant pitfalls when seeking to enforce the contractual right to take possession of a franchised location upon a former franchisee’s bankruptcy.

CHOICE OF LAW


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


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

CLASS ACTIONS


Fast-food franchisors, which claimed to have lost royalty fees due to their franchisees’ reduced business after the Deepwater Horizon Oil spill and which were denied recovery from the class action settlement, filed suit seek-
ing a review of the denial. The issue in this case was the interpretation of the economic and property damages settlement agreement. Pursuant to the settlement, entities doing business in the Gulf Coast areas were considered members of the class if they met one of four criteria (only two were at issue). Section 1.2.1 allowed membership if the entity owned, operated, or leased a physical facility in the Gulf Coast areas, and Section 1.2.2 allowed membership if the entities serviced businesses with one or more full-time employees who performed full-time services at the time of the oil spill.

The claimants argued for membership based on Section 1.2.2, which they contended allowed membership for franchisors that have franchisees in the Gulf Coast areas, regardless of the location of the franchisor. The court did not find this argument persuasive. The court held that because each of the four membership classifications required some geographic connection, the franchisors could not be members. The franchisees, as third-party operators, separate from the franchisors, could be members of the class, but not the franchisors. The court held that the geographic restriction could not be satisfied by relying on legally independent businesses.

Lastly, the claimants argued that a franchisor with at least one non-franchised location in within the defined geographic scope should be permitted in the class under Section 1.2.1. The court refused to consider this argument because it was raised for the first time on appeal under circumstances insufficient to warrant an exception.


The plaintiffs, a collection of franchised Volkswagen dealerships, filed a class action lawsuit, on behalf of all U.S. Volkswagen dealers, in the U.S. District Court for the Northern District of California, MDL against Volkswagen Group of America, Inc., Volkswagen Credit, Inc., and Volkswagen Ag (collectively, Volkswagen), seeking damages for lost compensation caused by Volkswagen’s use of defeat devices in its automobiles that were designed to circumvent Environmental Protection Agency (EPA) emissions testing. Volkswagen admitted to installing these defeat devices in certain of its 2009 through 2015 diesel vehicles.

On September 30, 2016, the plaintiffs filed a Volkswagen-branded franchise dealer amended and consolidated class action complaint, a franchise dealer settlement, and a motion for preliminary approval. The court granted the motion for preliminary approval of the settlement and ruled that the settlement was sufficiently fair, adequate, and reasonable to Volkswagen franchise dealers to move forward with class notice. The court also granted the plaintiffs’ motion to conditionally certify the proposed dealer class under Federal Rule of Civil Procedure 23(a), approve its proposed notice, and schedule a fairness hearing.
The franchise dealer settlement agreement that was preliminarily approved by the court provided average cash payments to each class member of $1.85 million, up to a maximum settlement amount of $1.208 billion, the option of each class member to defer any affirmative obligations to renovate or construct dealership facilities or otherwise make capital investments in real property or facilities, and required Volkswagen to repurchase any affected vehicles for which it was unable to provide an “approved emissions modification” within thirty days of determining that no such modification is available.


This decision continues the Jani-King of Philadelphia independent contractor versus employee saga and ultimately permits the case to move forward, affirming class certification. The franchisee-plaintiffs claim that Jani-King misclassified them as independent contractors under Pennsylvania state law, despite its exercise of significant controls over their operations and day-to-day activities. The issue, as framed by the majority of the Third Circuit panel, is whether the misclassification claim can be made on a class-wide basis through common evidence.

The U.S. District Court for the Eastern District of Pennsylvania found that each of the Federal Rule of Civil Procedure 23(a) factors for class certification and the predominance factor from Rule 23(b) were met. Jani-King either never disputed or did not dispute on appeal numerosity, superiority, typicality, or adequacy. The only factor at issue was Rule 23(a) commonality and Rule 23(b) predominance, which both measure whether the claims are capable of class-wide resolution and often involve some level of review of the merits of the allegations.

Analyzing what evidence the franchisees may need to prove their misclassification claim, the appeals court first examined what proof was necessary to establish that the franchisees were employees. The relevant Pennsylvania law, the Wage Payment and Collection Law (WPCL), 43 Pa. STAT. §§ 260.1-260.12, does not define employee. Looking to other state laws that do contain a definition and to various court interpretations, the Third Circuit found that the multifactor test—including control of the manner of work, responsibility for results, terms of agreement, nature of work, required skills, who supplies the tools or equipment, mode and manner of payment, whether worker is engaged in a business distinct from hiring party, and right to terminate at any time—was applicable. The court, however, focused on the right to control the manner in which the work is accomplished as the “paramount” factor. Although Jani-King argued that actual control was the real key, as opposed to merely having the “right” to control, the court disagreed, holding that the right to control was more significant and the law in the state of Pennsylvania.
The court next examined what common evidence the franchisees would proffer to demonstrate this right to control on a class-wide basis. The key evidence was the franchise agreement, policy manual, and training manual. Because these documents were relatively consistent across the putative class of 300 Philadelphia area franchisees, the district court concluded that the franchisees' claims could be proven through common evidence. The Third Circuit found this conclusion was not legal error or an abuse of discretion. The controls found convincing and significant included dictating how and when franchisees communicate with customers, what they must wear to customer meetings, and what they must wear to perform cleaning services; routing all billing, invoices, and contracts through the franchisor; and prohibiting individual advertising.

Jani-King argued that the franchise agreement and manuals were not dispositive of the franchisees’ status as independent contractors or employees because the law requires that the court assess the entire relationship to determine employment status. After an analysis of Pennsylvania cases cited by Jani-King, the court affirmed that, under certain circumstances, an employment relationship—or the lack of one—could be determined by examining the documents alone.

Jani-King also argued that the unique nature of the franchisor-franchisee relationship requires certain “franchise system controls” that are necessary to protect the franchisor’s trademark, trade name, and goodwill. The court should not consider, Jani-King argued, those franchise system controls in determining whether a franchisor exerted significant control over a franchisee to establish an employment relationship. Jani-King relied on *Juarez v. Jani-King of California, Inc.*, 273 F.R.D. 571 (N.D. Cal. 2011), which found, under California law, that a franchisee must be able to show the franchisor exercised significant control beyond that necessary to protect and maintain its interest in its trademark, trade name, and goodwill. The district court was not persuaded by *Juarez* because Pennsylvania law does not make any distinction or provide special protection for franchise system controls versus controls for other purposes.

Judge Cowen provided a strong rejoinder in his dissent, which relied heavily on an understanding of the nature of the franchise relationship and its historical, current, and future importance to the American economy. Considering this important relationship and the fact that Pennsylvania courts have not clearly determined, one way or another, whether franchise system controls should be treated differently than other controls for the purpose of establishing an employer-employee relationship, he concluded that the state supreme court would find that franchise system controls are not sufficient by themselves.

The dissent would vacate the class certification order, finding insufficient common evidence to establish an employment relationship once the franchise system control information is set aside.
CONTRACT ISSUES

This case is discussed under the topic heading “Tortious Interference.”


In affirming a trial court ruling, the California Court of Appeal held that the operator of a franchised restaurant was entitled to a rent reduction from its landlord based upon the deductibility of its franchise fees from the “net sales” threshold stated in its lease.

Plaintiff Goldmex, Inc. leased space in the Glendale Galleria Mall food court from defendant Glendale I Mall Associates, LLC, where Goldmex operated a franchised La Salsa Fresh Mexican Grill restaurant. The ten-year lease entitled Goldmex to a reduction in rent if its “net sales” fell below $800,000 for a continuous twelve-month period and further provided that Goldmex could exclude or deduct from its net sales “the proceeds of the sale of any franchise to operate the business on the Premises and all fees, charges or charges [sic] from such franchise.”

Midway through the lease, after subtracting the advertising and license fees paid to its franchisor, Goldmex determined that its “net sales” fell below the $800,000 threshold and therefore notified the landlord that it was exercising its right to a rent reduction. However, the landlord objected, arguing that Goldmex had not previously subtracted such fees in calculating its net sales and that the parties’ lease did not allow Goldmex to do so.

On appeal, after reviewing the well-settled principles of contract interpretation and standard of review, the court concluded that the lease provision quoted above was reasonably susceptible to the interpretations advanced by both parties; in other words, it was ambiguous. In reaching this determination, the court reviewed the language of the provision as well as extrinsic evidence offered by the parties.

Nevertheless, the court concluded that, upon review of the substantial evidence submitted by the parties, there was sufficient support in the record for the trial court’s holding that the parties’ lease permitted Goldmex to exclude the advertising and license fees paid to its franchisor from its net sales for purposes of receiving a reduction in rent. Specifically, the relevant evidence included unrebutted testimony from Goldmex’s principal, who testified that he had specifically negotiated the rent reduction provision and that he was previously unaware that the fees paid to its franchisor were not being excluded from net sales. Finally, the court held that Goldmex’s introduction of summary financial records, rather than canceled checks, as direct evidence
of its payment of fees to its franchisor was a sufficiently admissible basis from which the trial court could calculate Goldmex’s damages.


This case is discussed under the topic heading “Oral Agreements.”


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


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


This case is discussed under the topic heading “Trademark Infringement.”


This case is discussed under the topic heading “Good Faith and Fair Dealing.”


Plaintiff South Shore Honda sued its automobile distributor, American Honda, for breach of contract, breach of implied covenant of good faith and fair dealing, and violation of the New York Franchised Motor Vehicle Dealer Act for American Honda’s failure to enforce its wholesaling policy. The U.S. District Court for the Eastern District of New York granted American Honda’s motion to dismiss the plaintiff’s breach of contract and statutory claims, but found that the plaintiff stated a plausible claim for breach of the implied covenant of good faith and fair dealing.

South Shore Honda entered into an agreement with American Honda for the right to sell and service Honda products as an authorized Honda dealer. The dealer agreement included language incorporating by reference American Honda’s policies and procedures. The following year, American Honda adopted a wholesaling policy, which limited authorized Honda dealers to retail sales and leases and prohibited the creation of additional dealership locations. The wholesaling policy stated that American Honda would (1) strictly
enforce the dealer agreement, (2) require that dealers not engage in wholesaling of Honda vehicles, and (3) consider any wholesaling to be inconsistent with the dealer agreement. The wholesaling policy also explicitly acknowledged the potential harm wholesaling could inflict on American Honda and its dealers. The plaintiff’s complaint alleged that authorized Honda dealers were engaging in wholesaling in the plaintiff’s designated area and that American Honda failed to take any steps to curtail the wholesaling or to strictly enforce its dealer agreement, thereby preventing the plaintiff from exercising its rights to earn profits from the sale of Honda vehicles.

As a threshold matter, the court addressed whether the wholesaling policy was sufficiently incorporated by reference into the parties’ dealer agreement to support the plaintiff’s breach of contract claim. The court found that the dealer agreement did not sufficiently identify or describe the wholesaling policy beyond all reasonable doubt and thus could not be deemed incorporated by reference. Key to the court’s analysis was the timing of the wholesaling policy. Specifically, the wholesaling policy was not yet in existence at the time the parties executed the dealer agreement. Accordingly, the court dismissed the plaintiff’s contract claim and considered, alternatively, the plaintiff’s claim for breach of the implied covenant of good faith and fair dealing. Although American Honda argued that the wholesaling policy was an exercise of discretion, the court found that the plaintiff adequately alleged that American Honda acted arbitrarily by completely abandoning any enforcement of its wholesaling policy.

Finally, the court rejected the plaintiff’s argument that American Honda violated Section 463(2)(cc)(1) of the New York Dealer Act by permitting wholesaling by other dealers and thereby creating additional de facto dealership locations within the plaintiff’s relevant market. Because the statute specifically requires and the plaintiff failed to allege that American Honda served any written notice concerning additional authorized dealerships in the plaintiff’s designated area, the court dismissed the plaintiff’s New York Dealer Act claim.

DAMAGES

*Ford Motor Co. v. Darling’s, Bus. Franchise Guide (CCH) ¶ 15, 869, 151 A.3d 507 (Me. 2016)*

This case is discussed under the topic heading “State Disclosure/Registration Laws.”


This case is discussed under the topic heading “Trademark Infringement.”
DISCOVERY


Plaintiff Canon USA brought four separate lawsuits against the defendants, and the U.S. District Court for the Eastern District of New York ordered that they “eventually” be consolidated for the purposes of discovery. Although this decision merely addresses various pending discovery issues, it is notable because the court’s decision to consolidate the cases for purposes of discovery did not mean that the four defendants could share with each other information received from Canon in discovery. The court revised the parties’ proposed global stipulation of confidentiality to reflect that the defendants could not “freely exchange” Canon’s confidential documents and information.

FRAUD


Presented with a rambling and conclusory complaint, the U.S. District Court for the Middle District of Florida granted, in large part, a franchisor’s motion to dismiss the claims of its failed franchisee arising from alleged misrepresentations made by the franchisor in connection with the sale of a franchise, with leave to replead many of the franchisee’s claims in compliance with the Federal Rules of Civil Procedure.

Defendant Le Macaron Development LLC franchises retail pastry shops that feature a variety of signature macarons and other French pastries. The franchisor entered into a franchise agreement with plaintiff Le Macaron, LLC, pursuant to which the franchisee operated two franchised retail pastry shops in Nevada. The franchisee’s venture eventually failed. The franchisee commenced this action, asserting various state law claims against the franchisor, primarily focused on the franchisor’s purported misrepresentations to the franchisee before the parties entered into the franchise agreement as well as the franchisor’s alleged failure to perform under the franchise agreement. Specifically, the franchisee asserted claims of fraudulent inducement, violation of Florida’s Deceptive and Unfair Trade Practices Act, violation of the Florida Franchise Act, breach of contract, breach of the implied covenant of good faith and fair dealing, and tortious interference. Upon the franchisor’s motion to dismiss, the court found that the majority of the franchisee’s claims failed to state a cause of action, in large part due to the vague and conclusory nature of the allegations in the complaint. The court granted
the franchisee leave to amend and provide a more definite statement of its claims.

The franchisee’s first claim, for fraudulent inducement, alleged that the franchisor and its agents falsely represented the nature of their expertise in the business; falsely represented the cost to purchase, set up, and operate the shops; falsely represented the expected profitability of the franchise; and omitted required information from the Franchise Disclosure Document (FDD) concerning certain principals of the franchisor. The franchisor argued that the fraud claim was barred as a matter of law based on a non-reliance provision in the franchise agreement and other representations and disclaimers in the franchise agreement and other documents (which essentially stated that the franchisee understood the risks of the franchise and received and reviewed the FDD).

Reviewing applicable Florida law, the court first noted that Florida courts have adopted differing views on the impact of merger, non-reliance, and similar clauses on a claim for fraudulent inducement. The court concluded that the majority of federal courts applying Florida law appear to hold that merger and non-reliance clauses may prevent the plaintiff from establishing the element of reliance, assuming that the contractual language is sufficiently express, specific, and unambiguous with respect to the representation at issue. However, the court declined to apply this majority view in this case because: (1) at least some of the alleged misrepresentations were allegedly contained in the FDD and therefore were not barred by the merger and non-reliance clauses in the franchise agreement, expressly excluding from their reach representations made in the FDD; and (2) it was not clear that each of the representations at issue was specifically contradicted by the contractual disclaimers, as required by Florida law. Accordingly, the court, sua sponte, directed the franchisee to plead a more definite statement of the fraudulent inducement claim and denied, without prejudice, the franchisor’s motion to dismiss that claim.

The franchisee’s second claim alleged violation of Florida’s Deceptive and Unfair Trade Practices Act (FDUTPA), which prohibits “unfair or deceptive acts or practices in the conduct of any trade or commerce.” FLA. STAT. ANN § 501.204(1). The franchisee alleged that the franchisor engaged in unfair and deceptive practices by: (1) “providing the false information stated herein” and (2) violating the Federal Trade Commission’s (FTC’s) Franchise Rule by failing to make legally required disclosures in its FDD concerning certain of the franchisor’s principals.

With respect to the franchisee’s allegation that the defendant provided “false information stated herein,” the court held that the claim was impermissibly vague and must be repleaded, at which time the franchisor may reassert its arguments concerning the effect of the merger and non-reliance clauses on this claim. With respect to the violation of the FTC’s Franchise Rule, the court held that the franchisee’s allegation of non-compliance with the Rule adequately stated a claim under FDUTPA since it is well-established
that a violation of the FTC’s Franchise Rule constitutes a per se violation of the FDUTPA.

The franchisee’s third claim alleged violation of the Florida Franchise Act (FFA), which prohibits certain misrepresentations and omissions in connection with the sale of a franchise. Fla. Stat. Ann. § 817.416(2)(a). Once again, because the complaint alleged, in wholly conclusory fashion, that the franchisor violated the FFA and incorporated 209 paragraphs of background allegations, the court again required the franchisor to replead a more definite statement of the claim. Interestingly, the franchisor argued that the FFA claim, like the fraud and FDUTPA claims, was barred by the merger and non-reliance provisions in the franchise agreement. The court discussed, without deciding, whether reasonable reliance is required under the FFA and, thus, whether a non-reliance clause is effective to bar an FFA claim as a matter of law. This issue was reserved for future consideration.

The franchisee’s fourth claim, sounding in breach of contract, alleged that the franchisor breached various provisions of both the FDD and the franchise agreement. At the outset, the court dismissed the breach of contract claim to the extent it referred to the FDD, which was not a contract between the parties. The court further dismissed the breach of contract claim to the extent it related to the delivery, labeling, packaging, and quality of macarons because the macarons were purchased from the franchisor’s designated supplier, a non-party, and the franchisor was not a party to that contract. However, the court declined to dismiss the breach of contract claim to the extent it alleged that the franchisor failed to provide grand opening assistance and failed to place information concerning the franchisee’s store on the franchisor’s website. The court dismissed the remainder of franchisee’s breach of contract claim due to insufficient pleading that failed to give the franchisor a fair notice of the alleged breach, with leave to amend and replead.

The franchisee’s fifth claim, for breach of the implied covenant of good faith and fair dealing, was dismissed as a result of the franchisee’s failure to tie its claim to the performance of any specific contractual obligations, let alone explain how the implied covenant applied to the performance of such obligations. This claim was dismissed with leave to amend.

Finally, the franchisee’s sixth claim, for tortious interference with the franchisee’s business relationship with its former principal, was dismissed, again because the allegations were impermissibly vague. The court granted leave to replead.


Plaintiffs Cindy Baw and her company M&M Spice brought suit alleging fraudulent inducement to enter into the purchase of a restaurant by the defendants, Crème de la Crepe Franchising, Inc. and its owners Bruno Baio and Germaine Gillies, and Gillies’ company G3K, Inc. The trial court entered a judgment in favor of the plaintiffs following a bench trial. Baio and Crème ap-
pealed the judgments to the California Court of Appeal, which remanded to modify the judgment but otherwise affirmed the trial court’s decision.

The decision laid out a great level of detail regarding the factual allegations and findings and the procedural history, complicated by the trial court’s allowance of continued trial dates for the plaintiffs to present additional evidence. Ultimately, the trial court found that Gillies and Baio, individually and as representatives of G3K and Crème, made false statements to Baw and her husband (who was an officer in the company but not a party to the lawsuit). As the prevailing party, the trial court also awarded Baw and M&M Spice attorney fees.

On appeal, the appellate court found that the trial court did not err in permitting the plaintiffs to reopen their case for additional evidence because it was not a trial tactic; instead, the trial court requested the reopening believing there to be a gap in the evidence presented and later found that the prior evidence was sufficient anyway.

With respect to the fraud allegations, the appellate court noted the trial court finding that, regardless of the known risk inherent in purchasing a restaurant business, the plaintiffs were harmed because the defendants knowingly made false statements regarding the expected monthly revenue and profitability, the existence of an unpaid debt to a prior investor, the value of the restaurant equipment, and the level of expected support from the defendants.

The only adjustment to the judgment made in this case was to clarify that individual defendant Baio was not liable on the breach of contract claim or for attorney fees and to clarify that Crème was also not a party to the agreement that permitted attorney fees because the contract was between only the plaintiffs and G3K.

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

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

The U.S. District Court for the District of Arizona declined to dismiss a hearing aid business franchisee’s counterclaims against its franchisor as a result of release language in an assignment agreement between the parties, finding there was a disputed issue of material fact as to whether the release
was fraudulently induced. However, the court did dismiss the franchisee’s counterclaim under the Florida Franchise Misrepresentation Act as a result of the parties’ choice of Arizona law in their franchise agreement.

Plaintiff Zounds Hearing Franchising LLC is an Arizona limited liability company with its principal place of business in Arizona. It contracts with third parties to own and operate franchises that sell Zounds branded hearing aids and accessories. Defendant Coastal Hearing, Inc. entered into a series of franchise agreements with Zounds Franchising, pursuant to which Zounds Franchising licensed it to operate a number of Zounds franchised businesses in Florida. In addition, in connection with Coastal’s acquisition of an existing Zounds franchise in Florida, Zounds Franchising and Coastal entered into an assignment and consent to transfer agreement, which included a provision that released Zounds Franchising from all claims through the date of the agreement.

For reasons unexplained in the opinion, Zounds Franchising commenced an action against Coastal and its principal, Tina Moser. The defendants asserted counterclaims, alleging that Zounds Franchising made six material misrepresentations relating to the sale and operation of the franchise: four prior to the execution of the franchise agreements and two within the Zounds Franchising FDD. The counterclaims included fraudulent inducement, violation of the Wisconsin Franchise Investment Law, violation of the Florida Franchise Misrepresentation Act (Fla. Stat. Ann. § 817.416) (FFMA), violation of the Arizona Consumer Fraud Act (Ariz. Rev. Stat. § 44-1521) (CFA), and piercing the corporate veil. Zounds Franchising moved to dismiss the counterclaims in their entirety based upon the release and, in the alternative, sought to dismiss the fraudulent inducement, FFMA, and CFA counterclaims.

Zounds Franchising initially sought dismissal of all counterclaims on the ground that the release barred all causes of action accruing before and through the date of signing, including the fraud claims. In response, the defendants first argued that the claims were not within the scope of the release because they did not accrue until the defendants discovered the plaintiff’s misrepresentations after the release date. In the absence of controlling Arizona law, the court, citing cases from the Ninth and Sixth Circuits, suggested that the defendants’ fraud claims arose, for the purposes of the release, when the fraud was committed and as such, the claims would be barred by the release. The court also held that because the language of the release applied to both “known and unknown” claims, the release was intended to release all claims that arose before the date of signing, even unknown claims such as the defendants’ fraudulent inducement claims. As a result, the court held that the defendants’ contention that the fraudulent inducement claims accrued subsequent to their execution of their release was without merit.

However, the defendants alternatively contended that the assignment agreement, and the release therein, were void because they were the product of fraudulent inducement. The court framed the issue as whether a general release encompasses fraudulent inducement claims in the context of business
agreements, again noting the absence of controlling Arizona law. After a review of the treatment of the issue by various district courts, the court concluded that Arizona law would support the parties’ freedom to contract, but would not support waiver or release of fraudulent inducement claims without an express manifestation of such intent. Given this approach, the court declined to conclude, on a motion to dismiss, that the release barred the defendants’ counterclaims because the parties’ intent in entering into the release must be addressed at summary judgment and perhaps at trial. As a result, the plaintiffs’ motion to dismiss the counterclaims in their entirety based upon their release was denied.

The court then proceeded to analyze the motions addressed to four of the counterclaims, ultimately dismissing two of the four.

The plaintiffs first sought to dismiss the FFMA counterclaim as a result of the parties’ contractual choice of Arizona law. Applying the Restatement (Second) of Conflict of Laws Section 187, the court concluded that Arizona had the most significant contacts to the claim and that Arizona law permitted contractual waiver of statutory rights. As a result, the court held that the Arizona choice of law provision was valid, and through it, the defendants had waived their right to bring a claim under Florida law. Thus, the FFMA counterclaim was dismissed.

Similarly, the counterclaim for piercing the corporate veil was dismissed as an independent cause of action under Arizona law, which does not recognize a separate claim under that theory, with the proviso that the defendants would not be precluded from attempting to pierce the corporate veil in their pursuit of relief for their remaining counterclaims.

On the other hand, the court declined to dismiss the defendants’ fraudulent inducement claim based upon the merger and integration provision in the parties’ franchise agreement, finding that the counterclaim alleged at least two representations within the FDD that they contended induced them to sign the franchise agreement. These alleged misrepresentations were not barred by the merger and integration provisions and, as such, supported the fraudulent inducement claims, which therefore had to be adjudicated on the merits.

Finally, the court declined to dismiss the defendants’ counterclaim for violation of the CFA, which provides in relevant part: “the act, use or employment by a person of any deception, deceptive or unfair act or practice, fraud, false pretense, false promise, misrepresentation, or concealment . . . in connection with the sale or advertisement of any merchandise . . . is declared to be an unlawful practice.” Ariz. Rev. Stat. § 44-1521(a). The plaintiffs argued that the CFA did not apply to the sale of a franchise. However, finding that the Arizona Supreme Court had previously held that a franchise constitutes “merchandise” as used in the CFA, the court denied the plaintiffs’ motion to dismiss the CFA claim on that basis.
GOOD FAITH AND FAIR DEALING

This case is discussed under the topic heading “State Disclosure and Registration Laws.”

The Tennessee Court of Appeals affirmed the decision by the Tennessee Motor Vehicle Commission, concluding it would not be appropriate or fair for American Honda to establish a new dealership within the relevant market area (RMA) of the protesting franchisee under Tennessee Code Section 55-17-114(c)(2).

When American Honda sought to establish a new motorcycle dealership in Kingsport, Tennessee, it notified the owners of Jim’s Motorcycle (franchisee) of its intention by letter dated March 22, 2013. The letter also informed the franchisee that the new dealership may be within its RMA and that it may have the right to file a protest with the Commission. The franchisee filed a formal protest with the Commission, alleging the proposed dealership would have an unfair competitive advantage and disrupt the market base of the current dealers in the area. The Commission initiated a contested case hearing. American Honda filed a motion to dismiss, alleging it had not in fact assigned the franchisee a RMA and thus the franchisee lacked standing to protest the proposed dealership, but the Commission denied the motion.

American Honda sent the franchisee two more letters in December 2013, the first of which notified the franchisee that American Honda would identify and define the franchisee’s RMA, and the second which assigned the franchisee an RMA that did not include Kingsport or any part of the state north or west of Interstate 81. American Honda filed a second motion to dismiss, arguing the franchisee’s RMA did not include Kingsport and therefore the franchisee had no standing to protest. The Commission denied the motion, again noting the parties had not defined the RMA at the time the protest was filed. Undeterred, American Honda sent the franchisee a fourth letter rescinding its very first letter of March 22, 2013, and filed another motion to dismiss this time arguing the protest was moot. The Commission denied American Honda’s motion, reasoning there was an on-going controversy.

After a three-day hearing in October and December 2014, the Commission issued a final order, concluding American Honda was not authorized to establish a new dealership in Kingsport. The final order included findings of fact and conclusions of law. American Honda filed a petition for judicial review seeking reversal of the Commission’s final order on three grounds: (1) the Commission lacked jurisdiction because the franchisee lacked standing to pursue the protest; (2) alternatively, if the franchisee had standing, the
Commission’s conclusion that the franchisee’s RMA included Kingsport was arbitrary, capricious, and not supported by substantial and material evidence; and (3) the Commission failed to define the boundaries of the franchise’s RMA and thus had no basis to conclude whether the proposed dealership fell within the franchisee’s RMA.

The trial court affirmed the Commission’s decision, relying in part on an internal RMA map that American Honda had prepared showing that a significant portion of the Kingsport area was in the franchisee’s RMA. The trial court also recognized that the proposed Kingsport dealership injected the strong likelihood of the franchise disputes over market share, and the Commission had statutory authority to deny a license in such circumstances. American Honda appealed the trial court’s decision on the same three grounds and additionally argued the Commission erred in finding the Kingsport market was adequately serviced by existing dealers and concluding it was therefore inappropriate to establish a new dealership.

The appellate court first rejected American Honda’s standing argument because it would require the court to ignore the second part the statute, which is contrary to the rules of statutory construction. The appellate court also dismissed American Honda’s argument that its later letters had the effect of divesting the franchisee and the Commission of the authority to proceed with the protest; otherwise the appellate court recognized American Honda could effectively eliminate the protest rights of any existing dealer by simply removing the disputed area from the dealer’s RMA after protest was filed. The appellate court concluded the Commission likewise fulfilled its statutory requirement to define the franchisee’s RMA when the Commission concluded the RMA “includes the Kingsport area” because the statute did not require a more detailed definition of the RMA. Finally, the appellate court held there was no basis upon which to second-guess the weight the Commission gave to the evidence presented in concluding a Kingsport dealership would be inappropriate—the franchisee and American Honda (for at least some time) both treated Kingsport as part of the franchisee’s RMA, the Kingsport market was adequately served by the existing Honda dealers in the area, and any decline in area sales was due to the overall economy rather than poor performance of area dealers.


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


This case is discussed under the topic heading “Statutory Claims.”
Seven motor vehicle dealerships (franchisees) brought suit against a manufacturer franchisor alleging violations of the Automobile Dealers’ Day in Court Act (ADDCA), Robinson-Patman Act (RPA), and Racketeer Influenced and Corrupt Organizations Act (RICO), among other claims. The U.S. District Court for the Northern District of Illinois granted in part and denied in part franchisor’s motion to dismiss for failure to state a claim.

All of the franchisees’ claims centered on two schemes allegedly perpetrated by Fiat Chrysler Automobiles US, LLC (FCA) to drive the franchisees out of business. In the first alleged scheme, FCA falsely inflated the reported retail sales of FCA vehicles by soliciting fraudulent sales reports from certain dealers (conspiring dealers) and rewarding the conspiring dealers through the guise of incentive programs. The franchisees claimed they discovered this scheme after an FCA business center director contacted one of the franchisees’ employees and offered him $20,000 and extra allocations of high-demand vehicles if the dealership falsely reported new vehicle sales. FCA’s second alleged scheme used the fraudulent sales data generated by the first scheme to set the franchisees’ minimum sales responsibility metric (MSR) baseline at unrealistic levels and then threatened to terminate the franchisees’ dealership agreements based on a skewed assessment of the franchisees’ performance.

ADDCA authorizes dealers to bring suit against any manufacturer that has failed to act in good faith in complying with the terms of the franchise agreement or in terminating, canceling, or not renewing the franchise. 15 U.S.C. § 1221. The court found the franchisees’ allegations were sufficient to survive a motion to dismiss, recognizing that an indispensable element of an ADDCA claim is a lack of good faith in which coercion, intimidation, and threats thereof exist.

The franchisees also alleged violations of Section 13(a) and (d) of the RPA, which was codified as part of the Clayton Act, 15 U.S.C. § 13 et. seq. Section 13(a) prohibits sellers from discriminating in price between different purchasers of products of like grade and quality in interstate commerce to the injury or destruction of competition. The court was convinced the incentive programs in the first scheme satisfied the competitive injury prong of an RPA claim, which provides that injury may be inferred from evidence that a favored competitor received significantly better prices over an extended period of time. Fed. Trade Comm’n v. Morton Salt Co., 334 U.S. 37 (1948). The court likewise concluded the franchisees were injured by the price difference offered to the conspiring dealers since the hallmark of such injury is the diversion of sales or profits from a disfavored purchaser to a favored purchaser. For the same reasons, the court held the franchisees’ allegations were sufficient to state a claim under § 13(d), which prohibits sellers from offering payments to purchases that are unavailable on “proportionally equal terms
to all other customers competing in the distribution of such products or commodities.”

The franchisees asserted two RICO claims based on the two alleged schemes—a substantive RICO claim and a RICO conspiracy claim against FCA and one of its affiliates. FCA responded that the franchisees lacked standing because they failed to sufficiently allege the proximate and but-for cause of any of their alleged injuries. The court acknowledged the franchisees alleged they had suffered from a number of harms, including lost sales and the failure to receive incentives, for refusing to participate in the alleged schemes. However, the court agreed with FCA that the franchisees failed to connect any of these alleged harms to the alleged RICO activity and failed to eliminate other possible causes.

FCA moved to dismiss the franchisee’s breach of contract claim on the grounds that the allegations were vague and lacked factual support, but the court found the franchisees’ allegations satisfied the notice pleading standard. Finally, the court dismissed the franchisees’ fraud and negligent misrepresentation claims under Michigan’s economic loss doctrine, which applied pursuant to the terms of the dealer agreements, after finding the fraudulent inducement exception did not apply.


A franchisee asked a state district court to review the order by the Board of Texas Department of Motor Vehicles approving Volvo Trucks North America’s decision to modify its franchise agreement with a licensed Volvo Trucks dealer in Houston. Volvo immediately removed the case from district court to the Texas Court of Appeals, which affirmed the Board’s order.

The franchisee was assigned a geographic area of responsibility (AOR) in its franchise agreement with Volvo. In September 2013, Volvo notified the franchisee that it intended to modify the franchisee’s AOR by reducing it from twenty-four to thirteen counties. The franchisee filed a protest with the Texas Department of Motor Vehicles under Texas Occupations Code § 2301.455(a); an administrative law judge (ALJ) heard the case in a six-day contested hearing. The ALJ issued a proposal for decision with findings of fact and conclusions of law and recommended that Volvo’s proposed modification be granted. Almost a year later, the Board issued a final order approving Volvo’s proposed modification.

On appeal, the franchisee argued the Board improperly concentrated on past data instead of currently existing circumstances, the latter of which the franchisee argued was mandated by statute. The appellate court rejected the franchisee’s interpretation because any attempt to downplay consideration of historical data was self-defeating—the Board was required to compile and examine historical data in determining whether good cause existed to modify a franchise. Because the franchisee did not demonstrate the Board
wholly failed to consider recent data, the decision of how much weight to give to historical data compared to currently existing circumstances was solely within the province of the Board. The court likewise rejected the franchisee’s contention that the possibility of a future dealership materially diminished the present value of the franchisee’s investment because it was mere speculation.

In a dispute between an affiliate of a domestic automobile manufacturer and its auto parts distributor in the Republic of Angola, in which the distributor made allegations of bribery and favoritism toward government and military officials, the U.S. District Court for the Eastern District of Michigan dismissed five of the distributor’s claims under Federal Rule of Civil Procedure 12(b)(6).

Plaintiff Union Commercial Services, Ltd. is an entity organized under the laws of the Cayman Islands, is owned by Angolan residents, and conducts business in Angola. Union has sold Chrysler, Dodge, and Jeep motor vehicles and parts in Angola since 1988. In 2006, Union entered into a distributorship agreement with Chrysler International Corp. to sell these products in Angola. After Chrysler emerged from bankruptcy, defendant FCA US LLC assumed the agreement and assigned it to defendant FCA International Operations LLC (collectively, defendant). Union alleged that the breakdown of its business relationship with the defendant occurred when the defendant began bribing Angolan government and military officials to obtain an improper advantage in the Angolan auto market. Specifically, Union alleged that, in 2010, the defendant began working with Grupo Auto-Star S.A., an Angolan auto distributor owned by members of the Angolan government and military, and began shipping Chrysler products to Auto-Star even though Auto-Star was not an authorized distributor of those products in Angola. Union also made conclusory allegations that the defendant was engaged in the bribery of Angolan officials in connection with its dealings with Auto-Star.

In July 2013, the defendant delivered to Union a notice to terminate the parties’ distributorship agreement, effective August 2014. After the agreement terminated, Union lost the right to sell Chrysler, Dodge, and Jeep products in Angola. Union then sued the defendant, alleging claims for breach of contract, tortious interference, promissory estoppel, violation of the Lanham Act, and violation of the Racketeer Influenced Corrupt Organizations statute. The defendant filed a motion to dismiss under Rule 12(b)(6).

Union’s claim of breach of the implied covenant of good faith and fair dealing alleged that the defendant not only failed to comply with or make efforts to comply with the Foreign Corrupt Practices Act (FCPA), as required by the parties’ distributorship agreement, but that the defendant vio-
lated FCPA by conspiring with Auto-Star to bribe Angolan officials. After reviewing applicable Michigan law concerning the implied covenant, the court held that Union failed to state a claim for breach of contract because the relevant contractual provision was primarily directed at Union’s obligations, not those of the defendant, and spoke of mandatory, rather than discretionary, terms (and was therefore not subject to the implied covenant). Further, the court held that Union had failed to sufficiently plead that the defendant breached any part of the contractual provision by actually engaging in bribery and thus violating the FCPA. Rather, Union had pled only “upon information and belief” that the defendant was involved in bribery and had not pled any of the necessary information or context for its belief other than reference to public media reports and investigations into the auto industry for corruption in countries other than Angola. Accordingly, Union’s claim of breach of contract/breach of the implied covenant of good faith and fair dealing was dismissed.

As an alternative to its breach of contract claim, Union asserted a claim for a promissory estoppel regarding the defendant’s obligation to repurchase all parts delivered to Union at the time the agreement was terminated. However, because the parties’ distributorship agreement was valid and governed the relationship between the parties, the court dismissed the promissory estoppel claim as redundant with the breach of contract claim.

Union’s tortious interference claim alleged that the defendant tortiously interfered with Union’s business relationship with purchasers of Chrysler, Dodge, and Jeep motor vehicles and parts through acts of bribery, thereby causing a breach or termination of those relationships and resulting damages. However, the court dismissed this claim as well because Union did not allege that it was legally entitled to continue to serve as the sole operator in the Angolan auto market and, therefore, the defendant’s use of other distributors did not suggest that it had interfered with any of Union’s contracts or valid business expectancies. Further, the court held that, as noted above, Union had failed to adequately plead that the defendant engaged in bribery and therefore failed to sufficiently plead actual interference. Accordingly, Union’s tortious interference claim was dismissed.

Union also asserted four claims alleging the defendant violated the Racketeer Influenced and Corrupt Organizations Act (RICO), 18 U.S.C. § 1962. Specifically, Union alleged that the defendant and Auto-Star constituted an enterprise that engaged in and conspired to engage in acts related to the bribery of Angolan officials that constituted a pattern of racketeering in violation of the statute. The court dismissed the RICO claims on two grounds. First, the court held that Union had not adequately pled a required domestic injury because its alleged lost sales and profits occurred entirely outside of the United States and therefore it did not have standing to assert a claim under the statute. Second, the court held that even if Union had sufficiently pled a domestic injury, it had not sufficiently pled that the alleged bribery proximately caused its alleged damages. Specifically, the court held that
Union had not alleged any facts relating to how the defendant’s alleged acts of bribery and racketeering affected the Angolan government or that the officials who were bribed were in a position to influence the market structure. At most, Union alleged that the President of the Republic of Angola issued a regulatory framework to benefit the defendant and Auto-Star, but failed to provide any basis for suggesting this allegation was plausible. Absent sufficient allegations of causation of damages, the court dismissed Union’s RICO claims.

Finally, Union alleged that the defendant’s alleged acts of bribery violated Section 1126 of the Lanham Act because bribery is an act of unfair competition as defined by Article 10bis of the Paris Convention for Protection of Industrial Property. Absent precedent for this proposition, the court concluded that the scope of unfair competition under Section 1126 is limited to the substantive provisions of the Lanham Act, which address unfair actions related to marks, such as registration, trademark, or trade dress infringement; misuse of geographical origin marks; and false advertising. The court concluded that the Lanham Act addresses a specific subset of unfair competition claims related to certain forms of intellectual property and does not permit a plaintiff to sue for any act that it considers unfair competition, such as the allegation of breach of the Paris Convention. Thus, the court held that Union’s bribery allegation cannot form the basis for a cognizable claim under Section 1126 of the Lanham Act.


This case is discussed under the topic heading “Contract Issues.”


A franchisee filed suit for a violation of the New York Vehicle and Traffic Law § 463(2)(ff)(1) (Dealer Act) and other causes of action after General Motors approved another dealer’s request to relocate in the same area serviced by the franchisee’s dealership without providing notice. The trial court granted GM’s motion to dismiss with respect to five of the franchisee’s causes of action, and both parties moved for summary judgment on the remaining claims for breach of fiduciary duty and violation of the Dealer Act. The trial court granted the franchisee’s motion on its Dealer Act claim, and the Supreme Court, Appellate Division, modified that judgment, granting GM’s motion in its entirety.

The New York legislature enacted the Dealer Act “to address the historical inequality in the vehicle franchise business that favored automobile manufacturers over motor vehicle dealers.” Among other things, the Dealer Act makes it unlawful for any franchisor to modify the franchise of any fran-
chised motor vehicle dealer unless the franchisor provides written notice of its intention to modify the franchise and the specific grounds for such modification at least ninety days before the effective date. N.Y. VEH. & Traf. Code § 463(2)(ff)(1). “Modification” is defined as a change that may “substantially and adversely affect the new motor vehicle’s dealer’s rights, obligations, investment or return on investment.” A modification is deemed unfair if it is not undertaken in good faith or for good cause.

Pursuant to GM’s standard dealer agreement, every GM dealer is assigned an area of primary responsibility (APR), which is comprised of census tracts in which a particular dealer is deemed to have a competitive advantage in attracting customers. Although GM implicitly conceded that a change in the franchisee’s APR would constitute a modification under the Dealer Act, GM argued that mere approval of another dealer’s relocation request did not constitute a modification to the franchisee’s existing franchise agreement until the other dealer in fact relocates. Therefore, GM contended, notice under the Dealer Act was not required. The appellate court agreed, reasoning that the franchisee’s interpretation would render another section of the Dealer Act superfluous.

With respect to the franchisee’s claim for breach of fiduciary duty, the appellate court looked to Michigan law because it governed the parties’ dealer agreement. The appellate court first noted that Michigan courts were “reluctant to extend the cause of action for breach of fiduciary relationship beyond the traditional context.” Further, in light of the provision in the dealer agreement that expressly disclaimed any fiduciary obligations by the parties, the appellate court ruled the franchisee provided insufficient evidence to establish a fiduciary relationship with GM.

INJUNCTIVE RELIEF


The U.S. District Court for the Western District of North Carolina granted a preliminary injunction against Maaco’s former franchisee for the defendants’ continued unauthorized use of the Maaco trademarks and trade dress beyond the date of termination of the franchise agreement and operation of an identical business under similar or identical marks at the exact same location. Maaco sought injunctive relief based upon two claims: breach of the franchisee’s noncompete provision and violation of the Lanham Act as a result of the defendants’ trademark and trade dress infringement. The parties’ franchise agreement contained a one-year covenant not to compete that covered a span of ten miles of the former franchise and any other Maaco centers, which the court found to be reasonable in time and scope. The district court also found that Maaco was likely to succeed on the merits of its Lan-
ham Act claims. Because the defendants’ violation of the covenant not to compete and the Lanham Act threatened Maaco, its authorized franchisees, and the consuming public generally with immediate and irreparable harm, the court granted Maaco’s request for preliminary injunction.


Pirtek is a Florida franchise company that sells, assembles, and services hydraulic industrial hoses and related equipment, in part, through franchises. The Twillmans, who owned and operated a heavy equipment rental business that also allegedly manufactured hoses and fittings, expressed interest in owning a Pirtek franchise and executed a franchise agreement and personal guaranties. The franchise agreement prohibited the disclosure of confidential and proprietary information and a “non-disclosure obligation,” which prohibited the Twillmans from engaging in any business that sells products and services similar to the products and services sold by Pirtek. The covenant also barred the Twillmans from hiring any Pirtek employees.

In March 2016, after paying a portion of the franchise fee and receiving confidential and proprietary Pirtek information, the Twillmans purported to cancel the franchise agreement based on language in the FDD. They asserted that they genuinely intended to open the franchise, but were stymied by union activities. Contemporaneously, however, the Twillmans filed articles of incorporation for a new company “American Hydraulic,” which would provide the same services as their Pirtek franchise would have. They also hired two former Pirtek employees.

Pirtek initiated this litigation alleging a breach of the confidentiality obligations and noncompete covenant and seeking a preliminary injunction.

The U.S. District Court for the Middle District of Florida analyzed the factors necessary for a preliminary injunction: (1) substantial likelihood of success on the breach of contract claims; (2) showing of irreparable harm; (3) gravity of harm to each party; and (4) public interest.

The court found that Pirtek had a substantial likelihood of success on the breach of contract claims because the FDD cancellation procedure did not rescind the contractual obligations; the FDD itself stated that the franchise agreement would govern the franchise relationship, and the provision cited by the Twillmans did not define a cancellation procedure. Even if the FDD did outline a cancellation procedure, it would merely cancel the franchise agreement and not amount to a rescission. The court also found a substantial likelihood of success because the Twillmans did not identify the grounds necessary for the extreme remedy of rescission—there was no duress, fraud, or mistake that frustrated the formation of the franchise agreement to support its post-formation rescission. Lastly, the court held that the cancellation of a contract does not automatically procure its rescission and even a rescission does not always abrogate every contractual obligation
as a matter of law.” The legal fictions that accompany the rescission of a contract do not change the fact that the contract existed.

The court also found that Pirtek would suffer irreparable harm and that Florida law presumes irreparable harm where a violation of a noncompete agreement is adequately pleaded. Further, Florida courts consider injunctive relief the normal remedy for a breach of a restrictive covenant. The court was persuaded that the gravity of harm to Pirtek was high and that the injunction was in the public interest by promoting the stability of business relations and the reliability of contracts.


This case is discussed under the topic heading “Noncompete Agreements.”

**JURISDICTION**


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


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

**LABOR AND EMPLOYMENT**


Refusing to dismiss the franchisor defendants from a Fair Labor Standards Act (FSLA) collective action by twenty-three employees of a franchised hotel, the U.S. District Court for the Southern District of New York found that the plaintiffs’ allegation plausibly alleged that the franchisor defendants asserted functional control over them as employees, such that the franchisor defendants could be liable as joint employers.

455 Hospitality, LLC is the owner, operator, and manager of the Doubletree by Hilton hotel in Tarrytown, New York. 455 Hospitality is a franchisee of Doubletree Franchise LLC and Doubletree Hotel Systems, Inc. (collectively, franchisor defendants), which have granted licenses to 455 Hospitality to operate Doubletree by Hilton hotels under the Doubletree trademarks and system. The plaintiffs were 455 Hospitality employees in various capac-
ities at the hotel, who asserted claims against, inter alia, 455 Hospitality and the franchisor defendants for unpaid minimum wages, overtime pay, gratuities, and tips; failure to maintain records; and wage statement violations under the FLSA (29 U.S.C. § 201) and New York Labor Law (NYLL) § 190.

The franchisor defendants moved to dismiss the second amended complaint as to them. Because the relevant sections of the FLSA and NYLL apply only to employers, as defined by those statutes, the court began its analysis by noting that the plaintiffs must plausibly plead that the franchisor defendants were their “employers” in order for their claims to survive a motion to dismiss.

After setting forth in detail the legal definition of the term “employer” under the FLSA, as construed by the Supreme Court and the Second Circuit, the court examined the allegations in the plaintiffs’ complaint under the controlling legal principles. Ultimately, the court found that the allegations in the complaint, taken together, stated a plausible claim that the franchisor defendants were the plaintiffs’ joint employers under the FLSA and NYLL.

Interestingly, the court rejected the franchisor defendants’ argument that the parties’ franchise agreement demonstrated that the plaintiffs were employed solely by 455 Hospitality, which was merely an independent contractor of the franchisor defendants. The court held that economic realities, not contractual labels, determine employment status for the remedial purposes of the FLSA and the economic realities pled by the plaintiffs plausibly supported an inference that the franchisor defendants exerted sufficient control over the hotel employees to meet the definition of a joint employer under the FLSA. Thus, based upon its review of the totality of the circumstances, the court held that the plaintiffs pled sufficient facts to plausibly suggest functional control by the franchisor defendants and, as a result, denied the franchisor defendants’ motion to dismiss the complaint as against them.

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

NONCOMPETE AGREEMENTS

This case is discussed under the topic heading “Oral Agreements.”

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

This case is discussed under the topic heading “Trademark Infringement.”

Based on a covenant not to compete, plaintiff U.S. Lawns, Inc. filed a motion for a preliminary injunction to enjoin defendant Landscape Concepts of CT, LLC from competing with the franchisor after expiration of the franchise. The U.S. District Court for the Middle District of Florida granted the motion, finding the noncompetition clause in the franchise agreement to be enforceable under Florida law because the franchisor had adequately established one or more legitimate business interests justifying the noncompetition clause, including protecting the viability and goodwill of its franchise system and preventing previous franchisees from breaching their franchise agreements. Additionally, the court found the noncompetition clause to be reasonable in scope and duration because it only prohibited the sale or offer of landscape services to persons or business entities that were a customer of the franchisor or of specific franchise owners within twenty-four months after termination of the franchise agreement.

The preliminary injunction prohibited the franchisee from offering or selling any landscape maintenance services or rendering any landscape maintenance services that were the same or similar to those offered, sold, or rendered by the franchisor. Further, the franchisee was barred from diverting any business to competitors of the franchisor. Additionally, the franchisee’s new corporate entity, which did not sign the original franchise agreement, was bound by the preliminary injunction as a person “in active convert or participation with” the franchisee under Federal Rule of Civil Procedure 65. The injunction bond was set at $500,000, based on franchisor’s estimated lost profits for the two-year injunction period.

ORAL AGREEMENTS

H&R Block Tax Services, LLC sought to enforce a settlement agreement it purportedly reached with a franchisee in a dispute related to a franchise agree-
ment that licensed the franchisee to operate tax return preparation offices under the H&R Block service mark. The U.S. District Court for the Northern District of New York denied enforcement of the settlement agreement.

The franchisee and the franchisor’s predecessor-in-interest entered into a satellite franchise agreement in September 1984 that enabled the franchisee to operate a tax return preparation office in Cobleskill, New York, under the H&R Block service mark. The franchise agreement automatically renewed every five years and, upon termination or expiration, prohibited the franchisee from soliciting former clients or competing with the franchisor within forty-five miles of Cobleskill for one year. Prior to the expiration of the most recent term, the franchisor notified the franchisee that it would not renew the 1984 version of the franchise agreement and instead offered an updated version for the parties to execute. The franchisee declined to sign the updated version, and the parties’ franchise relationship terminated on September 1, 2014.

About five months later, the franchisor secured a temporary restraining order (TRO) enjoining the franchisee from competing with the franchisor within forty-five miles of Cobleskill and soliciting clients of the Cobleskill office. The franchisor then moved to hold the franchisee in contempt of the TRO. The court granted the contempt order on July 7, 2015, and extended the covenants against competition and solicitation in the franchise agreement for an additional year.

Prior to the contempt order, the court ordered the parties to attend mandatory mediation, which took place on July 21. The franchisee attended mediation with her counsel at the time, Gregory Schaaf. The parties agreed during mediation on the general terms that would be included in any settlement agreement and agreed to exchange settlement proposals with more detailed terms. The franchisor’s counsel emailed the final settlement proposal, which largely tracked the general terms the parties agreed to at mediation, to Schaaf a week after mediation. Five days later, Schaaf left a voicemail accepting the on behalf of the franchisee and asking the franchisor’s counsel to prepare formal settlement documents for the franchisee to sign. On August 12, the franchisor’s counsel emailed the formal settlement documents, which contained a merger clause that stated the agreement constituted the entire agreement of the parties and superseded all prior agreements concerning the same subject matter. The franchisee did not sign the formal settlement documents, and on August 24, Schaaf informed the franchisor’s counsel that he had been discharged by the franchisee.

In response to the franchisor’s motion to enforce the settlement agreement, the franchisee argued she never gave Schaaf authorization to settle on her behalf and thus the settlement agreement was unenforceable as a matter of contract law. Using the four factors outlined by the Second Circuit in Winston v. Mediafire Entertainment Corp., 777 F.2d 78, 80 (2d Cir. 1985), the court denied enforcement of the settlement agreement. While no single factor under Winston was dispositive, the Second Circuit emphasized the first
factor (whether there was an express reservation of the right not to be bound in the absence of a writing) was particularly important because a court need look no further where there is a writing between the parties indicating that one party did not intend to be bound. Here, even though the parties never explicitly reserved the right not to be bound in the absence of a writing, the final settlement proposal prepared by the franchisor’s counsel contained a merger clause. The court noted that the Second Circuit previously found a similarly worded merger clause to be persuasive evidence that the parties did not intend to be bound prior to the execution of a written agreement. Thus, although the other three factors were neutral when taken together, the court reasoned that it had no choice but to deny enforcement due to the merger clause in the settlement agreement the franchisor sought to enforce.

RELEASES


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

REMOVAL


A home care franchisee filed suit for declaratory relief that various provisions of the franchise agreement entered into with Synergy Homecare Franchising were invalid and unenforceable. Synergy removed the case to the U.S. District Court for the Northern District of California and filed a motion to dismiss and to compel arbitration. The court stayed any decision on the motion to dismiss pending the franchisee’s motion to remand.

District courts have original jurisdiction over all civil actions between citizens of different states and where the matter in controversy exceeds $75,000. 28 U.S.C. § 1332(a). The franchisee first argued that the amount in controversy was not met because a contemporaneous arbitration claim by the franchisor against the franchisee had a value of $12,000. The court disregarded this argument because the arbitration claim represented an unrelated claim by the franchisor and had no bearing on the value of the purported claims by the franchisee.

Next, the franchisee claimed that the claims of the three defendants (franchisee business entity and two individual owners and guarantors) could not be aggregated to reach the minimum amount in controversy to support removal. The court found that the claims were not separate and distinct be-
cause they arose out of the same franchise agreement and from the same set of facts.

Finally, the court found that, regardless of whether the claims were valued by potential revenue or income, they exceeded the jurisdictional threshold, and thus, removal was proper.

STATE DISCLOSURE/REGISTRATION LAWS


After a franchisor terminated its franchisee’s license agreement and filed trademark infringement claims, its franchisee brought counterclaims, alleging violations of the Indiana Franchise Act and the Indiana Deceptive Franchise Practices Act. However, because the franchisee, a limited liability company, was a resident of Colorado, the U. S. District Court for the Southern District of Indiana dismissed the franchisee’s claims under the Indiana Franchise Act and the Indiana Deceptive Franchise Practices Act.

The franchisor (7E), located in Indiana, entered into a licensing agreement with the franchisee (Highlands Ranch), pursuant to which the franchisee obtained a license to use the franchisor’s intellectual property and system in connection with its health spa business within a four-mile radius surrounding a licensed location in Littleton, Colorado. Believing that Highlands Ranch failed to materially comply with the terms of the license agreement, 7E ultimately terminated the parties’ license agreement. When Highlands Ranch failed to cease using 7E’s trademark and system in connection with its spa business in Colorado, 7E commenced an action alleging, inter alia, trademark infringement. Highlands Ranch filed a sixteen-count counterclaim, including claims for violations of the Indiana Franchise Act and the Indiana Deceptive Franchise Practices Act, which 7E moved to dismiss.

The principal issue addressed by 7E’s motion to dismiss was whether Highlands Ranch had standing to assert claims under the two Indiana franchise statutes. 7E contended that these statutes apply only where the franchisee is an Indiana resident or has a business operated in Indiana and that regardless of the foregoing, the subject licensing agreement did not create a franchise as defined in the statutes.

Under both statutes, a franchise means a contract by which (1) a franchisee is granted the right to engage in the business of dispensing goods or services, under a marketing plan or system prescribed in substantial part by a franchisor; (2) the operation of the franchisee’s business pursuant to such a plan is substantially associated with the franchisor’s trademark; and (3) the person granted the right to engage in this business is required to pay a franchise fee. Ind. Code §§ 23-2-2.5-1(a); 23-2-2.7-5. If a franchise exists, Indiana’s statutory provisions will apply to the franchise if “(a) the offeree or franchisee
is an Indiana resident; or (b) the franchise business contemplated by the offer or franchise will be or is operated in Indiana.” IND. CODE § 23-2-2.5-2.

Because the franchisee’s counterclaim sufficiently alleged the elements of a franchise, as defined under the statutes, the court denied the franchisor’s motion to the extent it was based upon the ground that the existence of a franchise had not been pleaded. However, despite the allegation that the franchisee was an Indiana limited liability company with its business office in Indiana and business operations in Colorado, the court held that the franchisee did not have standing to assert claims under the Indiana statutes. Specifically, for purposes of the Indiana statutes, the court held that the state of formation and principal place of business were inapposite for limited liability companies because the citizenship of a limited liability company is the citizenship of each of its members under Indiana law. Because each member of Highlands Ranch was a citizen of Colorado, Highlands Ranch was a citizen of Colorado and, therefore, not a citizen of Indiana. As a result, the court held that the Indiana statutes did not apply to the alleged franchise created by the parties’ licensing agreements and therefore dismissed Highlands Ranch’s claims under both of the Indiana statutes.

The court also considered a number of other challenges to Highlands Ranch’s complaint. First, 7E moved to dismiss Highlands Ranch’s claims for breach of the implied covenant of good faith and fair dealing, arguing that the implied covenant applies, under Indiana law, only to insurance and employment agreements. Based on that limitation, and the failure to allege in the counterclaim that the contracts were ambiguous, the court dismissed these claims.

Second, 7E moved to dismiss Highlands Ranch’s claims for unjust enrichment and promissory estoppel, arguing that these equitable claims are available only when no express contract exists. The court declined to dismiss these claims, finding that parties may plead claims in the alternative and that Highlands Ranch had pled factual allegations sufficient to support these claims.

Third, 7E sought to dismiss Highlands Ranch’s claims for tortious interference with a contract and tortious interference with a business relationship on the ground that the counterclaim did not allege illegal conduct. Agreeing with 7E, the court dismissed the tortious interference with a business relationship claim. However, the court declined to dismiss the interference with a contract claim, finding that all requisite elements under Indiana law were sufficiently pled.

Finally, the court declined to dismiss Highlands Ranch’s fraud claims under the heightened pleading standard of Federal Rule of Civil Procedure 9(b), finding that the counterclaim provided the necessary level of specificity to support the fraud claims at the dismissal stage of the litigation.

_Ford Motor Co. v. Darling’s, Bus. Franchise Guide (CCH) ¶ 15, 869, 151 A.3d 507 (Me. 2016)_

The Supreme Judicial Court of Maine held that, pursuant to the Maine Dealers Act, 10 ME. REV. STAT. § 1174(3)(B), a proposed modification of a franchise
remains ineffective unless and until a manufacturer provides a dealer with clear written notice of the modification in conformity with the statute and necessary to trigger the dealer’s opportunity to request a good cause determination.

In 1989, Darling’s and Ford entered into a service and sales agreement. In 2000, Ford created the Blue Oval Certified (BOC) program, which provided special certificates to dealers that met certain standards—those dealers received a 1.25% cash bonus on every automobile sale. Four years later, Ford announced that it was ending the BOC program. In response to the cancellation, Darling’s filed suit alleging, among other claims, that Ford’s termination of BOC payments constituted a modification of the franchise that substantially and adversely affected Darling’s rights, obligations, investment, or return on investment in violation of the Dealers Act.

Following a decision by the Motor Vehicle Board that Ford violated the Dealers Act when it failed to give proper notice, Darling’s was awarded $145,223.08 in damages. Those damages represented the amount Darling’s would have earned during a 270-day period. The period represented the ninety-day period within which a dealer may file a protest, plus the 180-day period within which the Board must decide the matter.

The sole issue on appeal was the calculation of damages arising from Ford’s violation of the notice requirement. The court held that, because Ford failed to provide adequate notice, the obligation to pay under the BOC program remained in place and Darling’s damages continued to accrue. Accordingly, the court held that the lower court erred by limiting the damages only to the 270-day period.


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

**STATUTE OF LIMITATIONS**


This case is discussed under the topic heading “Statutory Claims.”

**STATUTORY CLAIMS**


This case is discussed under the topic heading “Good Faith and Fair Dealing.”

Two Volkswagen dealerships brought an action against Volkswagen for violations of the New York Franchised Motor Vehicle Dealer Act, N.Y. VEH. & Traf. LAW § 460, based on Volkswagen’s allegedly unfair incentive and benefit programs. The dealerships’ claims arose from Volkswagen’s dealer agreements, which set out a system for evaluating each dealer’s sales performance (Dealer Sales Index). Volkswagen uses the Dealer Sales Index to provide performance incentives for dealerships via Volkswagen’s Variable Bonus Program. The plaintiffs underwent various ownership changes, and, after requesting additional records regarding the structural changes, Volkswagen demanded that the plaintiffs sign new dealer agreements, which contained, inter alia, additional agreements, guarantees, and releases.

The dealerships sought injunctive and declaratory relief under Section 463(2)(g) of the New York Dealer Act, which makes it unlawful to sell or offer to sell any new motor vehicle to any franchised motor vehicle dealer at a lower actual price than the actual price offered to any other franchised motor vehicle dealer for the same model vehicle similarly equipped or to utilize any device including, but not limited to, sales promotion plans or programs that result in such lesser actual price. The district court granted dismissal on the plaintiffs’ Section 463(2)(g) claims. Although the dealership alleged its consumers’ car preferences made it impossible to meet the bonus criteria, the district court agreed with Volkswagen that the bonus program was not applied disproportionately merely because it did not take into account specific consumer preferences.

The district court also addressed the plaintiffs’ Section 463(2)(gg) claim, which makes it illegal for a franchisor to use an unreasonable, arbitrary, or unfair sales or other performance standard in determining a franchised motor vehicle dealer’s compliance with a franchise agreement. The district court found that claims related to Volkswagen’s lack of consideration related to local consumer preferences and the threat of falling short of the Dealer Sales Index, which could subject the dealerships to early termination, could go forward. Finally, the district court dismissed the plaintiffs’ claims that Volkswagen unreasonably withheld its consent to the ownership transfers and made unreasonable modifications to the dealer agreements in violation of the New York Dealer Act.

The plaintiffs appealed the district court’s opinion and order and the Second Circuit vacated and remanded the judgment to consider a recent holding from the New York Court of Appeals, Beck Chevrolet Co. v. General Motors LLC, 27 N.Y.3d 379 (N.Y. 2016), which held that franchisor sales performance standards relying on state-wide data and that do not take into account local brand popularity violate Section 463(2)(gg) of the New York Dealer Act. Summary Order, CMS Volkswagen Holdings, LLC v. Volkswagen Grp. of Am., Inc., No. 15-3961-cv (2d Cir. Nov. 18, 2016), ECF No. 93.
The plaintiffs operated two franchises—Giuffre Kia and Giuffre Hyundai. In connection with disputes arising as a result of the defendants’ termination of both franchise agreements, the plaintiffs brought this action against Kia, Hyundai, and its financier Hyundai Capital for, inter alia, price discrimination in violation of the Robinson-Patman Act, 15 U.S.C. § 13; violations of the New York Franchised Motor Vehicle Dealer Act, N.Y. VEH. & Traf. Law § 460; California dealer statutes; Automobile Dealer’s Day in Court Act, 15 U.S.C. § 1221 (ADDCA); and various common law theories. The U.S. District Court for the Eastern District of New York dismissed the plaintiffs’ price-discrimination claims against Hyundai and all claims against Kia.

First, the plaintiffs’ price discrimination claim against Hyundai arose from certain advertising subsidies Hyundai was allegedly providing to competing Hyundai franchisees. The district court found that the plaintiffs’ claims were time barred by the four-year statute of limitations under the Robinson-Patman Act. In addition, the court noted that, even if timely, the price-discrimination claims against Hyundai would be barred by the release of claims contained in the prior settlement agreement reached by the parties concerning the advertising subsidies at issue.

Next, the district court examined the plaintiffs’ claims against Kia for refusal to approve a sales agreement for Giuffre Kia’s dealership after Kia provided notice that it was terminating the franchise agreement. After receiving the termination notice from Kia, the plaintiffs and Kia entered into an interim settlement agreement to extend the effective date of termination and Kia agreed to consider the asset purchase agreement for the dealership. The agreement, however, specifically stated that the plaintiffs agreed not to challenge Kia’s decision, even if Kia declined to approve the sale agreement, and it also contained a merger provision. The plaintiffs’ claims were based on Kia’s subsequent refusal to approve the sale agreement.

As an initial matter, the district court determined that the interim settlement agreement superseded the franchise agreement. In addition, the court applied the choice-of-law rules of New York and determined that the grouping of contacts weighed in favor of applying New York law because the plaintiffs were New York citizens and the dealership subject to the agreement was located in New York. The court held that the interim settlement agreement was a valid agreement pursuant to which the plaintiffs agreed to release all claims against Kia with regard to Kia’s decision as to the sale agreement. In doing so, the court rejected the plaintiffs’ contention that Kia fraudulently induced them to enter into the interim settlement agreement because it never intended to review the sale agreement. Instead, the district court agreed with Kia’s position that a fraud claim cannot be based on an alleged misrepresentation of a party’s intention to perform its contractual promises. The court also held that the extension of the termination date
allowed the plaintiffs to avoid costs of litigating the termination notice—a bargained-for advantage—which constituted valid consideration.

Lastly, the court dismissed the plaintiffs’ claims regarding the dealership’s remaining inventory. The plaintiffs contended that following the termination, Kia was required to purchase the remaining inventory for fair and reasonable value. Instead, the plaintiffs argued that Hyundai Capital repossessed the remaining inventory and sold it to Kia for less than fair value in violation of the New York Dealer Act § 463(2)(o) & (u). The New York Dealer Act prevents a franchisor from using a third-party source to engage in acts on behalf of the franchisor where the franchisor is prohibited from engaging in such an act. The court found that although Section 463(2)(o) makes it unlawful for a franchisor to refuse to purchase any returned inventory at less than fair and reasonable value, the New York Dealer Act does not regulate the conduct of a judgment creditor disposing of property it has repossessed. Because Hyundai Capital repossessed the remaining inventory to satisfy judgments against the plaintiffs, the Act did not apply to and the plaintiffs failed to state a claim against Kia under the New York Dealer Act.

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

In a dispute arising from an automobile manufacturer’s refusal to consent to the relocation of its licensed dealer’s retail sales location, the U.S. District Court for the Northern District of California dismissed the dealer’s claims against the manufacturer under the federal Automobile Dealer’s Day in Court Act, California’s Motor Vehicle Dealer Law, and the implied covenant of good faith and fair dealing.

Defendant FCA US, LLC (FCA) is the manufacturer and distributor of Chrysler, Dodge, Jeep, and Ram motor vehicles. Pursuant to a series of agreements, plaintiff Mathew Enterprise, Inc. operated a franchised motor vehicle dealership selling FCA’s Chrysler, Dodge, Jeep, and Ram motor vehicles. On December 6, 2006, Mathew entered into a two-year lease with FCA for Mathew to occupy its franchised dealership location. In addition to the lease, the parties executed a sales and service agreement, which provided that Mathew could not change the location of the dealership without the prior written approval of FCA.

In December 2015, FCA sent a letter to Mathew stating that, since the parties’ 2006 lease had expired in 2008, Mathew had thereafter been a “holdover tenant” at the dealership location. FCA provided Mathew with a proposed new dealer lease, but Mathew refused to agree to its terms. Thereafter,
Mathew requested FCA’s approval for it to relocate and enter into a new fac-
cility plan at a location less than a mile away from its existing operation lo-
cation. FCA rejected the relocation proposal and, upon Mathew’s resubmis-
sion, again rejected the proposal. Thereafter, Mathew commenced this
action, asserting three causes of action: (1) violation of the federal Automo-
ble Dealer’s Day in Court Act, 15 U.S.C. § 1222 (ADDCA); (2) violation of
California Vehicle Code § 3060; and (3) breach of the implied covenant of
good faith and fair dealing. FCA moved to dismiss each of these claims.

In its first claim, Mathew alleged that FCA violated the ADDCA by re-
jecting its relocation proposal and insisting that Mathew remain at its cur-
rent location, which was economically unsustainable, to coerce Mathew to
abandon its franchise and exit the business. In order to state a claim under
the ADDCA, a plaintiff must allege, inter alia, that it was injured by the de-
fendant’s failure to act in good faith in performing or complying with any of
the terms or provisions of the franchise, or in terminating, canceling, or not
renewing the franchise. The issue before the court was whether Mathew had
adequately alleged that FCA failed to “act in good faith.”

Under the ADDCA, good faith has a limited and restricted meaning. It is
not lack of good faith in the ordinary sense, but a lack of good faith in which
coercion, intimidation, or threats are at least implicit. More specifically, co-
ercion or intimidation must include a wrongful demand that will result in
sanctions if not complied with. The court began its analysis by finding
that Mathew had no legal right to move to a location of its own choosing
under the terms of the parties’ agreements. As a result, the court held that
FCA’s denial of Mathew’s relocation requests did not amount to coercion
or intimidation within the meaning of the ADDCA. Accordingly, because
Mathew had failed to allege that FCA acted in bad faith within the meaning
of the ADDCA, its claim under that statute was dismissed as a matter of law.

Mathew’s next claim alleged that FCA violated California Vehicle Code
§ 3060 by constructively terminating its franchise without providing written
notice and without a finding by the California New Motor Vehicle Board
(CNMVB) of “good cause for termination,” as required by Section 3060.
FCA contended that Mathew failed to state a claim for violation of Sec-
tion 3060 because a violation of that section falls within the jurisdiction of
the CNMVB and Mathew had failed to exhaust its administrative remedies
available therefrom.

The court began its analysis by noting that claims filed pursuant to Sec-
tion 3060 of the California Vehicle Code fall within the CNMVB’s jurisdic-
tion and that California courts have routinely held that where administrative
remedies are provided by statute, relief must be sought from the administra-
tive body and this remedy exhausted before the courts will act. Accordingly,
in this context, the court noted that California courts have held that the
CNMVB is the administrative forum authorized to make good cause deter-
minations under Section 3060 and provide administrative remedies and that
a party that fails to exhaust its administrative remedies within the CNMVB is
precluded from seeking judicial relief. As a result, because Mathew’s complaint contained no allegation that it exhausted its administrative remedies with the CNMVB prior to filing this action, the court dismissed Mathew’s claims under Section 3060.

Finally, Mathew asserted a claim for breach of the implied covenant of good faith and fair dealing as a result of FCA’s refusal to approve its relocation proposal. Reviewing applicable Michigan law, the court noted that Michigan generally does not recognize a claim for breach of the implied covenant of good faith and fair dealing, although courts have recognized such a duty when a party to a contract makes the manner of its performance a matter of its own discretion. Michigan law further provides that discretion arises, and thus the implied covenant is recognized, when the parties have agreed to defer decision on a particular term of the contract or from a lack of clarity or from an omission in the express contract. However, where the plain language of an agreement gives a decision exclusively to one party to the agreement, the contract presumes no discretion and thereby removes any basis upon which to imply a covenant of good faith and fair dealing. Reviewing the parties’ contract, the court noted that the contract gave FCA the authority to approve or disapprove relocation for its own reasons and thus set out the limits of what the contract required of the parties. In other words, the parties’ agreement presumed no discretion and thereby removed any basis upon which to imply a covenant of good faith and fair dealing. As a result, the court dismissed Mathew’s implied covenant claim as a matter of law.


Upon an exhaustive review of the proceedings in the district court through trial, the First Circuit has held that a Puerto Rico food distributor’s claim that a food products manufacturer, Hormel, violated their alleged oral exclusive distribution agreement for retail refrigerated food products by selling those products to statewide distributors that in turn sold them in Puerto Rico was time-barred by the Puerto Rico Dealers’ Contracts Act’s three-year statute of limitations.

This case involves a dispute over an unwritten and allegedly exclusive distributorship agreement between plaintiff Medina & Medina, Inc. and defendant Hormel Foods Corp. under Puerto Rico’s Dealer’s Contracts Act (Law 75), P.R. LAWS ANN. § 278-278e. Medina, a Puerto Rico-based distributor of refrigerated food products, commenced an action against Hormel seeking a declaration that Medina was the exclusive distributor of Hormel’s retail refrigerated food products in Puerto Rico. Medina also claimed that Hormel violated the exclusive distribution agreement and, thus, Law 75, by selling refrigerated food products to Costco, bypassing Medina, and subsequently refusing to sell its new refrigerated food products to Medina as a result of its commencement of this action.
Law 75 governs the business relationship between principals and their locally appointed distributors in Puerto Rico that market their products. The statute was enacted to avoid the inequity of arbitrary termination of distribution relationships once the designated dealer had successfully developed a local market for the principal’s products. Law 75 prohibits principals from engaging in conduct that, directly or indirectly, impairs or is detrimental to the established relationship without just cause. Law 75 enumerates certain detrimental acts that give rise to a rebuttal presumption of an impairment, which include establishing a distribution relationship with one or more additional dealers for the area of Puerto Rico in conflict with the contract existing between the parties. P.R. LAWS ANN. § 278 a-1(b)(2). However, courts construing this provision have been clear that while non-exclusive distributors are entitled to the protections of Law 75, the statute does not operate to convert non-exclusive distribution contracts into exclusive distribution contracts.

The parties’ claims were evaluated by the district court through multiple proceedings, including, ultimately, a bench trial. After the trial, the district court reached the following conclusions: (1) Medina’s exclusivity claim was time-barred by the three-year statute of limitations under Law 75; (2) Hormel’s counterclaim that Medina was not its exclusive distributor was moot in light of the court’s statute of limitations ruling; (3) notwithstanding the time-bar for Medina’s exclusivity claim, Hormel’s sales of refrigerated food products to Costco violated Law 75; and (4) Hormel was not liable for refusing to sell its new refrigerated food products to Medina. The parties cross-appealed.

On appeal, Medina argued that the district court fundamentally misunderstood its exclusivity claim, construing it as one of “airtight exclusivity,” a type of exclusive arrangement that prohibits stateside distributors from reselling products into the Puerto Rico market. Rather, Medina argued that it had only claimed to be the exclusive distributor based in Puerto Rico for Hormel’s retail refrigerated food products. In its cross-appeal, Hormel contended that the court’s imposition of liability for Hormel’s Costco transactions was inconsistent with the court’s finding that any exclusivity claim was barred by the applicable statute of limitations.

The First Circuit undertook an exhaustive review of the record, including the factual record, pleadings, summary judgment argument and determination, trial, and the district court’s final order after trial. In construing the record, the court noted that there was an “Alice-in-Wonderland” quality to the case in that Medina faulted the district court for construing its exclusive distribution claim as one of “airtight exclusivity,” arguing it never sought airtight exclusivity, while the pleadings and other proceedings demonstrate that Medina did so. Focusing on this issue, the court ultimately found that Medina had, at all times, asserted a claim of airtight exclusivity—that is, an alleged agreement that prohibits stateside distributors from reselling Hormel products into the Puerto Rico market as well as Hormel’s direct sales into the Puerto Rico market—and affirmed the district court’s under-
standing and disposition of the exclusivity claim on that basis. As a result, the court had little difficulty in affirming the district court’s dismissal of the exclusivity claim based on Law 75’s three-year statute of limitations. Further, based upon its holding concerning “airtight exclusivity,” the court reversed the district court by holding that Medina’s claim that Hormel’s sales of refrigerated food products to Costco was likewise barred by Law 75’s statute of limitations. Finally, the court affirmed the district court’s finding that Hormel’s counterclaim that Medina was not its exclusive distributor was moot in light of the dismissal of Medina’s claims and that Hormel was not liable for refusing to sell its new retail refrigerated food products to Medina.

This case is discussed under the topic heading “Good Faith and Fair Dealing.”

In this dispute between watch manufacturer Swatch and its authorized dealer of Swatch’s premier “Omega” brand of watches, the Third Circuit modified a district court’s determination of the parties’ respective motions for summary judgment, concluding that the dealer failed to establish that the parties’ relationship was a franchise as that term is defined in the New Jersey Franchise Practices Act. The court also found that the dealer raised genuine issues of material fact, precluding summary judgment, concerning its claim that the watch manufacturer violated the Robinson Patman Act by failing to provide promotional benefits to all of its authorized dealers in a proportionately equal manner. The court affirmed the district court’s denial of the dealer’s motion to strike Swatch’s answer based upon alleged evidence spoliation.

Defendant The Swatch Group (U.S.) Inc. is a manufacturer of watches under various brand names. Plaintiff Orologio of Short Hills, Inc. operates a business in The Mall at Short Hills in Millburn, New Jersey, selling high-end watches of various brands. Since 1994, the plaintiff’s shop was an authorized dealer of Swatch’s premier “Omega” brand of watches. Pursuant to the informal understanding between the parties (there was no written agreement), the plaintiff purchased Omega watches from Swatch for resale, was permitted to display Swatch’s trademarks, and benefitted from advertising assistance from Swatch. In 2011, Swatch terminated its relationship with the plaintiff because Swatch planned to open its own company store in The Mall at Short Hills.

Upon being terminated as an authorized Omega dealer, the plaintiff brought suit first in New Jersey state court alleging that, under the New Jersey Franchise Practices Act (FPA), N.J. STAT. ANN. § 56:10-4, it was a fran-
chisee of Swatch and that Swatch’s termination of their business relationship without cause violated New Jersey law. After the state court denied the plaintiff relief, the plaintiff filed its complaint in federal court, seeking declaratory and injunctive relief for its FPA claim along with claims under Section 2(d) and (e) of the Robinson-Patman Act, 15 U.S.C. § 13(d) and (e) (RPA) and a state law claim for breach of the implied covenant of good faith and fair dealing. The plaintiff’s RPA claims rested on the allegation that Swatch failed to provide promotional benefits to all of its authorized Omega dealers in a way that was “available on proportionately equal terms.” 15 U.S.C. § 13(d).

After discovery, the parties cross-moved for summary judgment and the plaintiff moved to strike Swatch’s answer based upon its alleged spoliation of evidence. The district court found in favor of Swatch on all counts and entered a corresponding order. The plaintiff appealed, seeking reversal of the district court’s grant of summary judgment on the FPA and RPA claims and reversal of the district court’s denial of its motion to strike Swatch’s answer. Upon review, the Third Circuit concluded that the district court properly entered summary judgment in favor of Swatch on the plaintiff’s FPA claim and did not abuse its discretion in denying the plaintiff’s motion to strike and issue sanctions. However, because the court perceived genuine factual disputes concerning the plaintiff’s RPA claims, the court reversed the district court’s order granting summary judgment of those claims and remanded the case for further proceedings.

Regarding its FPA claim, the plaintiff alleged that its relationship with Swatch was a franchise as that term is defined in the FPA and that its termination without cause was thus in violation of the statute. The FPA makes it unlawful for a franchisor to terminate, cancel, or fail to renew a franchise without having first given a written notice setting forth all the reasons for such action at least sixty days in advance or to take such action without good cause. N.J. STAT. ANN. § 56:10-5. While there are a number of additional requirements a franchisee must meet before it can benefit from the FPA, a business must first demonstrate that its business relationship meets the threshold definition of a franchise under the statute, which provides that a franchise “means a written arrangement for a definite or indefinite period, in which a person grants to another person a license to use a trade name, trademark, service mark, or related characteristics, and in which there is a community of interest in the marketing of goods or services at wholesale, retail, by lease, agreement, or otherwise.” N.J. STAT. ANN. § 56:10-3(a).

Although the district court considered each component of the franchise definition, the Third Circuit addressed only the “community of interest” element of the definition. Citing federal and state case law, the court noted that the community of interest analysis is a balancing test in which the court considers four factors: (1) licensor’s control over the licensee; (2) the licensee’s economic dependence on the licensor, (3) the disparity in bargaining power, and (4) the presence of a franchise-specific investment by the li-
censee. Reviewing these factors, and taking into account the purpose of the FPA, the court concluded there was no community of interest between the plaintiff and Swatch. First, although the plaintiff alleged that it obtained nearly 25 percent of its revenue from Omega sales, New Jersey courts have not been persuaded that there is a community of interest even when an alleged franchisee obtains 38 percent of its revenue from the alleged franchisor’s product or service. Moreover, the plaintiff obtained and sold watches from other suppliers and thrived after losing its ability to sell Omega watches, making it clear that the plaintiff was not economically dependent upon Swatch. Second, although the plaintiff alleged it made two types of franchise-specific investments during its relationship with Swatch, the court found that the plaintiff failed to establish non-recoupable investments specific to the license relationship such that it could not find that the plaintiff lacked bargaining power with Swatch sufficient to create a community of interest. Third, the court discerned no significant level of control exerted by Swatch over the plaintiff. As a result, the court affirmed the district court’s dismissal of the FPA based upon a failure to establish the requisite community of interest.

On the other hand, the appeals court reversed the district court’s dismissal of the plaintiff’s RPA claim. Section 2(d) of the RPA makes it unlawful for a supplier in interstate commerce to grant advertising or other sales promotional allowances to one customer that resells the supplier’s products or commodities unless the allowances are available on proportionately equal terms to all other customers competing in the distribution of such products or commodities. The court noted that in practice, this means that entities like Swatch that provide products to retailers like the plaintiff may not offer promotional assistance to its retailers unless the programs are administered based on some objective, proportionately equal criteria rather than at the whim of a supplier, and unless all retailers that compete with one another are on notice of the availability of such programs.

The district court granted Swatch summary judgment on the plaintiff’s RPA claims for two independent reasons: (1) the plaintiff failed to provide record evidence of who its competitors were; and (2) even if it had, promotional assistance was available on proportionately equal terms. However, upon review of the record, the appeals court disagreed and reversed, finding that the plaintiff had pointed to record evidence sufficient to present a genuine issue of material fact as to the plaintiff’s competitors that warranted consideration by a finder of fact; that the plaintiff had provided record evidence that calculated its lost revenues as a result of Swatch’s provision of certain promotional assistance to its competitors, again sufficient to create a disputed issue of fact; and that the plaintiff had provided record evidence that Swatch offered promotional assistance to its competitors on proportionately unequal terms sufficient to raise a triable issue of fact. As a result, the court reversed the district court’s order granting summary judgment to Swatch on
the plaintiff’s claims under the RPA and remanded to the district court for further proceedings.

Finally, the plaintiff had filed a motion in the district court to strike Swatch’s answer and issue sanctions based on its alleged spoliation of evidence, based on Swatch’s destruction (during the course of the litigation) of video tapes that contained television commercials provided to certain Omega retailers. The district court denied the motion, finding that the plaintiff failed to show bad faith on the part of Swatch. Reviewing the record evidence, including email exchanges between Swatch personnel concerning the destruction of the videotapes, the Third Circuit affirmed the district court’s determination that Swatch’s employees did not act in bad faith. As a result, the district court did not make a clearly erroneous assessment of the evidence and did not abuse its discretion in denying the plaintiff’s motion based on lack of showing bad faith on the part of Swatch.


This case is discussed under the topic heading “Good Faith and Fair Dealing.”


This case is discussed under the topic heading “Contract Issues.”


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

**TAXATION**


The U.S. District Court for the Southern District of New York lacked subject matter jurisdiction to hear a claim that New York City Dunkin’ Donut stores assessed an unlawful surcharge to customers, in the guise of a sales tax, on its sale of prepackaged coffee, finding that the administrative remedies provided for by New York Tax Law Section 1139 were the exclusive remedies for seeking a refund of a sales tax.

The plaintiffs, who were Dunkin’ Donuts retail customers, commenced a collective action asserting claims arising from an alleged unlawful surcharge, disguised as a “sales tax,” on the sale of prepackaged coffee at New York City Dunkin’ Donuts stores. The plaintiffs asserted claims for breach of contract,
unjust enrichment, negligence, fraud, and violations of New York General Business Law Section 349. The defendants were Dunkin’ Brands, Inc. (DBI), four named Dunkin’ Donuts stores, and 500 unnamed Dunkin’ Donuts stores in New York. Defendants DBI and the named Dunkin’ Donuts stores moved to dismiss the First Amended Complaint pursuant to Federal Rules of Civil Procedure 12(b)(1) and 12(b)(6).

Specifically, the plaintiffs alleged that under New York law, customers should not be charged a sales tax in connection with the purchase of prepackaged coffee and that the defendants included a surcharge on prepackaged coffee under the guise of a “sales tax.” Each of the plaintiffs alleged that they purchased prepackaged coffee from Dunkin’ Donuts stores and were assessed a surcharge of $.89 on each purchase, which was listed as sales tax on the store receipt.

New York Tax Law Section 1139 dictates how a taxpayer may seek a refund for a sales tax that was erroneously, illegally, or unconstitutionally collected. Further, New York Tax Law Section 1140 establishes that the remedies delineated by Sections 1138 and 1139 are exclusive, which exclusive remedies have been upheld by federal district courts in New York. The court held the plaintiffs’ allegations, namely, that the defendants improperly collected sales tax on prepackaged bags of coffee, fall within the ambit of the exclusive remedy provided by New York Tax Laws Sections 1139 and 1140, and that this conclusion could not be changed by referring to the tax as a mere “surcharge.” As a result, because New York law is clear that Section 1139 provides the exclusive remedy for the refund of any tax “erroneously, illegally, or unconstitutionally” collected, the court held it was without jurisdiction to adjudicate the claims set forth in the complaint. Accordingly, the court dismissed the plaintiffs’ complaint under Federal Rule of Civil Procedure 12(b)(1). (Readers should note that on November 4, 2016, the plaintiffs filed a notice of appeal to the Second Circuit.)

TERMINATION AND NONRENEWAL

The Supreme Court of Nebraska has held that, under applicable Nebraska law, a terminated donut shop franchisee did not breach an implied-in-fact franchise agreement by failing to pay its franchisor royalty and advertising fees after the franchisor directed the franchisee to discontinue using the benefits of the expired franchise agreement, notwithstanding the fact that the franchisee continued to operate its store using the franchisor’s trademark and system for more than two years after that direction.

Franchisor Donut Holdings, Inc. (DHI) and franchisee Risberg Stores, LLC entered into a franchise agreement in 1994, which had a ten-year
term. When the term ended in 2004, neither Risberg nor DHI took any action to formally extend the term of the franchise agreement. Instead, Risberg continued to operate the store and continued to pay DHI royalty and advertising fees, which DHI accepted. Risberg stopped paying royalties and fees to DHI on June 7, 2009. In a letter dated June 18, 2009, DHI advised Risberg that, because it had not taken any steps to renew the 1994 franchise agreement and the agreement expired in 2004, Risberg should review the provisions of the franchise agreement related to its obligations upon the expiration of the agreement, which included immediate discontinuance of the franchisee’s use of the franchisor’s trademarks and system. Despite this letter, Risberg continued to operate its store using the franchisor’s trademarks and system and continued to report its sales to DHI; however, Risberg did not actually pay any royalties or marketing fees to DHI after June 2009.

In December 2009, DHI sent Risberg another letter stating that, to the extent that the franchise agreement had not expired by its own terms, DHI was terminating the agreement effective immediately based upon Risberg’s nonpayment of royalties. Notwithstanding this termination notice, Risberg continued to operate using the franchisor’s trademarks and system until October 2011. The franchisor commenced an action seeking, inter alia, payment of royalty and advertising fees accruing after June 2009. At trial, the district court found that DHI was not entitled to any royalty or advertising fees from Risberg after June 2009, holding that the June 2009 letter to Risberg was compelling evidence that DHI did not consider the franchise agreement to have continued and therefore was not entitled to any payments under the agreement beyond that date.

On appeal, the court first confirmed the district court’s sub silentio ruling that the parties were operating under an implied in fact contract based upon Risberg’s acknowledgment that it continued to use DHI’s system after the 1994 franchise agreement expired and that DHI continued to accept royalty and advertising payments. The court next reviewed the district court’s conclusion that DHI was not entitled to any fees after June 2009 because any agreement between the parties clearly ended with the June 2009 letter, which the district court interpreted as “evidence that [DHI] was not extending [Risberg] the benefits of the franchise relationship.”

The court agreed and affirmed the district court’s finding that the implied in fact contract ended in June 2009 with DHI’s letter to Risberg advising that the 1994 franchise agreement had expired and that Risberg should comply with its post-expiration obligations. The court held that the district court’s reading of the letter that DHI was unwilling to continue to extend benefits was reasonable. Thus, the court held that it was not clearly erroneous for the district court to conclude that DHI’s June 2009 letter terminated the parties’ implied in fact contract. As a result, DHI was not entitled to any contractually mandated payments accruing after the June 2009 letter.
This case is discussed under the topic heading “Oral Agreements.”

The U.S. District Court for the Eastern District of Missouri granted partial summary judgment to the franchisor of roast beef sandwich restaurants on its claim seeking a declaratory judgment that it had validly terminated a franchisee’s franchise agreement due to the franchisee’s insolvency.

Franchisee Valley Beef, LLC, a Lion’s Choice restaurant franchisee, filed a Chapter 11 bankruptcy petition ten years after it became a Lion’s Choice franchisee. After emerging from bankruptcy, LC Franchisor LLC (Lion’s Choice) and Valley Beef entered into a modified franchise agreement and a promissory note and repayment agreement. The franchise agreement provided, in pertinent part: “This Agreement shall terminate immediately upon written notice from franchisor to Franchisee in accordance with the notice provisions hereof upon: . . . the insolvency of Franchisee. . . .” The franchise agreement and the promissory note were executed in February 2014 and Valley Beef thereafter regularly submitted to Lion’s Choice monthly income statements that the parties agreed correctly reflected all of the franchisee’s assets and liabilities.

On July 7, 2014, Valley Beef provided Lion’s Choice with a balance sheet dated May 31, 2014, showing that Valley Beef’s total liabilities exceeded its total assets. On August 1, 2014, Lion’s Choice sent Valley Beef written notice of termination under Section 13.1 of the franchise agreement, stating that the May balance sheet established that Valley Beef was insolvent. Following its receipt of the termination notice, Valley Beef continued to operate Lion’s Choice brand restaurants and to use Lion’s Choice’s trademarks and copyrights. Thereafter, Lion’s Choice commenced this action and moved for partial summary judgment on its declaratory judgment claim.

In support of its motion for partial summary judgment, Lion’s Choice argued that under the franchise agreement, a franchisee was “insolvent” if its liabilities exceeded its assets and that it was beyond genuine dispute that Valley Beef was insolvent because its liabilities exceeded its assets, as reflected in the May 31, 2014, balance sheet. Valley Beef countered that mere reliance on a balance sheet was improper and that a debtor is insolvent if the sum of its debts is greater than all of its property, fairly valued. As a result, Valley Beef argued that, because it was a going concern with real value in its operating business, it was entitled to have its business fairly valued prior to termination.

After noting that the parties had identified two definitions of the term “insolvent” under applicable Missouri law, the court held that, reading the franchise agreement and the promissory note as a whole, it was apparent that the
plain and ordinary meaning of the term “insolvency” as used in the parties’ franchise agreement, meant having debts greater than the entity’s property at fair value. The court further concluded that the balance sheet demonstrated, as a matter of law, that Valley Beef was insolvent because case law supported the principle that an entity’s balance sheet serves as substantial, and in this case unrebutted, evidence of its “fair value.”

Finally, the court concluded that the terms of the parties’ franchise agreement rendered Valley Beef’s arguments relating to waiver and estoppel without merit and, as a result, termination was proper. As a result, the court granted the franchisor’s motion for partial summary judgment and dismissed Valley Beef’s counterclaim for breach of the implied covenant of good faith and fair dealing because the parties’ franchise agreement expressly permitted the termination by Lion’s Choice.


This case is discussed under the topic heading “Trademark Infringement.”


The Tenth Circuit affirmed a federal district court’s finding that a franchisee’s failure to offer a mandatory promotional menu was grounds for termination of its franchise agreement, without notice or an opportunity to cure.

The plaintiff, Steak n Shake Enterprises, Inc., entered into franchise agreements with two defendants, Globex Company, LLC and Springfield Downs, LLC (collectively, franchisees), in connection with the operation of franchised Steak n Shake restaurants in Sheridan and Centennial, Colorado. The franchise agreements gave Steak n Shake control over the franchisees’ standards, specifications, and procedures, including menu and pricing, and specifically provided that franchisees would “not to deviate from [Steak n Shake] standards, specification and procedures for serving or selling the same (including, to the fullest extent the law allows, the maximum, minimum, or other prices for products and services offered and sold by Steak n Shake Restaurants and mandatory promotions) without [Steak n Shake’s] prior written consent.” Further, the franchise agreements contained two relevant termination provisions. First, Section 11.1(A)(iii) provided that Steak n Shake could terminate the franchise agreements immediately upon written notice, with no opportunity to cure, if “[f]ranchisee knowingly sells products for a price in excess of any maximum price established by [Steak n Shake] from time to time or knowingly fails to offer the mandatory promotion.” Second, Section 11.1(B)(i) provided that Steak n Shake could terminate the agreements with notice and a thirty day cure period if “[f]ranchisee fails to operate
the Restaurant in compliance with the standards prescribed by [Steak n Shake].”

In late 2012, the franchisees had requested permission to increase the prices at their franchised Steak n Shake restaurants. Getting no response to these requests, the franchisees ultimately advised Steak n Shake that they intended to implement higher prices than those mandated by Steak n Shake for their menu items. In May 2013, Steak n Shake rolled out a new $4 Menu, which the franchisees failed to implement. Specifically, the franchisees failed to display the $4 Menu marketing materials provided by Steak n Shake and instead offered menu items at a la carte prices rather than the $4 Menu price. Upon receipt of customer complaints that the franchisees’ restaurants were overcharging, Steak n Shake conducted an investigation, determined that the franchisees were not offering the $4 Menu and immediately terminated their franchise agreements, pursuant to Section 11.1(A)(iii), for cause without opportunity to cure.

On summary judgment, the district court determined that the franchisees had breached the franchise agreements and therefore that Steak n Shake’s termination was proper under Section 11.1(A)(3). On appeal, the court had little difficulty finding that the franchisees knowingly violated the franchise agreements by overcharging customers for various items. The evidence showed that the franchisees charged customers for meals at a la carte prices (unless the customers specifically requested the new $4 Menu price), did not utilize the $4 Menu marketing materials; and offered only large size drinks, at a large size prices, while nevertheless providing such drinks in regular sized cups. Because Section 11.1(A)(3) of the franchise agreement permitted Steak n Shake to terminate upon the franchisees’ failure to offer the new $4 Menu promotion, the court affirmed the trial court’s finding that Steak n Shake properly terminated the franchisees’ franchise agreements without an opportunity to cure. As a result, the court affirmed the district court’s grant of summary judgment to Steak n Shake.

This case is discussed under the topic heading “Good Faith and Fair Dealing.”

TORTIOUS INTERFERENCE

This case is discussed under the topic heading “State Disclosure and Registration Laws.”
This case is discussed under the topic heading “Arbitration.”

Franchise consultant Blue Sky 1, LLC entered into a consultant agreement with an individual who was trying to purchase a Jaguar franchised dealership. The consultant agreement entitled Blue Sky to a success fee if the target franchise was purchased. After negotiations, the prospective franchisee entered into an asset purchase agreement (APA) with the current franchise owner. The current dealer agreement, however, contained a provision restricting the right to change ownership and a right of first refusal for the benefit of Jaguar. Ultimately, Jaguar opted to exercise the right of first refusal, and the franchise was sold to another party.

Blue Sky filed this action for a declaratory judgment against Jaguar in the Superior Court of New Jersey. Jaguar removed the action to federal court. Blue Sky sought to “determine the rights of parties relative to the acts and/or omissions of Jaguar to prevent Blue Sky from obtaining [its] success fee.” Jaguar moved to dismiss Blue Sky’s action, and the U.S. District Court for the District of New Jersey granted that motion to dismiss.

The court found that, under general principles of contract interpretation, Blue Sky was not entitled to the success fee. The court held that nothing in the APA created an enforceable obligation for the buyer to pay the fee; the APA did not incorporate the consultant agreement; and, even if the APA required payment of Blue Sky's success fee, the purchase never occurred so Blue Sky was not entitled to the fee.

The court also found that Blue Sky’s tortious interference claim failed. First, the APA did not create any right or entitlement to the success fee, and the contingent event—purchase of the franchise—never occurred. Also, under New Jersey law, the court found that a tortious interference claim must allege some protectable right, intentional or malicious interference, and that the interference caused the loss. Because Blue Sky had no protectable right the success fee, absent the actual closing of the sale, Jaguar could not have interfered.

This case is discussed under the topic heading “Trademark Infringement.”
This case is discussed under the topic heading “Good Faith and Fair Dealing.”

TRADEMARK INFRINGEMENT

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

The U.S. District Court for the Southern District of Florida has ruled that a former fish food distributor failed to demonstrate that it owned the rights to a foreign fish food manufacturer’s trademark in the United States or that it was granted a “naked license” to the trademark though the manufacturer’s abandonment of the trademark.

The plaintiff, Living Color Enterprises, Inc., a business that provided products and services related to all aspects of facilitating the enjoyment of marine life, entered into an agreement with marine animal food manufacturer New Era Aquaculture, Ltd. Under the two-year agreement, Living Color agreed to be the exclusive distributor of New Era’s marine animal foods in North America. Additionally, although no formal agreement existed concerning the use of New Era’s trademark, New Era allegedly expressed that it did not object to Living Color’s use of the trademark in the United States. After the distribution agreement expired, Living Color continued to distribute New Era’s products and was interested in signing another distribution agreement. However, New Era pursued another United States-based distributor, defendant Aqua-Tech Co. Living Color’s sales manager, John O’Rourke, and New Era exchanged emails outlining a plot to divest Living Color of its business relationship with New Era, its relationships with O’Rourke and sales representative Daniel Leyden, and Living Color’s customers and other trade secrets. New Era subsequently terminated its business relationship with Living Color and O’Rourke and Leyden resigned their employment with Living Color, stating that they had accepted employment with New Era.

Living Color sued, asserting claims against New Era, Aqua-Tech, O’Rourke, and Leyden for, inter alia, trademark infringement, unfair competition, breach of a noncompete agreement (against O’Rourke), breach of fiduciary duty (against O’Rourke and Leyden), aiding and abetting breach of fiduciary duty (against New Era and Aqua-Tech), tortious interference with a business relationship and misappropriation of trade secrets. The par-
ties moved for summary judgment and the court, after an extensive recitation of the facts, addressed the parties’ claims.

Living Color asserted a trademark infringement claim against Aqua-Tech and Leyden, who moved for summary judgment, arguing that Living Color did not own or have any vested rights in the “New Era” trademark that the defendants allegedly infringed. In response, Living Color argued an express agreement or implied agreement existed between Living Color and New Era providing that Living Color would own the rights in the “New Era” trademark in the United States. The court noted that absent a specific agreement to the contrary, a distributor does not acquire any rights to a manufacturer’s trademark. Further, the court specifically noted that as between a foreign manufacturer and an exclusive United States distributor, the foreign manufacturer is presumed to be the trademark owner absent any other agreement. Reviewing the undisputed evidence, the court found no express or implied agreement giving Living Color any vested rights in the “New Era” trademark. Further, the court noted that although a foreign manufacturer’s presumption of ownership may be overcome upon a proper showing, Living Color failed to present evidence sufficient to rebut the presumption that New Era owned the trademark.

In the alternative, Living Color contended that New Era granted it a “naked license” to its trademark through its abandonment of the trademark in the United States. Noting that the Eleventh Circuit has held that in order to establish “naked licensing” through abandonment, a party must prove an intent to abandon on the part of the trademark owner, the court found that Living Color failed to raise a triable issue of fact on the issue of abandonment. As a result, the court granted summary judgment, dismissing Living Color’s trademark infringement claims.

Living Color also asserted a claim of unfair competition against the defendants as a result of their alleged scheme to misappropriate Living Color’s customers and employees and put it out of business in the marine animal food industry. Under applicable Florida law, a claim of unfair competition although elusive of a precise definition, requires a plaintiff to prove, at minimum, competition and unfairness. The court held there were questions of fact preventing entry of summary judgment for Living Color against Aqua-Tech and O’Rourke on this claim. Although there was evidence that New Era, Aqua-Tech, and O’Rourke colluded together to cause the change-over of Living Color to Aqua-Tech as distributor for New Era, there was also record evidence that raised a genuine issue of material fact as to whether Aqua-Tech engaged in unfair business practices. With respect to New Era, however, the court held that there was undisputed evidence that New Era engaged O’Rourke to supply it with Living Color’s business information in order to divest Living Color of its marine food business, and as a result, granted Living Color’s summary judgment on its unfair competition claim against New Era.
The court also granted Living Color summary judgment on its claim against O’Rourke for breach of his noncompete agreement, which prohibited him from disclosing any of Living Color’s trade secrets or customer information, on the basis of the undisputed evidence demonstrating that he solicited Living Color’s customers and Leyden for Aqua-Tech’s benefit and provided customer information to Aqua-Tech.

Similarly, the court granted Living Color summary judgment on its claim for breach of fiduciary duty against O’Rourke, finding undisputed record evidence that he held a high ranking position of authority with Living Color, coordinated the misappropriation of Living Color’s business while still employed by Living Color, coordinated the selection of Aqua-Tech while still employed by Living Color, competed with Living Color, disclosed Living Color’s trade secrets, and derived an improper benefit from these actions. In contrast, the court granted Leyden’s motion for summary judgment on Living Color’s claim for breach of fiduciary duty against him, finding that there was no evidence that he communicated with Aqua-Tech prior to his resignation from Living Color and that, even if he had, he was not covered by a non-solicitation agreement and was therefore free to compete against Living Color once he resigned.

The court next turned to Living Color’s claims against New Era and Aqua-Tech for aiding and abetting breach of fiduciary duty by O’Rourke and Leyden. The court granted Living Color’s motion for summary judgment on its claim against New Era for aiding and abetting a breach of fiduciary duty by O’Rourke (but not by Leyden since the underlying claim against Leyden was dismissed) based upon the undisputed record evidence; however, the court denied the motion against Aqua-Tech, finding that the evidence concerning Aqua-Tech created a genuine issue of material fact.

Living Color also sought summary judgment against all defendants on its claims for tortious interference with a business relationship. Once again, the results varied depending on the defendant. With respect to New Era, the court held that the undisputed record evidence showed that New Era was aware of the business relationship between Living Color and O’Rourke, sought to interfere with Living Color’s relationships with its employees and customers, and ultimately caused Living Color to lose its marine animal food business. As a result, the court held that summary judgment was appropriate as against New Era. However, with respect to Aqua-Tech, the court held that there was a question of fact as to whether it tortiously interfered with Living Color’s business relationships, whether it intentionally interfered with the business relationship of Living Color and New Era, and whether it caused Living Color any damage. Next, with respect to O’Rourke, the court held there was a genuine issue of material fact concerning whether he interfered with Living Color’s relationship with New Era. Lastly, with respect to Leyden, the court granted Leyden’s motion for summary judgment, holding that he was not introduced to Aqua-Tech until after New Era and
Aqua-Tech entered into a business relationship and therefore could not have engaged in tortious interference.

Finally, the court found that there was an issue of fact with regard to Living Color’s claim for misappropriation of trade secrets against all defendants (except for Leyden) because it was unclear from the record whether Living Color freely shared trade secrets with New Era. If so, the claim could not succeed. With respect to Leyden, however, the court dismissed the claim, finding that there was no evidence he provided any information to Aqua-Tech.


After previously issuing a preliminary injunction enjoining a former franchisee’s post-termination operation of franchised ice cream trucks, the U.S. District Court for the District of New Jersey issued a permanent injunction enjoining the franchisee’s violation of the franchise agreements’ noncompete provisions and his continued use of the franchisor’s trademarks.

Defendant Reza Amanollahi, entered into twenty-two substantially similar franchise agreements with plaintiff Mister Softee, Inc., a franchisor of mobile ice cream trucks using the “Mister Softee” name and trademarks. He also signed two promissory notes in connection with the purchase of two ice cream trucks. With the knowledge of the franchisor, Amanollahi transferred his franchises to four transferees in an installment sale, while remaining responsible for collecting royalties from the transferees and forwarding them to the franchisor. Mister Softee terminated the franchise agreements in February 2014, after Amanollahi moved the trucks to an unauthorized location and stopped making truck payments. Mister Softee commenced this action, alleging, inter alia, breach of contract and trademark infringement and in July 2014, the court granted Mister Softee a preliminary injunction enjoining Amanollahi’s continuing violation of the noncompete provisions in the parties’ franchise agreements (Mister Softee, Inc. v. Amanollahi, 2014 WL 3110000 (D.N.J. July 1, 2014)).

In the 2016 opinion, the court addressed Mister Softee’s motions for a permanent injunction, summary judgment granting it lost future royalties under the franchise agreements, and dismissal of Amanollahi’s counterclaim for breach of the franchise agreements.

Initially, the court had little difficulty converting its previous preliminary injunction into a permanent injunction enjoining the former franchisee’s infringement of Mister Softee’s trademarks and mandating enforcement of the noncompete provisions in the parties’ franchise agreements. Finding that Amanollahi had not presented evidence to create a genuine dispute as to material facts, the court recast its previous findings under the appropriate permanent injunction legal standard and granted the motion. In addition, the court held that the permanent injunction extended to any other persons acting in concert or participation with Amanollahi and who received actual no-
tice of the injunction. However, because the noncompete provision expired on July 1, 2016, the court held that Amanollahi may engage in the retail ice cream business in any of his former territories, provided that he does not infringe Mister Softee’s trademarks or violate any other provision of the parties’ agreements.

In addition to the permanent injunction, Mister Softee sought summary judgment on its claim for future royalties it would have received under the parties’ franchise agreements. Specifically, Mister Softee sought $462,400 in lost future royalties, calculated by multiplying the number of remaining years on each of the twenty-two franchise agreements by the minimum annual royalty fee set forth in the franchise agreements. The court began by invoking familiar New York law, which provides that plaintiffs seeking lost future profits must show that the loss was caused by the defendant’s breach of contract, that the amount lost could be proven with reasonable certainty, and that the parties contemplated this type of damages at the time the contract was made. Further, the damages may not be merely speculative, possible, or imaginary, but must be reasonably certain and directly traceable to the breach, not remote or the result of intervening causes. With that background, the court briefly reviewed New York and other states’ case law in the franchise context and found that lost future royalties are not routinely available as damages, especially when, as in this case, the franchisor’s own action, by terminating the franchise agreement, deprived it of future royalties that would have been generated under the franchise agreement. The court concluded that Mister Softee faced a choice upon Amanollahi’s breach of the franchise agreements: terminate the agreements or continue to perform under the agreements and sue Amanollahi for the ongoing unpaid royalties. Because Mister Softee chose to terminate the agreements, the court held that Mister Softee was not, as a matter of law, entitled to future royalties under the franchise agreements.

The court also granted Mister Softee additional affirmative relief, including summary judgment based upon Amanollahi’s non-payment under certain promissory notes; granting Mister Softee’s motion to release the preliminary injunction bond it posted in connection with the court’s issuance of a preliminary injunction; and awarding Mister Softee reasonable attorney fees—to be determined by the court upon appropriate submission of evidence—pursuant to the parties’ franchise agreements.

Mister Softee also sought summary judgment dismissing Amanollahi’s counterclaims for rescission of the franchise agreements pursuant to the New York Franchise Act and for breach of the franchise agreements. In its prior order, the court preliminarily determined that Amanollahi’s claims for rescission under the New York Franchise Act (New York General Business Law Section 683) with regard to eight of the franchise agreements were barred by the applicable three-year statute of limitations. The court also previously found sufficient evidence that Amanollahi admitted to receiving at least one prospectus to satisfy the disclosure requirement of Section 683.
and that there was no evidence that any failure to provide a prospective franchisee with such a prospectus was willful or material—a required showing for rescission of a franchise agreement under Section 691. Because Amanollahi failed to put forth any new evidence sufficient to challenge these preliminary determinations, the court granted Mister Softee’s motion for summary judgment, dismissing this counterclaim for rescission under the New York Franchise Act.

Finally, Mister Softee sought summary judgment dismissing Amanollahi’s breach of contract counterclaim, in which he alleged that Mister Softee failed to provide required training, periodic assistance, continuing consultation, and advice and that Mister Softee breached its obligation to provide a clean and safe warehouse environment at prescribed truck depots. Mister Softee argued that these counterclaims were barred as a matter of law because Amanollahi did not comply with the condition precedent of thirty days written notice as set forth in the parties’ franchise agreements. Determining that the condition precedent applied to the assertion of a counterclaim as well as to the commencement of an action, the court found the provision applicable and further found that Amanollahi’s alleged oral complaints (there was no written notice) were insufficient to satisfy the condition precedent. As a result, the court granted Mister Softee’s motion for summary judgment dismissing the breach of contract counterclaims based on lack of notice under the condition precedent provision of the parties’ franchise agreement.

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES


This case is discussed under the topic heading “Trademark Infringement.”

VENUE


The three remaining California franchisee-plaintiffs in the once larger, eleven-plaintiff action against the professional cleaning franchisor moved the U.S. District Court for the District of Massachusetts to sever and transfer to California their remaining common law and state law claims. Those claims arose out of the core allegation that the unit franchisees that contracted with regional master franchisees were misclassified as independent contractors when they should have been employees. Following the parties’ cross motions for summary judgment, the lower court narrowed the case
to address only the Boston unit franchisee Giovani Depianti. He lost on all but two of his claims and then dismissed those, leaving only his right to appeal two claims. Many of the other plaintiffs followed suit, dismissing their claims, except for the final three California plaintiffs.

First, the court analyzed whether severance would be appropriate under a five-factor test. The district court found that Depianti, a Massachusetts franchisee, shared some common questions of fact but few common questions of law with the California plaintiffs. Moreover, Jan-Pro would not be prejudiced by a severance, according to the court, because there should not be any additional substantial investment bringing a new judge up to speed since the court had focused only on Massachusetts law thus far.

Next, the court addressed the motion to transfer venue. Citing Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas, 134 S. Ct. 568 (2013), the court evaluated both the convenience of the parties and various public interest considerations. Basically, the court found that JPI was based in Georgia and would be litigating “out of state,” whether in California or Massachusetts. As for the California plaintiffs, the court found that they and their as-yet identified witnesses would probably all favor a transfer to California. Finally, the court found all of the public interest factors to favor California or be neutral. Most importantly, the court noted that the Massachusetts plaintiffs had been dismissed; a California district judge would have to get up to speed on the California claims, just as the district court in Massachusetts would; and the plaintiffs could not be accused of venue shopping because it was the court’s idea to focus only on Massachusetts first. As a result, the court transferred the case to California.

The U.S. District Court for the Middle District of Tennessee denied the defendant-franchisee’s motion to dismiss this action for improper venue or transfer it to the U.S. District Court for the Eastern District of California. Although acknowledging Atlantic Marine, the court determined that it must first decide whether venue is wrong or improper, regardless of any forum selection clause. The defendants all resided in California so 28 U.S.C. § 1391(b)(1) did not provide proper venue. The court concluded that a substantial portion of the events giving rise to the dispute occurred in California and thus venue was not proper under 28 U.S.C. § 1391(b)(2): the franchisor contacted franchisee in California, the franchisee signed agreements in California, and services were provided in California. Because the claims could have been brought in the Eastern District of California, § 1391(b)(3) did not apply. Accordingly, the court held that venue was not proper in its court and the case should be dismissed, unless the defendant-
franchisee waived its right to object to venue by agreeing to a forum-selection clause.

The court then turned to *Atlantic Marine* to apply its holding that a valid forum selection clause should be given controlling weight. The court gave short shrift to the defendants’ argument that the bargained-for forum selection clause contravened California public policy because the proper consideration was whether the forum selection clause contravened the public policy of the forum in which suit is brought, i.e., Tennessee.