STATEMENT OF OWNERSHIP

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From the Editor-in-Chief

Daniel J. Oates

Good writing tantalizes in its simplicity; yet it is simplicity itself that requires experience, skill, and talent to prepare. It is this high quality that you have come to demand from the Franchise Law Journal. Thankfully, the Journal’s audience of readers comprises a large percentage of its talented pool of writers.1

If you have never written for the Journal, and haven’t yet sensed what I’m getting at, I’m talking about you.2 Of course, this is a somewhat self-serving entreaty on my part, as one of my primary duties as editor-in-chief is to encourage you to write for the Journal. But conflicts of interest aside, you should want to write. To make your mark on the world. To place your stamp on history. To plant your flag on an undiscovered island of franchise law. To boldly go where no one has gone before.

Some of you need more incentive, however. I get that. Like me, I know that many of you want to have written but shudder at the prospect of committing the time it takes to do the actual writing. The allure of hunkering down behind a keyboard and fitfully typing away while pondering some esoteric legal topic isn’t felt by everybody. It is for precisely this reason that I am constantly appealing to your sense of duty, personal proclivities, academic interest, and vanity3 as I persuade, cajole, and pester you all into writing for the Journal. I do it out of love for the institution, but I suspect you all see it for what it really is: nakedly partisan appeals for content.4

Which brings me back to incentives. An incentive has to be real, and not marketing fluff, for it to work. I have the Edward Wood Dunham Rising

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1. Buttered up yet?
2. [insert Uncle_Sam_Finger_Pointing.jpg].
3. My own personal favorite.
4. Thankfully, I have no shame.

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Scholar Award for the up-and-coming set.\(^5\) Coming up with new and inventive ways of pitching writing opportunities to everyone else is a challenge. To that end, I want to try something a little different and tell you about some of the benefits you can expect if you persevere through the process all the way to publication.

The *Journal* has a long history of influencing courts and legal scholars. In the last twenty years, the *Journal* has been cited in at least eighty court decisions,\(^6\) approximately 1,700 secondary sources, and hundreds of briefs.\(^7\) This does not include the hundreds, if not thousands, of *Journal* articles cited in unpublished court opinions, the CCH Business Franchise Guide, or the twenty to thirty white papers prepared annually for our beloved Forum on Franchising, or the International Franchise Association’s Legal Symposium.

The roguish among you will say, “Never tell me the odds.”\(^8\) I appreciate those brave souls that have supreme confidence in their work and don’t need me telling them that their toil will result in accolades, recognition, and professional respect. For the rest of you, however, these numbers translate into great odds for getting your work cited and recognized by courts and other scholars. In the *Journal*’s existence, we have published, by my count, approximately 692 articles.\(^9\) Accordingly, better than one in nine articles published in the *FLJ* have been subsequently cited by a court in drafting a decision. About one article every two issues of the *Journal* gets cited by a court, and there is an extremely high probability that any given article will be referenced in a subsequent article or paper, thereby advancing the scholarship of franchising.\(^10\) And you probably have something like 1/20 chance of being cited by the supreme court of a state or U.S. jurisdiction, or one of the federal circuit courts. Those are good odds! And they reflect the high esteem with which the courts have held the *Journal*, a credit to the leaders of the Forum, as well as my predecessors and their decades of hard work and commitment to excellence.

Rest assured, my tenure will be marked by this good-natured pandering because I really do want you to write for the *Journal*. But you don’t need to listen to me. The numbers speak for themselves.

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5. Submissions for the 2019 award in Denver are due by July 15, 2019. All individuals who have seven years of practice or less are eligible for the award. The winner receives a beautiful, engraved award, free tuition to the Denver Forum, and payment of reasonable travel expenses to Denver.

6. This includes cases decided by the First Circuit, the Third Circuit, the Fourth Circuit, the Ninth Circuit, the California Supreme Court, the Colorado Supreme Court, the Maine Supreme Judicial Court, the Supreme Court of Missouri, the Supreme Court of Nebraska, the New Hampshire Supreme Court, the Supreme Court of New Jersey, the New Mexico Supreme Court, the New York State Court of Appeals, the Supreme Court of Ohio, the Supreme Court of Pennsylvania, the Tennessee Supreme Court, the Washington Supreme Court, the Supreme Court of Appeals of West Virginia, the Supreme Court of Guam, and the Tribunal Supremo de Puerto Rico.

7. These admittedly unscientific results are based on an afternoon of Westlaw database searches.


9. This includes the six articles in this issue but excludes editorials and currents.

10. To paraphrase Sir Isaac Newton, we all stand on the shoulders of giants.
Franchising at Its Peak

Bethany Appleby & K. Whitner

Rocky Mountain High—The ABA Forum on Franchising Annual Meeting is headed to the mountains of Denver!

This year’s meeting will take place October 16–18, 2019, and will provide many opportunities for socializing and networking, CLE credits, ethics credits, and the highest quality franchise programs. Whether you are experienced in or new to franchise law, a litigator or transactional lawyer, in-house or outside counsel, represent franchisors or franchisees, we will have thought-provoking programs for you. The Forum will kick off with three intensive programs on Wednesday, October 16. The first is the classic “Fundamentals of Franchising” course. The second intensive will be “A Comprehensive Legal Review of the Creation of a Start-up Franchise System.” The third intensive program will have an international focus: “Further Abroad: A Deeper Dive into the Fundamentals of International Franchising.”

Our lineup of twenty-four high-quality workshops will offer the best in franchise education and cover a variety of litigation, transactional, international, and regulatory issues. Topics include the “highly” timely Franchising Under the Radar in the USA and Canada: How to Ensure Your Client’s Franchise Dreams Don’t Go “Up in Smoke,” as well as programs on anti-poaching issues, effective witness preparation and presentation in a franchise case, keys to successful negotiation and early dispute resolution, balancing hospitality with privacy and security issues, franchisee evaluation and approval processes, buying and selling franchised businesses, territorial rights and encroachment, developing social media policies, artificial intelligence and the next frontiers of discovery, navigating privacy and data laws domestically and abroad, consumer advertising claims, addressing international expansion and franchising in the Asia-Pacific region, and much more.

Of course, it would not be a Forum without the signature Plenary program, Annual Franchise and Distribution Law Developments, an informative

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overview of the most important franchise and distribution cases of the past year. This program will be presented by two of our colleagues, Denver resident Heather Carson Perkins and Trish Treadwell.

The second Plenary program, “Implicit Bias and Its Impact on the Legal Profession and Beyond,” will provide an opportunity to hear from Dr. Arin N. Reeves of Nextions LLC to help us understand, in an interactive presentation, the myriad “mental shortcuts” that we use and the impact that they have on the way we interact with and value others, and what to do about those shortcuts.

We have planned two evening gatherings. Our Thursday night event will take place at Punch Bowl Social. “A general store in a former life, the vibe of this 27,000-square-foot fun factory is industrial chic” with “3 bars, a scratch-to-craft restaurant and ridiculous entertainment options such as: virtual reality, shuffleboard, life-size Jenga, pool, karaoke, and old school arcade games. Let the smack talk begin.” Friday’s event will take place at the Denver Milk Market, “an all-local, all-wonderful mix of take-away and dine-in restaurants and bars run by Colorado chef Frank Bonanno.” We hope to celebrate with you at both of these wonderful venues.

Please join us in Denver, Colorado, for the 42nd Annual Forum on Franchising, October 16–18, 2019, for Franchising at Its Peak!
Legal Considerations for Franchisors
Expanding into Inner-City Markets
Zachary K. Iacovino & Michael R. Daigle

Franchising as a business model largely originated in the suburbs, with companies selling franchises for units to be opened in strip malls, shopping centers, and retail plazas throughout the United States. As markets became saturated, competition grew, and demographics changed, franchisors started exploring new opportunities for growth, which involved considering or reconsidering those inner-city markets that might initially have been thought to be too expensive, too office-focused, too non-traditional, or just too risky. While many companies have sought expansion overseas, an enormous amount of domestic retail demand remains unmet. Indeed, many franchisors have neglected the significant prospects for growth that exist in the United States. To find them, companies need only look just a bit beyond their suburban strongholds and toward downtown areas of cities across the United States.

The Initiative for a Competitive Inner City (ICIC), a research group founded by faculty from Harvard Business School that strives to promote


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economic prosperity in inner cities throughout the United States, defines “inner cities” as urban areas that are economically distressed in relation to surrounding areas. In the context of franchising, that definition might be too simple and could conceal the existence of franchise development opportunities. For example, downtown regions have traditionally been made up of people who worked there, rather than lived, making them unattractive to concepts that count on evening or “going home” traffic. However, many large cities are turning this model on its head as younger workers choose to live where they work. In these markets, the infrastructure for successful franchising already exists, and “there is no need to struggle with a new language, culture, [or] currency,” as is often the case in international markets. Unfortunately, many inner-city regions also experience higher levels of unemployment and poverty compared to surrounding areas, and franchisors will often be forced to make critical and creative choices to adapt their concepts to prevailing real estate constraints (including both size of available space and costs).

Nevertheless, inner-city markets present a tremendous opportunity to franchisors because of their concentrated, aggregate buying power and changing demographics. Conservatively, U.S. inner cities contain an estimated 7.7 million households, who collectively contribute over $85 billion in annual retail spending. The retail market in downtown areas is “concentrated by consumers with significant aggregate spending power, yet lacking


4. See Boston Consulting Group, supra note 2, at 29 (defining “inner cities”); see also Key Battlegrounds, supra note 3 (displaying statistics about inner-city communities).

5. Between 2013 and 2016, Chicago added an average of 5,000 to 7,000 apartment units per year. Analytics Contributor, Apartment Completion Volumes Spike in Chicago, REALPAGE (Feb. 27, 2018), https://www.realpage.com/analytics/apartment-completion-volumes-spike-chicago. However, in 2017 alone, “developers brought 10,545 new apartments to the market,” which constitutes an increase of nearly 50% over 2016’s completion volume. Id. “Since the start of 2010, about 40,000 units have come online across Chicago.” Id.

6. Id.

7. Id.

in competitive offerings, and underpenetrated by retailers of all kinds,”
including franchise companies. This vast appetite for spending has gone
largely unmet by franchise systems, with retail demand averaging twenty-five
percent in many cities and reaching up to sixty percent in others. Indeed,
the concentrated customer base and aggregate spending power are cited as the
primary competitive advantages of inner-city markets.

Within the past few decades, inner-city areas have experienced a resur-
genous as young adults under the age of thirty-five have increasingly moved
into downtown regions. “Since 1990, downtowns and central neighbor-
hoods in cities across the country have attracted significantly more educated
and higher-income residents.” As inner-city markets have become increas-
ingly populated with younger generations, the aggregate spending on some
products and services has started to exceed spending in some suburban
areas. Historically, downtown areas were composed of workers rather than
dwellers, which resulted in high daytime demand but lower-to-non-existent
nighttime demand and, in many cases, a more streamlined offering for both
franchise and non-franchise concepts. As the demographics of these areas
continue to change, franchisors will be forced to reconsider their strate-
gies within inner-city markets. Put simply, these communities are full of
residents who have a certain level of disposable income and appetite for
retail spending, but are unable to purchase goods and services because fran-
chise companies have not yet expanded into their neighborhoods. Despite
the untapped potential of downtown areas, franchises have been slow to
emerge.

Along with the potential, inner-city expansion brings with it a number
of challenges franchisors should consider. This article discusses several of
those challenges and seeks to identify the various considerations franchisors

10. See id. (explaining retail demand in inner-city markets). Specifically, unmet demand for
retail spending approaches thirty percent in Boston, Massachusetts; forty percent in Chicago,
Illinois; and sixty percent in Harlem, New York, New York. Id.
11. See id. (identifying competitive advantages of inner-city markets); see also Tolbert &
Alphonse, supra note 3 (same). The Initiative for a Competitive Inner City has identified a num-
er of additional competitive advantages associated with expansion in inner cities, including
strategic downtown locations and an underutilized labor supply. See id. at 6.
ChangingShape-AmericanCities_UVA-CooperCenter_February2015.pdf (examining the
changing demographics in cities across the United States).
14. See Seid & Ainsley, supra note 1 (noting that aggregate spending in inner-city markets
often exceeds aggregate spending in suburban areas); see also Boston Consulting Group, supra
note 2, at 12 (same). In a study conducted by the Boston Consulting Group and the Initiative
for a Competitive Inner City, which analyzed the performance of drugstores in the inner city
compared to suburban areas, the researchers found that inner-city drugstores can generate sales
up to forty-five percent higher than the regional average, with some areas achieving double the
regional average. Boston Consulting Group, supra note 2, at 12.
15. See Devlin Smith, Are Inner City Franchise Programs Working?, ENTREPRENEUR (Nov. 5,
have an increased appetite for franchise concepts).
should keep in mind as they explore inner-city opportunities. First, Section I presents a discussion of general operational issues, ranging from incorporating local considerations to improving operational flexibility. In Section II, the focus is on real estate considerations concerning both territories and unit-level issues. Next, Section III includes an analysis of recruitment and employment issues, including recruitment and vetting of franchisees and the hiring, training, and retention of employees. Finally, Section IV discusses crime and the perception of crime in these areas, along with their impact on franchised units, focusing on an examination of crime-prevention policies and strategies for avoiding liability. By keeping many of these considerations in mind, franchisors will be better equipped to expand into inner-city markets, which offer underdeveloped and unique retail space, an accessible labor market, and the potential for intense local brand loyalty.16

I. General Operational Considerations

Franchise expansion into inner-city markets shares many of the same considerations as franchising in traditional markets—managing system standards, recruiting well-qualified franchisees, and generating and collecting revenue, among other things. Yet, inner-city franchising presents its own unique angles on many of the traditional issues facing franchise systems. These issues can be broadly divided into two categories: those that come from an outward look and those that come from an inward look. First, franchisors should consider and examine the cities themselves, including the local, community-based factors impacting franchise expansion. Second, franchisors should look inward at their systems and operations to maximize their effectiveness within inner-city markets. By combining an outward examination of target markets with an internal examination of operational practices, franchisors can set themselves up for successful expansion.

A. The “Locality Factor” of Inner-City Franchising

As a preliminary matter, franchisors must identify what brand-critical characteristics distinguish inner-city markets from suburban markets, aside from the locations themselves. Given these differences, many franchisors have historically struggled to enter inner-city areas due to a lack of understanding of the wants and needs of the local markets, compounded by a relatively rapidly changing landscape as inner cities morph into hubs for both daytime and nighttime activities. While a franchise generally relies on the broad name recognition of a large company, the success of individual units also depends upon various local considerations. To that end, franchisors should rid themselves of any assumptions that all inner cities have the same

16. See generally Seid & Ainsley, supra note 1 (illustrating the benefits of franchising in inner-city markets).
Legal Considerations for Franchisors Expanding into Inner-City Markets

A successful business must consider the consumers living in a given region. This “locality factor” requires a franchisor to evaluate various aspects of a local market to determine how best to tailor its business model to that market. The critical considerations can be consolidated into two overarching categories: (1) gaining a general understanding of the community and customers; and (2) developing the operational flexibility to tailor the franchise offering to local needs.

Initially, franchisors should undertake a thorough evaluation of a targeted inner-city market to gain a sense of the community, its customers, their desires, and the ever-important trends in the market. Franchisors should strive to understand local community tastes and preferences to establish relationships with community organizations, which will aid in expansion. In total, 328 areas meet the definition of an “inner city,” spread across U.S. cities that each have a population exceeding 75,000 people. These 328 inner cities account for roughly ten percent of the total population of the United States. Undoubtedly, no two cities are the same—each contains its own unique characteristics and communities. Thus, in the early stages of franchise expansion, franchisors should collaborate with local governments and community organizations, and should place an emphasis on exploring expansion opportunities that appeal to potential franchisees and the customers living in their communities. This step should involve a preliminary determination of what barriers may exist—real or perceived—that may keep people from wanting particular products in their community. Clearly, not all franchises are suitable in all markets, at least not on a broad scale or in the same way that the concept might operate in the suburbs. For example, a lawn-care franchisor might, at first blush, think it impossible to mount a successful business in the inner cities of Chicago due to the lack of residents with extensive greenspaces. But, by looking outward to determine the local market’s needs, and looking inward to determine how its business model might adapt to meet those needs, the lawn-care franchisor might very well find untapped opportunities by refocusing its business model on small greenspaces or common areas—both indoors and out—that, if mined properly, can provide a strong base on which to support the basics of a business.

17. See generally MSA Worldwide, The Challenges of Entering Inner-City Neighborhoods, https://www.msaworldwide.com/blog/the_challenges_of_entering_inner-city_neighborhoods (“[Franchisors] have to shake off any preconceived notions about the emerging markets, including an assumption that all of the inner cities share the same attributes.”).
18. See Jose Torres, Connecting to Hispanic Consumers Through Hispanic Franchisees, Franchising World (Feb. 2012), https://www.thefreelibrary.com/Connecting+to+Hispanic+consumers+through+Hispanic+franchisees%3a...-a0280386764 (emphasizing the importance of characteristics unique to local areas).
19. See generally MSA Worldwide, supra note 17 (noting that franchisors should seek to understand local communities for successful inner-city franchising).
20. Key Battlegrounds, supra note 3.
21. Id.
22. See Smith, supra note 15 (explaining that franchisors should tailor their franchise offering to specific markets).
Once that determination is made, the franchisor must determine whether there is enough interest from existing or prospective franchisees who may want to bring a specific franchise concept to their communities, and whether the pool of customers is large enough to support the franchise. Without both factors, an inner-city franchise is doomed to fail.

Once a franchisor recognizes that there is an appetite for their franchise system from both prospective franchisees and potential customers, the next step is to consider how to bring that concept to fruition. Many downtown residents may be unaccustomed to franchise investment in their communities and will have a certain level of skepticism as to whether there is a genuine community interest. In response to that hurdle, franchisors should strive to connect with members of the community from the onset of the expansion. This might involve seeking potential franchisees who live in the communities and who are connected to other local residents. Considerations for attracting franchisees in inner-city markets are discussed in more detail in Section III.

**B. Viability of Franchise Concepts in Inner-City Markets**

In addition to understanding local tastes and preferences, franchisors might have to adapt their franchise systems to achieve success in inner-city markets. This requires a certain degree of operational flexibility to tailor the franchise offering to local needs. To that end, the ICIC has noted that successful inner-city retailers have managed to succeed due to an understanding of “inner-city dynamics and the varied preferences of many distinctive micro-markets.” Often, these companies have empowered local store managers by giving them the authority to adapt merchandise to local customers’ needs on a store-by-store basis. In other words, franchisors may have to modify the products and services they offer to meet customer preference. If a company requires its franchisees to sell its products at a price higher than what a community is used to paying, the franchisee may have trouble establishing long-term success. If a franchisee’s product or service is too expensive or too unusual, the local community might be reluctant to support the franchisee and the overall business. In addition, local marketing and advertising may have to be revised to account for language and cultural differences, which

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23. See id. (noting that many inner-city residents may be skeptical to franchise expansion in their communities).
25. See id. (noting that successful inner-city retailers provide for decision making at the store level).
26. See MSA Worldwide, supra note 17 (explaining that consumer tastes vary from location to location).
will impact signage, distributions, and other marketing materials.\textsuperscript{28} Although some modification of the franchise may be necessary, franchisors should be careful not to change or lower their system standards, which would be counterproductive to a successful franchisor-franchisee relationship.\textsuperscript{29}

Some franchisors, like McDonald’s and Burger King, have seen success with their traditional concepts in inner-city markets for decades, while other franchisors are crafting new concepts specifically designed for downtown markets. Taco Bell serves as a prime example of a franchisor overhauling its franchise offering to adapt to the generational shift toward urban areas. According to brand officials, Taco Bell is “underrepresented” in inner-city markets, \textit{“which [are] viewed as potential locations for the chain’s Taco Bell Cantina variation.”}\textsuperscript{30} Through this relatively new “Cantina” concept, Taco Bell has introduced a more modern restaurant that serves alcohol and offers tapas-style dishes.\textsuperscript{31} The company hopes to eventually build around 300 Cantinas, which will each be specifically designed to “reflect the local community and respect the architecture of the existing buildings.”\textsuperscript{32} Moreover, they will feature digital menu boards, mobile ordering, energy efficiency, and open kitchens, all of which are intended to appeal to inner-city markets and urban communities.\textsuperscript{33}

As another example, Primrose Schools—which offers early-childhood education franchises—has targeted downtown neighborhoods that lack quality early-education facilities.\textsuperscript{34} Similar to Taco Bell, Primrose Schools has adapted its offering to fit within cramped urban areas: it has constructed multi-level structures instead of single ranch-style buildings and offers rooftop green areas for children to play on rather than traditional playgrounds.\textsuperscript{35} Moreover, in congruence with the earlier discussion about maximizing community buy-in, Primrose Schools has targeted tightly knit communities in desperate need of early-childhood education facilities. Both concepts reflect

\textsuperscript{28} See MSA Worldwide, \textit{supra} note 17 (arguing that marketing strategies should be tailored to local markets).
\textsuperscript{29} See id. (expressing the caveat that while franchisors should be flexible with their concepts, they should be careful to avoid lowering system standards).
\textsuperscript{32} \textit{Taco Bell}, supra note 31.
\textsuperscript{33} Id.
\textsuperscript{35} \textit{Urbane Franchisor}, \textit{supra} note 31.
the importance of understanding local markets and adapting the franchise concept to meet the desires of those markets, which is especially crucial in inner-city areas.

C. Additional Operational Considerations for Downtown Stores

In addition to the general need to evaluate a franchise concept for inner-city expansion, there are a number of specific considerations associated with bringing a business downtown. First and foremost, franchisors must keep in mind cost and expense considerations. As compared to their suburban counterparts, inner cities typically have higher costs for “water and other utilities, workers’ compensation, health care, insurance, permitting and other fees,⁶⁶ real estate and other taxes,⁶⁷ OSHA compliance, and neighborhood hiring requirements.”⁶⁸ While each of these costs are implicated at different levels—for example, workers’ compensation fees are imposed statewide and property insurance is localized—they can be perceived to disproportionately impact inner-city markets.⁶⁹ These costs may affect wages and other operating expenses of franchisees.⁷⁰ Similarly, inner cities tend to include stricter governmental regulation, which drives up building and other costs and slows down development at nearly all stages.⁷¹

As a corollary to the increased costs associated with inner-city areas, franchisee access to debt and equity capital can be a significant barrier to franchising. Equity capital can be more difficult to come by for some inner-city franchisees, who may be from traditionally marginalized racial or ethnic groups or from lower socioeconomic levels.⁷² With respect to debt capital, it is an unfortunate fact that many inner-city businesses still suffer from poor access to debt financing because large banks have historically neglected inner-city businesses, anticipating an inability to succeed.⁷³ Transaction costs

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⁶⁷. Porter, supra note 36, at 18. “It is an unfortunate reality that many cities—because they have a greater proportion of residents dependent on welfare, Medicaid, and other social programs—require higher government spending and, as a result, higher corporate taxes. The resulting tax burden feeds a vicious cycle—driving out more companies while requiring even higher taxes from those that remain.” Id. at 19.

⁶⁸. Id. at 18.

⁶⁹. See id. at 19 (arguing that increased business costs disproportionately impact inner cities).

⁷⁰. See id. (explaining the impact of increased costs).

⁷¹. See id. (“Cities have been reluctant to challenge entrenched bureaucracies and unions, as well as inefficient and outdated government departments, all of which unduly raise city costs. Finally, excessive regulation not only drives up building and other costs but also hampers almost all facets of business life in the inner city, from putting up an awning over a shop window to operating a pushcart to making site improvements. Regulation also stunts inner city entrepreneurship, serving as a formidable barrier to small and start-up companies.”).

⁷². See id. at 21–22 (noting some inner-city franchisees may lack the extensive personal or family savings required to establish a franchise).

⁷³. See id. (identifying gaps in availability of debt capital in inner-city markets).
associated with small-business lending can be high relative to the smaller loan amounts.\textsuperscript{44} Fortunately, the federal government has implemented programs to help ease the strain on small-business owners. “As a result of legislation like the Community Reinvestment Act, passed in order to overcome bias in lending, banks have begun to pay much more attention to inner-city areas.”\textsuperscript{45} In addition, Small Business Administration 7(a) loans are an attractive option for banks and franchisees alike as they are guaranteed by the Small Business Administration and offer flexible terms and low interest rates.\textsuperscript{46}

In short, franchising in inner-city markets presents a number of general considerations for franchisors to keep in mind. Prominent among those is the importance of examining the conditions of local markets, which behave differently from traditional suburban markets. In addition, success in urban areas requires the operational flexibility to adapt to changing circumstances. Franchisors should strive to work closely with local community residents and governmental authorities to establish a lasting footprint.

\section*{II. Real Estate Considerations}

Real estate is one of a handful of considerations noteworthy enough to warrant its own discussion. Historically, real estate has been one of the most important aspects of a successful inner-city franchise—a franchisee may have outstanding operational knowledge of a franchise concept, but if the franchise itself is located in a poor trade area, the franchisee may not succeed.\textsuperscript{47} Given the fundamental differences between suburban and inner-city markets, franchisors should think carefully about the territories that they grant to franchisees and the real estate factors that they consider when approving franchised locations, as the data supporting standard real estate factors—for example, population density, foot traffic, retail space, property values, and so on—may vary greatly. Accordingly, this section will explore various considerations related to downtown real estate, with an emphasis on the strategies available to franchisors. Primarily, franchisors can either seek out prime, expensive spaces to create one-of-a-kind locations, or they can settle on underdeveloped downtown areas that offer more affordable land, but potentially higher development costs.

\subsection*{A. Unique Franchised Locations in Downtown Areas}

Not only do all downtown areas differ from one another, but the various neighborhoods within each urban area vary greatly from one to the next. “A

\textsuperscript{44} See id. (explaining potential causes of lower availability of debt capital).
\textsuperscript{45} Id. at 21.
\textsuperscript{47} However, traditional brick-and-mortar locations are increasingly giving way to franchises that may only have an online presence.
ride through a large U.S. city can seem like a visit to the United Nations, passing through neighborhoods whose signs and languages change by the minute.” Franchise companies should keep in mind that many downtown regions contain numerous historical buildings, and local governments may prohibit franchisees from building out certain locations into the standardized designs often required by franchisors. In other words, not all city units may be identical—what works well in a strip mall or stand-alone unit in a suburban vanilla box may not work in a decades-old building in a downtown area. To that end, franchisors may have to reconsider design elements so their concept fits visually in a given space. Although reconfiguring design and structural elements may be a hurdle, some innovative build-outs can result in lower overhead costs; reduced space means fewer employees, less equipment, smaller signage, and the need to support different operating platforms, among other things. As a consequence, inner-city businesses can drive “extraordinary sales per square foot, especially for carry-out [and delivery], which [are] extremely popular for on-the-go city residents.”

In addition to the reduced costs, trendy urban spaces may serve to increase customer counts. Millennials increasingly gravitate toward downtown urban areas, often seeking out trendy, innovative concepts. Arby’s is a prime example of a franchisor adapting to urban real estate by building a sprawling three-story, 5,000-square-foot restaurant in a 100-year-old building in the heart of Manhattan. To create a footprint in the ultra-competitive downtown area, Arby’s discarded its cookie-cutter suburban layout and curated a design unique to the specific Manhattan location. The restaurant features a “shotgun-style main level, a guest mezzanine over the back half of the store, and a full basement that also serves as a crewmember break room, dry storage and full-service catering kitchen to replace those drive-thru dollars the brand typically relies on in suburban locations.” In addition, the company improved its capacity to handle catering orders—which have higher demand in downtown areas—by reducing its back-of-house area by twenty percent when compared to its suburban locations. Similarly, Primrose Schools, discussed earlier in Section II, uniquely embraces urban spaces by putting “its playground on a massive rooftop [that is] fun for kids and is off the street to

49. See id. (arguing that franchisors should be flexible with store layouts given the unique nature of downtown buildings).
50. See id. (encouraging franchisors to develop new design concepts for downtown stores).
51. Id.
53. Id.
54. Id.
55. Id.
56. Id.
alleviate parental safety concerns.” By adapting to the unique qualities of inner-city real estate options, franchisors can create one-of-a-kind locations and remain true to their system standards.

B. Underdeveloped Real Estate in Inner Cities

As noted earlier, franchisors can take two strategies when considering a move downtown—on one hand, they can seek out more expensive, prime pieces of real estate to establish statement stores; on the other hand, they can seek out underdeveloped areas, which offer reasonable prices per square foot. Underdeveloped inner-city neighborhoods present an opportunity to find locations at lower costs compared to traditional locations. Furthermore, as cities revitalize their downtown areas, companies are increasingly moving into neighborhoods previously reserved for factories and warehouses. These neighborhoods provide large spaces at more reasonable prices, which are often located in easy-to-access areas near public transportation.

Conversely, vacant property in inner cities may not be economically usable. Numerous federal, state, city, and local governmental agencies have extraordinary control over land and development, which may result in increased costs for developers who attempt to assemble several small vacant lots into usable sites. Even once the land is acquired, development, environmental cleanup, and litigation can be extremely expensive. Furthermore, the costs of building downtown can be much higher than in the suburbs due to logistics, negotiations, the requirement to use trade unions, and city regulations including zoning, city codes, permitting, and inspections. Perhaps most prohibitive is the amount of time that these steps can take.

Overall, real estate in downtown markets can be a mixed bag. Underdeveloped neighborhoods often offer cheaper real estate with unique designs and layouts—provided a franchisor is willing to take the time to

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57. The Urbane Franchisor, supra note 31.
58. See Seid & Ainsley, supra note 1 (arguing that one of the main competitive advantages of inner-city markets is the existence of underdeveloped real estate).
59. See id. (noting that existing real estate is getting repurposed for franchise concepts).
60. See id. (explaining that former warehouses and factories provide opportunities for franchise expansion).
61. See Porter, supra note 36, at 17 (identifying hurdles to real-estate development in inner cities). “For example, development of the Jeffrey Plaza shopping center in Chicago’s South Side required government efforts over eight years to assemble 21 contiguous parcels. Similarly, attempts to rebuild South Central Los Angeles after the 1992 riots have been hampered because only 9 of 200 vacant or underutilized properties are larger than one acre.” Id.
63. See Porter, supra note 36, at 18 (comparing costs in suburban markets and inner-city markets).
64. See id. (“Managers interviewed in Boston, Los Angeles, and Chicago expressed frustration with the three-year to five-year waiting periods necessary to obtain the numerous permit and site approvals required to build, expand, or improve facilities.”).
design and construct a restaurant that visually matches those spaces. At the same time, the steps required to acquire, develop, and construct buildings in these underdeveloped areas can make the costs potentially prohibitive. And, of course, given the density and competitive nature of more developed downtown areas, real estate can be quite expensive. Nevertheless, the opportunities can be attractive to franchisors due to the prime location, unique layouts, potential for high sales per square foot, and the number of impressions created by the density of foot and vehicular traffic. Franchisors looking to expand into urban markets should keep these considerations in mind, as they all will have an impact on franchisee success.

III. Franchisee and Employee Considerations

To find lasting success within inner-city markets, franchisors should, as a priority, take steps to identify and attract strong franchisees who understand the local markets and encourage franchisees to find employees who will support and advocate for the brand within their communities. Many urban areas may be unfamiliar with certain franchise concepts. For those concepts that do have existing brand recognition, local community members may not fully trust the intentions of franchisors expanding into their communities. Once franchisors get past those initial barriers to entry, they may find that inner-city markets are full of residents who are both brand-conscious and brand-loyal.65

A. Recruiting Well-Qualified Franchisees

As with suburban markets, successful urban franchising starts with recruiting the right franchisees. To find well-qualified franchisees, franchisors may have to reevaluate their traditional methods of franchisee search and selection.66 It may be tempting for franchisors to seek out franchisees interested in remote ownership; that is, those individuals living in the suburbs but operating franchises in downtown areas. Franchisors who have seen success expanding into inner-city markets, however, have paired local franchisee candidates with available capital and other resources unique to their communities.67 As noted earlier, franchisors should be careful not to lower selection or operating standards, which would be counterproductive to a successful relationship.68 With that in mind, franchisors should be wary of the challenges of trying to find franchisees within inner-city markets. Unfortunately, given the higher rates of poverty in inner cities, franchisors may struggle to

66. See MSA Worldwide, supra note 17 (emphasizing the importance of flexibility in franchisee recruitment strategies).
68. See id. (cautioning franchisors against lowering system standards to east expansion).
find franchisees who live in the market and have the capital, business experience, and appetite for risk required to start a franchise.69 When compared to suburban markets, franchisors may have to engage a greater number of prospects to find the ideal franchisee.70 Patience and collaboration with local communities, governmental agencies, and inner-city revitalization projects will be key to tracking down well-qualified candidates. Franchisors must hold a firm belief in the success of their units in inner-city markets and must demand the same from their franchisees. By combining a genuine interest in the local communities with well-recruited and well-qualified franchisees, franchisors will set themselves up for success.

Nevertheless, the real or perceived inexperience of franchisees may have a negative impact on a franchisor’s expansion strategy. Preliminarily, potential franchisees in inner cities may have less experience analyzing and negotiating contracts than suburban franchisees, which could result in overlooked or ignored contract terms.71 In addition, they may have trouble comparing other opportunities and could end up in an unfavorable business arrangement.72 The unfortunate truth is that due to the lack of both capital and available franchise concepts, many prospects are likely to be lacking extensive franchise business experience.73 Although franchisors should not negotiate against themselves during the sales process, companies should keep in mind that they may be dealing with prospects who have less experience than their suburban counterparts or who are entrepreneurial enough to adapt to the changing needs of a downtown micro-market, yet able and willing to follow what they might believe are too rigid of system standards. Accordingly, franchisors should allocate additional time to search for and vet potential franchisees, and should work closely with prospects to ensure a franchise relationship is beneficial for all parties.

B. Hiring and Training Inner-City Employees

Once a franchisee has been selected, the franchisor should work closely with the franchisee to educate and empower it to recruit the right personnel. Regarding labor and employment, the existing shortages of retail establishments present a largely untapped labor market from which franchisees may be able to draw. Many residents living in inner-city markets must travel away

70. See id. (identifying potential strategies for inner-city franchisee recruitment). “To find one franchisee, he noted, most franchise companies talk with 40 to 100 prospects. For the inner-city partnership program, Chandler said, ‘It’s more than 200, probably several hundred.’” Id.
71. See Leigh et al., supra note 27, at 15 (noting that inexperienced franchisees may have trouble interpreting franchise agreements).
72. See id. (explaining that the inexperience of inner-city franchisees may adversely impact urban growth).
73. See id. (pointing out that many inner-city franchisees lack extensive franchise experience).
from home to find jobs, so local opportunities benefit everyone. Nevertheless, franchisors may face a number of challenges related to hiring and training and, unfortunately, the perception of a less skilled labor force. To combat these challenges, franchisors should encourage their franchisees to find well-qualified employees who will be loyal and dedicated to the brand. In addition, franchisors may need to rethink their training programs to better train inner-city franchise employees. For example, some retailers who have found success in inner cities have dedicated additional training resources and offered incentives to increase retention and avoid turnover. As with franchisees, management-level employees within franchised units must share in the franchisor’s belief that their concept will be successful within the local communities. “Top management must allocate the necessary resources, set high operational standards, and institute practices that capitalize on the market opportunity and position inner-city stores to succeed. Franchisors must hire qualified, profit-focused in-store managers and hold them to the same performance expectations as managers in other store locations.”

A franchise will struggle to achieve long-term success without emphasizing buy-in by both the franchisees and their employees. Franchisors should avoid making the hiring decisions on behalf of franchisees, but franchisees will undoubtedly look to the franchisor for guidance in recruiting, hiring, training, and retaining effective personnel. Thus, when considering an expansion into inner-city markets, franchisors should keep in mind that they may have to pay extra attention to their brand standards that will help franchisees focus their hiring and training, or develop suggestions to aid those franchisees.

IV. Crime and the Perception of Crime

Crime and the perception of crime are certainly elements franchisors must deal with in suburban markets, but the unfortunate reality is that crime rates tend to be higher within inner-city areas. Particularly, franchisors must contemplate criminal acts that threaten both employees and customers. To that end, successful franchising in urban areas necessitates robust and effective management of both actual crime and the perception of crime. “The perceived magnitude of crime in inner cities may be exaggerated, partly because of excessive and perhaps myopic coverage by the media of criminal activity...”

74. See Seid & Ainsley, supra note 1 (arguing that inner-city residents will benefit from local businesses).
75. See generally Boston Consulting Group, supra note 2 (identifying employment challenges facing franchisors in inner-city markets).
76. See id. at 13 (suggesting that success in inner-city markets depends on franchisees hiring well-qualified employees from the local community).
77. See id. (stressing the importance of effective hiring and training strategies).
78. Id. at 14.
79. See generally Boston Consulting Group, supra note 2 (discussing crime rates in inner cities).
in these areas.\textsuperscript{80} While recent statistics have marked a decrease in violent crime nationwide,\textsuperscript{81} crime rates remain higher in downtown areas relative to the suburbs.\textsuperscript{82} As a consequence, franchisors should work to develop and recommend suggested strategies to franchisees for combating crime and the perception of crime. In many companies that already have an inner-city presence, in-store managers are encouraged to work closely and effectively with law enforcement officials and community groups.\textsuperscript{83} Moreover, many local units outfit their stores with extra lighting, surveillance, and private security personnel.\textsuperscript{84} Franchisors should consider the unique elements present in inner-city markets and account for the potentially higher crime rates, or at least consider creating an environment that emphasizes security to avoid even a high-crime perception.

Notably, franchisors should never assume a duty to protect employees and patrons, and they must avoid implications of joint-employer liability. To that end, franchisors should present certain safety policies—particularly those centered around staffing levels and employee behavior—as recommendations rather than requirements. In much of the litigation across the United States concerning the issue of crime in franchised outlets, many courts have declined to hold franchisors liable for failing to prevent crime in their franchised units. For example, in \textit{Kerl v. Dennis Rasmussen, Inc.},\textsuperscript{85} the victim of a shooting perpetrated by an employee at a franchised unit brought a negligence action against the franchisee and the franchisor under a theory of vicarious liability.\textsuperscript{86} The case was appealed to the Wisconsin Supreme Court, where the court held, as a matter of first impression, that the franchisor did not have control or the right to control the franchisee’s supervision of its employees.\textsuperscript{87} Without the requisite level of control, the court declined to hold the franchisor liable for the franchisee’s alleged negligence.\textsuperscript{88} Additionally, in a pair of cases out of the Circuit Court of Cook County, Illinois, the court considered whether the franchisor had voluntarily undertaken

\begin{thebibliography}{88}
\bibitem{80} Id. at 16.
\bibitem{81} Boston Consulting Group, \textit{supra} note 2 (“Between 1989 and 1996, the total crime rate fell by 46 percent in New York, by 33 percent in Boston, and by 25 percent in Miami.”).
\bibitem{83} \textit{See Boston Consulting Group, supra} note 2, at 16 (discussing strategies for dealing with higher crime rates); \textit{see also} Zeuli, \textit{supra} note 82, at 13 (same).
\bibitem{84} \textit{See Boston Consulting Group, supra} note 2, at 16 (discussing strategies for dealing with higher crime rates).
\bibitem{85} \textit{Kerl v. Dennis Rasmussen, Inc.}, 682 N.W.2d 328 (Wis. 2004).
\bibitem{86} \textit{Id.} at 331.
\bibitem{87} \textit{Id.}
\bibitem{88} \textit{Id.} at 332; \textit{see also} Wu v. Dunkin’ Donuts, Inc., 105 F. Supp. 2d 83, 84 (E.D.N.Y. 2000), aff’d, 4 F. App’x 82 (2d Cir. 2001) (finding that the franchisor was not vicariously liable for security lapses associated with assault of a franchisee’s employee because the franchise agreement did not give the franchisor considerable control over security).
\end{thebibliography}
to provide safety to franchisees and consequently breached that duty. In both cases, the court declined to find the franchisor liable, despite the fact that the franchisor in both cases encouraged its franchisees to adopt crime-prevention strategies. Finally, in VanDeMark v. McDonald’s Corp, a restaurant worker brought both a negligence and vicarious liability claim against the franchisor after the restaurant employee was attacked while working. There, the New Hampshire Supreme Court found that the franchisor did not attempt to provide security to the franchisee’s employees and therefore did not assume a duty to the worker. Moreover, the court found the franchisor did not assume control over the franchisee’s security measures and rested its decision on the fact that the franchisor simply made recommendations rather than mandating specific actions. With these decisions in mind, franchisors should prepare their crime-prevention strategies with caution, emphasizing that they are presented to franchisees as suggestions and recommendations, rather than requirements. In doing so, franchisors can help make franchisees feel comfortable, which will result in the franchisee’s employees and customers feeling safe and secure as well.

In addition to violent crime, inner-city markets experience increased levels of graffiti and vandalism. Graffiti, in particular, is an especially burdensome nuisance because it can quickly return after walls and windows are cleaned, repainted, or replaced. In 1992, the City of Chicago made it illegal to purchase spray paint within city limits due to the nuisance posed by graffiti—a ban which exists to this day. Similarly, vandalism to store signage and premises presents a potentially costly burden to franchisees who must repair or replace any damage to their units. In response, franchisors should consider the degree to which they should enforce their image and system standards on urban franchisees. On one hand, uniformity of brand standards across the system is essential to a franchise company’s success—thus, many franchisors may want inner-city locations to maintain the same store appearance as suburban locations, regardless of the potentially increased rate of crime; although doing so may result in higher maintenance costs. On the other hand, franchisors can take a flexible approach and relax image standards slightly to account for the increased problems associated with graffiti and vandalism, or they could even intentionally decorate with murals to preempt or incorporate any graffiti. Understandably, these exceptions may

90. Chelkova, 771 N.E.2d at 1110; Castro, 732 N.E.2d at 40.
91. VanDeMark v. McDonald’s Corp., 904 A.2d 627 (N.H. 2006).
92. Id. at 629.
93. Id. at 633.
94. Id. at 636.
96. See generally id. (discussing Chicago’s spray paint ban).
make it harder to enforce uniformity across the system. Thus, it may be beneficial for franchisors to take a hybrid approach; as noted earlier, operational flexibility is a crucial component to success in inner-city markets.

Conclusion

Franchisors’ investments in inner-city markets may create some additional risks and involve considerations not as prominent in more traditional suburban markets, but when evaluating expansion options, franchisors would do well to balance those considerations and both the real and perceived risks, especially as compared to those presented by international expansion or other expansion methods. The needs and desires of community residents can be unpredictable, and the barriers to entry are sometimes steep—governmental regulations can be cumbersome, and capital can be scarce. Nevertheless, expansion into these areas presents a tremendous opportunity for franchisors to tap into markets with enormous buying potential. To do so successfully requires a careful evaluation of the viability of the concept in a particular urban area along with flexible standards related to a number of different aspects of the franchise system, including operations, real estate, and training. To maximize success in these regions, franchisors must combine self-awareness of their concept with a keen understanding of the unique characteristics of the local markets.
The Economic Loss Doctrine: Getting Rid of the Surplusage in Franchise Case Complaints

Justin Sallis

Your franchisor client has paid good money for a franchise agreement that expressly and exhaustively defines its rights and obligations and limits its exposure to damages in the event of a breach. A dispute arises under the agreement, and the franchisee sues. Despite the contractual nature of the dispute, you find yourself staring at a bevy of tort claims supposedly arising from your client’s failure to perform under the contract. Worse yet, the complaint seeks not only consequential damages but punitive damages. There may be a doctrine for that.

The economic loss doctrine (or the economic loss rule, the Moorman doctrine, the independent duty doctrine, or the gist of the action doctrine, as it is known in some jurisdictions) is widely applied to bar “tort claims, and the broader damage awards associated with tort law, when economic losses arise from a contractual relationship.”1 Although “economic losses” may vary by jurisdiction, they generally include “the loss of bargain, meaning the difference in value between what is given and received,” and “all indirect loss, such as loss of profits resulting from” the failure to receive the benefit of the bargain.2

1. Andrew Gray, Drowning in a Sea of Confusion: Applying the Economic Loss Doctrine to Component Parts, Service Contracts, and Fraud, 84 Wash. Univ. L. Rev. 1513, 1513, (2006); see also Lamar Homes, Inc. v. Mid-Continent Cas. Co., 242 S.W.3d 1, 12 (Tex. 2007) (“The [economic loss] rule generally precludes recovery in tort for economic losses resulting from the failure of a party to perform under a contract.” (citation omitted)).

2. Rodman Indus., Inc. v. G&S Mill, Inc., 145 F.3d 940, 943 (7th Cir. 1998) (citation and internal quotations omitted); see also Gennady A. Gorel, The Economic Loss Doctrine: Arguing for the Intermediate Rule and Taming the Tort-Eating Monster, 37 Rutgers L.J. 517, 520–21 (2006) (“[P]ersonal injury and damage to other property are not economic losses. All other losses are, thus, economic.” (citations omitted)).

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Almost every state has adopted some form of the economic loss doctrine; however, the contours of the doctrine vary across jurisdictions—a fact that has undoubtedly contributed to the doctrine’s description by some as “obscure,” “confusing,” and “concerning.” But when properly applied under the law of any given state, the economic loss doctrine can be an effective tool for eliminating contract claims masquerading as tort claims (and with them the damages exposure and other baggage that tort claims may entail). These claims may include allegations that a party negligently or fraudulently performed its duties under a contract or misrepresented the quality or nature of the goods or services to be provided under a contract. Moreover, the doctrine can often be invoked as a matter of law in the early stages of litigation.

On the one hand, for more than twenty years, courts—when asked—have regularly applied the economic loss doctrine in franchise cases to bar tort claims premised on purely economic losses arising from frustrated commercial expectations in connection with a franchise agreement. On the other hand, courts have also regularly rejected attempts by counsel to extend the reach of the doctrine beyond its limitations in the relevant jurisdiction. This article seeks to clear up some of the confusion over the economic loss doctrine: first, by discussing the doctrine’s origin; second, by discussing the kinds of claims that typically fall squarely within the doctrine’s reach in franchise...

cases; and third, by discussing limitations on the doctrine of which franchise lawyers should be aware.

I. The Origins of the Economic Loss Doctrine

A. Seely v. White Motor Co., 403 P.2d 145 (Cal. 1965)

The origin of the economic loss doctrine lies in the historical tension between contract and tort law in products liability cases. Plaintiffs suffering purely economic losses resulting from defective products would seek to hold manufacturers liable in tort, under theories of strict liability and negligence, instead of under contract or warranty law. Tort actions present many benefits to plaintiffs (and detriments to defendants). For example, tort claims may provide a basis for punitive damages, emotional distress damages, and attorney’s fees. They may also have a less restrictive standard of proof for damages. In addition, tort claims may fall outside of contractual limitations on damages and liability and may be excluded from insurance coverage.

In 1965, in *Seely v. White Motor Co.*, the California Supreme Court addressed the tension between contract and tort law in products liability cases head on, and its decision in that case is often seen as the genesis of the economic loss doctrine. The case arose after Seely purchased a truck manufactured by White Motor for use in his heavy-duty hauling business. Shortly after Seely purchased the truck, it experienced mechanical problems that inhibited Seely’s ability to effectively carry out his business. The truck was subsequently damaged in an accident in which Seely himself was not injured. Following the accident, Seely stopped making payments on the truck, and the seller repossessed it. Seely then sued White Motor seeking (1) his cost to repair the truck after the accident; (2) the amount he had paid toward the truck’s purchase; and (3) his lost profits resulting from the mechanical defects that had inhibited his use of the truck as intended.

The trial court concluded that the truck’s mechanical defects breached the manufacturer’s express warranty and awarded Seely the amount he had paid toward the truck’s purchase. But it held that Seely was not entitled to his costs to repair the truck because he had failed to prove that the truck’s mechanical defects caused the accident. On appeal, the California Supreme Court affirmed the trial court’s holding. In doing so, it rejected Seely’s invitation to hold the manufacturer strictly liable in tort for damages resulting

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7. Grams v. Milk Prods., Inc., 699 N.W.2d 167, 171 n.4 (Wis. 2005); Gray, supra note 1, at 1515 n.16.
8. Gray, supra note 1, at 1515 n.16.
9. Grams, 699 N.W.2d at 171 n.4.
11. Id. at 147.
12. Id. at 147–48. Seely also sued the company that sold him the truck but later dismissed the claim.
13. Id. at 148.
from the truck’s defects. The court’s reasoning forms the underpinnings of the economic loss doctrine.

Writing for the court, Chief Justice Traynor observed that the laws governing strict liability, on the one hand, and sales, on the other, serve distinct purposes.\textsuperscript{14} Strict liability imposes liability on manufacturers, regardless of negligence, for physical injuries to purchasers of a product.\textsuperscript{15} The law of sales, on the other hand, imposes liability for commercial loss where the quality of the product delivered fails to meet the quality promised.\textsuperscript{16} The strong public policy in favor of holding a manufacturer strictly liable when its defective product causes physical injuries, whether or not the manufacturer had warranted the product, is not present where the only injuries caused by a defect are frustrated economic expectations.\textsuperscript{17}

In the absence of the strong policy justifications for preventing personal injury, the Seely court was unwilling to expose manufacturers to “unknown and unlimited” damages.\textsuperscript{18} Instead, it concluded that if the only harm caused by a defective product is frustrated commercial expectations, the manufacturer’s exposure should be limited by its warranties and warranty law.\textsuperscript{19} As stated by the court:

> The distinction [between tort recovery for physical injuries and warranty recovery for economic loss] rests . . . on an understanding of the nature of the responsibility a manufacturer must undertake in distributing his products. He can appropriately be held liable for physical injuries caused by defects by requiring his goods to match a standard of safety defined in terms of conditions that create unreasonable risks of harm. He cannot be held for the level of performance of his products in the consumer’s business unless he agrees that the product was designed to meet the consumer’s demands. A consumer should not be charged at the will of the manufacturer with bearing the risk of physical injury when he buys a product on the market. He can, however, be fairly charged with the risk that the product will not match his economic expectations unless the manufacturer agrees that it will.\textsuperscript{20}

As pointed out in a 2008 *Franchise Law Journal* article on the economic loss doctrine, the most impactful aspect of the Seely holding may have come in dicta immediately following the passage above quoted.\textsuperscript{21} There, Chief Justice Traynor asserted the domination of warranty law, to the exclusion of not just strict liability but also negligence law, where the only loss alleged is frustrated business expectations: “[E]ven in actions for negligence, a manufacturer’s liability is limited to damages for physical injuries, and there is no recovery for economic loss alone.”\textsuperscript{22} Twenty years after *Seely*, the U.S.

\textsuperscript{14} Id. at 149.
\textsuperscript{15} Id.
\textsuperscript{16} Id. at 150.
\textsuperscript{17} Id. at 150–51.
\textsuperscript{18} Id.
\textsuperscript{19} Id. at 151.
\textsuperscript{20} Id.
\textsuperscript{22} Seely, 403 P.2d at 151.
Supreme Court would solidify the economic loss doctrine’s role as a bulwark against the incursion of tort law on contract claims.


In *East River Steamship Corp. v. Transamerica Delaval, Inc.*, the U.S. Supreme Court resolved a split among federal circuit courts applying admiralty law over “whether injury to a product itself is the kind of harm that should be protected by products liability or left entirely to the law of contracts.” The case arose after four supertankers chartered by the plaintiffs experienced mechanical defects in their turbines (the ships’ propulsion systems). The plaintiffs sought in excess of $8 million in damages from the manufacturer of the turbines for the cost of repairing the ships and for lost profits under theories of strict liability and negligence. The plaintiffs had accepted the ships in “as is” condition and therefore had no warranty claims.

Writing for a unanimous Court, Justice Blackmun embraced the approach taken in *Seely* and held that neither a claim for strict liability nor a claim for negligence lies where the only physical harm suffered is to the product itself and the only actual harm suffered by the consumer is frustrated commercial expectations. Justice Blackmun shared Chief Justice Traynor’s concern over imposing potentially open-ended liability and damages in tort for purely economic losses where the strong public policy considerations for protecting individuals from personal injury are not present. Were the Court to hold otherwise, Justice Blackmun observed (with a nod to the maritime nature of the case) that “contract law would drown in a sea of tort.”

As the Court observed in *East River*, “the failure of the purchaser to receive the benefit of its bargain” is “traditionally the core concern of contract law.” Following *East River*, courts across the country adopted the economic loss doctrine in one form or another, many of them embracing the doctrine’s broader implications to bar claims sounding in tort but premised on frustrated commercial expectations in contexts other than products liability. As one court put it:

The economic loss rule emerged largely from the development of products liability jurisprudence. Although its initial development was in direct response to the emergence of strict liability in tort theories, its application is now much broader as it serves today to maintain the boundary between contract law and tort law.

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24. Id. at 859–61.
25. Id. at 861.
26. Id. at 875
27. Id. at 871.
28. Id. at 871–72.
29. Id. at 866.
30. Id. at 870.
It was not long before courts began to apply the economic loss doctrine in franchise cases, where disputes frequently test the boundary between contract and tort.

II. The Economic Loss Doctrine in the Franchise Setting

A. Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998)

Broussard v. Meineke Discount Muffler Shops, Inc. is the case that put the economic loss doctrine on the map for many franchise lawyers. It highlighted (1) the enormous exposure that a franchisor could face if frustrated commercial expectations could be converted into tort claims, and (2) the extent to which the principles underlying the economic loss doctrine could be employed to avoid that exposure.

Ten Meineke franchisees initiated a class action against Meineke, several of its affiliates, and three of its officers alleging that Meineke had breached its franchise agreements with the class members by misusing the advertising fees that the franchisees were required to pay under the agreements. According to the franchisees, advertising fees were to be used only to pay for advertisements, and Meineke breached that obligation when it used the fees to defend and settle a lawsuit brought against it by a third-party advertising agency, pay commissions to outside ad agencies, and pay commissions to Meineke’s in-house ad agency. In addition to alleging a breach of the franchise agreements, the franchisees alleged that the defendants’ mishandling of the advertising fees gave rise to claims for fraud, negligence, negligent misrepresentation, unjust enrichment, breach of a fiduciary duty, intentional interference with contractual relationships, and unfair and deceptive trade practices under North Carolina law.

Following a seven-week trial, a jury awarded the franchisees $196,956,596 in compensatory damages and $150 million in punitive damages. The franchisees elected to forego punitive damages in favor of treble compensatory damages under North Carolina’s unfair and deceptive trade practices act, and the trial court initially entered a judgment for the franchisees of $590,869,788. The court ultimately reduced that amount to $390 million after taking into consideration releases that had been entered into by some members of the putative class.

On appeal, the Fourth Circuit held that the trial court had wrongly certified the class, an error that so tainted the proceedings that the Fourth Circuit deemed it necessary to vacate the jury’s finding on the merits of the
named plaintiffs’ claims. But the court did not stop there. It went on to admonish the trial court, on remand, not to again allow what were at their core contract claims to be cast as tort claims.

Applying North Carolina law, which had adopted the principles underlying the economic loss doctrine, the court held that the wrongdoing giving rise to a tort claim must be “identifiable and distinct” from a breach of contract claim “[i]n recognition of the fundamental difference between tort and contract claims, and in order to keep open-ended tort damages from distorting contractual relations . . . .” In the Fourth Circuit’s view, none of the franchisees’ tort claims, including their fraud and unfair and deceptive trade practices claims, was meaningfully distinguishable from the alleged failure of Meineke to carry out its contractual obligations. The court concluded: “If Meineke has failed to fulfill its contractual obligations, the remedy is contract damages, not the blank check afforded to juries when they are authorized to return a punitive award.”

B. Franchise Cases in the Doctrine’s Wheelhouse

Since its development in *Seely* and *East River*, the economic loss doctrine has been used with some frequency to bar purported tort claims premised on alleged breaches of a franchise agreement. And, in general, courts have had little trouble applying the doctrine to bar claims that a party negligently performed its duties under the agreement causing lost profits and other economic harm.

For example, in *Medicap Pharmacies, Inc. v. Roach*, the U.S. District Court for the Southern District of Iowa held that the economic loss doctrine barred a counterclaim for negligence asserted by the Roaches, who were franchisees of Medicap (a franchisor of prescription pharmacies). The Roaches had alleged that Medicap was liable for negligence based on its inadequate provision of and failure to provide “the various services required under their agreements.” The court held that purely economic losses arising from what

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39. Id. at 344.
40. Id. at 345.
41. Id. at 346.
42. Id. at 346–47.
43. Id. at 347.
46. Id. at *5. The Roaches’ negligence claim mirrored their counterclaim for breach of contract, which alleged that Medicap had failed and refused to provide, among other things, “training and guidance, periodic visits to Defendants’ pharmacy, and accounting services and advice, to Defendants in connection with the operation of their pharmacy.” Id. at *3.
was in effect a breach of contract were compensable, if at all, under contract law not tort law.\textsuperscript{47} Similarly, in \textit{Learning Express, Inc. v. Ray-Matt Enterprises, Inc.}, the U.S. District Court for the District of Massachusetts applied the economic loss doctrine to bar claims by a franchisee that its franchisor had “carelessly, negligently, and recklessly performed their duties to provide [the franchisee] with guidance, training, and assistance with site selection.”\textsuperscript{48}

Franchisees have utilized this application of the doctrine as well. In \textit{Huddle House, Inc. v. Two Views, Inc.}, Huddle House terminated its franchise agreement with Two Views after determining that Two Views was using unapproved products in its franchised restaurant.\textsuperscript{49} Following the termination, Two Views continued to operate the restaurant under a different name using Huddle House’s proprietary products, trademarks, and logos.\textsuperscript{50} Huddle House sued to enforce the post-termination obligations contained in the parties’ franchise agreement. Among its claims was also one for negligence, alleging that Two Views owed Huddle House a duty not to compete or use Huddle House’s proprietary products, trademarks, and logos after the franchise agreement’s termination.\textsuperscript{51} The court granted Two View’s motion to dismiss the negligence claim as barred by the economic loss doctrine, rejecting Huddle House’s creative argument that it had alleged more than purely economic harm because Two Views’ alleged trademark infringement constituted “property damage.”\textsuperscript{52}

Although not as uniformly recognized as barred by the economic loss doctrine as claims for the negligent performance of a contract, many courts have extended the doctrine’s application to claims of alleged misrepresentation in the performance of a contract.\textsuperscript{53} Because they often turn on nothing more than allegations of a failure to perform a contractual duty,\textsuperscript{54} such claims are likely candidates for the doctrine’s application. The U.S. District Court for the District of Utah reasoned in holding the economic loss doctrine barred cross-claims for misrepresentation based on alleged failures to perform under a contract:

\textit{[I]t is clear that the duties alleged by [the cross-claimant] in its tort claims are not independent of the parties’ contract but are part and parcel of the defined rights, obligations and potential liabilities mutually agreed to by the parties. These allegations fall squarely within the four corners of the contract. And, once parties have required something to be performed pursuant to a contract, then an action

\textsuperscript{47} Id. at *5.
\textsuperscript{48} Learning Express, Inc., 74 F. Supp. 2d at 87.
\textsuperscript{49} Huddle House, Inc., 2013 WL 1390611, at *1–2.
\textsuperscript{50} Id. at *2.
\textsuperscript{51} Id. at *4.
\textsuperscript{52} See id. at *5 (“Plaintiff has not cited any authority, and the Court has found none, supporting its contention that “injury” arising from trademark infringement constitutes “property damage” that is actionable in tort, notwithstanding the economic loss rule.”).
\textsuperscript{53} Giles v. Gen. Motors Acceptance Corp., 494 F.3d 865, 877 (9th Cir. 2007) (listing cases where economic loss doctrine applied “to bar recovery on tort claims beyond negligence and strict liability.”).
\textsuperscript{54} Id. at 876.
for nonperformance of that obligation will only be recognized in contract and not tort. This is the reason for and the essence of the economic loss doctrine. The parties’ contractual relationship, therefore, governs in this case.55

Thus, in franchise cases where misrepresentation claims were based on alleged failures to perform contractual duties, courts have found those claims barred by the economic loss doctrine.56 Again, franchisees as well as franchisors have benefitted from this application of the doctrine. In *7-Eleven, Inc. v. Maia Investment Co.*, for example, 7-Eleven determined that one of its franchisees had conspired to sell 7-ELEVEN branded and proprietary products at another convenience store with which the franchisee was affiliated.57 The parties’ franchise agreement prohibited the franchisee from operating a competing store and from offering 7-ELEVEN products from another location.58 The agreement also contained provisions governing the franchisee’s obligation to accurately report the inventory and sales data for its franchise.59 Among other claims, 7-Eleven sued its franchisee for fraud based on its alleged submission of inaccurate inventory and sales records arising from its relationship with the other convenience store.60 The court dismissed the fraud claims as barred under the economic loss doctrine because they were premised on the franchisee’s performance under the franchise agreement; thus, 7-Eleven was left to its remedies under contract law.61

### III. Limitations on the Reach of the Economic Loss Doctrine

Much of the confusion surrounding the economic loss doctrine stems from a failure to appreciate its limits. And the lack of uniformity of those limits across jurisdictions exacerbates the confusion. Still, a general understanding of the kinds of limits that have been imposed on the doctrine in franchise litigation can be helpful.

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56. See, e.g., Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331, 347 (4th Cir. 1998) (observing that tort claims, including fraud and negligent misrepresentation, asserted by franchisees were likely precluded because they concerned franchisor’s performance of advertising-related duties that were governed by contract and therefore controlled by remedies in contract); Jani-King Franchising, Inc. v. Jani-King (GB) Ltd., 2016 WL 7680527, at *4 (N.D. Tex. Feb. 25, 2016) (dismissing fraud claims based on franchisor’s alleged misrepresentation that “plans [were] being made for changes to our franchise system” because misrepresentation occurred after the franchise agreement was executed and only resulted in, allegedly, lost profits expected under the agreement); 7-Eleven, Inc. v. Maia Inv. Co., Inc., 2015 WL 1802512, at *6 (D.N.J. Apr. 17, 2015) (dismissing franchisor’s fraud claims based on franchisee’s performance under franchise agreement).
58. Id.
59. Id. at *2–3.
60. Id. at *3–4.
61. Id. at *6.
A. Contracts for Services

Some jurisdictions have definitively declined to extend the application of the economic loss doctrine beyond its product liability roots and, thus, have held that the doctrine does not apply to services contracts. Furthermore, some lower courts in jurisdictions where the state’s highest court has yet to address the reach of the doctrine have themselves declined to extend its reach beyond products liability cases.

The potential for this issue to be outcome-determinative is highlighted by ERA Franchise Sys., LLC v. Hoppens Realty, Inc. There, ERA sued to enforce its termination of its franchise agreement with Hoppens. Hoppens responded with counterclaims alleging, among other things, that ERA had breached the parties’ franchise agreement by failing to provide the training and support it had promised; misrepresented its intention to provide training and support; and committed conversion by retaining money that Hoppens had paid under a prior settlement agreement between the parties. The franchise agreement contained provisions addressing the services that ERA was obligated to provide to Hoppens, as well as an integration clause. ERA moved to dismiss Hoppens’s misrepresentation and conversion claims on the grounds that they were barred by the economic loss doctrine.

The parties disputed whether Wisconsin or New Jersey law controlled the issue. The court found that although both Wisconsin and New Jersey recognized the economic loss doctrine as precluding “contracting parties from pursuing tort remedies for purely economic or commercial losses associated with the contract relationship,” Wisconsin law did not apply the doctrine to contracts for services, while New Jersey law did. Thus, the court observed, “[B]ecause the parties appear to agree that the Franchise Agreement in this case is a contract for services, the economic loss doctrine comes

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65. Id. at *5, 7.

66. Id. at *2.

67. Id. at *7.

68. Id.

69. Id.
into play only if New Jersey law applies.\textsuperscript{70} After concluding that New Jersey law applied, the court held that the economic loss doctrine barred Hoppens's misrepresentation and conversion claims because they sought commercial losses associated with the parties’ contractual relationship.\textsuperscript{71}

Even if a particular jurisdiction limits the economic loss doctrine to products liability cases, that does not necessarily preclude a litigant from attacking contract claims masquerading as tort claims and seeking the early dismissal of those claims. For example, Florida and Michigan have both limited the application of the economic loss doctrine to the products liability context;\textsuperscript{72} nonetheless, courts applying the laws of both those jurisdictions have recognized that the maintenance of a boundary between tort and contract claims remains an operative principle of common law.\textsuperscript{73} Thus, courts in both jurisdictions have held that, even though the economic loss doctrine does not apply, claims sounding in tort must be premised on duties independent of the underlying contract.\textsuperscript{74}

B. Fraud in the Inducement

Disagreement over the economic loss doctrine’s applicability to misrepresentation claims arises most often in connection with claims for fraud in the inducement—that is, claims that the defendant never intended to deliver the quality of product or services promised. On the one hand, the allegedly false promise would appear to be extra-contractual; on the other hand, frequently such claims, at bottom, allege nothing more than disappointed expectations with respect to the quality of goods or services delivered under a contract, seemingly the core concern of contract law. As one scholar observed:

\begin{quote}
The rules for recovery in fraud inherently conflict with the economic loss rule. Fraud expressly allows for the recovery of purely economic losses arising out of a defendant's misrepresentations in a sale of goods or other property. Conversely, the economic loss rule prohibits the recovery of purely economic losses in tort—particularly when the claim arises out of a contract.\textsuperscript{75}
\end{quote}

A strict application of the economic loss doctrine could conceivably lead to the elimination of fraud claims arising from contractual relationships where the only resulting harm is frustrated commercial expectations.\textsuperscript{76} Yet

\textsuperscript{70.} Id.
\textsuperscript{71.} Id. at *9.
\textsuperscript{72.} Tiara Condo. Ass’n, Inc. v. Marsh & McLennan Cos., 110 So. 3d 399, 407 (Fla. 2013); Cargill, Inc. v. Boag Cold Storage Warehouse, Inc., 71 F.3d 545, 550 (6th Cir. 1995).
\textsuperscript{76.} Id. at 1824. The Barton article indicates that at the time the article was written a few jurisdictions appeared to follow this approach. Id. (identifying Wisconsin and Connecticut,
strong public policies favor tort liability for intentional misrepresentations in the commercial context, regardless of whether the alleged misrepresentation arose from a contractual relationship and the harm was solely economic.77

The approach that courts take to the doctrine’s application to fraud in the inducement claims varies among jurisdictions and is often an evolving area of the law within a jurisdiction. Although a detailed survey of the current state of the law in every jurisdiction would likely be outdated shortly after its publication, it is worth identifying the two general approaches that courts have taken to the issue.78

The first approach is to recognize an exception for all fraud in the inducement claims, regardless of whether the alleged promise related to the subject of an underlying contract.79 This exception is usually justified on the

among others, as jurisdictions observing no exception to the economic loss doctrine for fraud claims). However, most of those jurisdictions have subsequently acknowledged some form of an exception to the economic loss doctrine for alleged fraud. See, e.g., Ulbrich v. Groth, 78 A.3d 76, 98 (Conn. 2013) (acknowledging exception to economic loss doctrine for misrepresentation claims premised on inducement into a contract); Digicorp, Inc. v. Ameritech Corp., 662 N.W.2d 652, 662 (Wis. 2003) (adopting “narrow” exception to economic loss doctrine for fraud in the inducement claims). It is not clear that any jurisdiction currently recognizes the economic loss doctrine as an absolute bar to all fraud claims for purely economic losses.

77. See Robinson Helicopter Co., Inc. v. Dana Corp., 102 P.3d 268, 273–74 (Cal. 2004) (“Allowing Robinson’s claim for Dana’s affirmative misrepresentation discourages such practices in the future while encouraging a business climate free of fraud and deceptive practices.”) (citations and internal quotations omitted); Bermel v. BlueRadios, Inc., 440 P.3d 1150, 1154 n.6 (Colo. May 6, 2019) (observing, although dictum, that “the economic loss rule generally should not be available to shield intentional tortfeasors from liability for misconduct that happens also to breach a contractual obligation”).

78. See Kaloti Enters., Inc. v. Kellogg Sales Co., 699 N.W.2d 205, 217 (Wis. 2005) (discussing three approaches). Of course, although the economic loss doctrine may not bar certain fraud claims in some jurisdictions, defenses based on disclaimer, merger, integration, and non-reliance clauses in franchise agreements may nonetheless preclude such claims. Karen B. Satterlee & Kerry L. Bundy, “You Made Me Do It”: Reliance in Franchise Fraud Cases, 26 Franchise L.J. 191 (2007).

79. See, e.g., Robinson Helicopter, 102 P.3d at 273 (observing that court’s previous decisions had held that tort damages are available in contract cases where the contract was fraudulently induced); 2314 Lincoln Park W. Condo, Ass’n v. Mann, Gin, Ethel & Frazier, Ltd., 553 N.E.2d 346, 352 (Ill. 1990) (“Moorman expressly recognized two instances—intentional misrepresentation and negligent misrepresentation—in which tort recovery may be allowed for economic loss” (citing Moorman Mfg. Co. v. Nat’l Tank Co., 435 N.E.2d 443 (Ill. 1982))); Formosa Plastics Corp. USA v. Presidio Eng’rs & Contractors, Inc., 960 S.W.2d 41, 47 (Tex. 1998) (“[T]ort damages are recoverable for a fraudulent inducement claim irrespective of whether the fraudulent representations are later subsumed in a contract or whether the plaintiff only suffers an economic loss related to the subject matter of the contract.”); Strategic Intent, LLC v. Strangford Lough Brewing Co. Ltd., 2011 WL 1810474, at *12 (E.D. Wash. May 11, 2011) (“Under Washington law, [defendant] has an independent duty to not commit fraud.”); Trident Atlanta, LLC v. Charlie Graingers Franchising, LLC, 2019 WL 441187, at *3 (E.D.N.C. Feb. 4, 2019) (holding economic loss doctrine did not bar franchisee’s fraud in the inducement claims based on alleged pre-contractual misrepresentations in a Franchise Disclosure Document and marketing materials regarding resources and support to be provided and financial performance claims). In Trident, the court distinguished the case from Broussard v. Meineke Discount Muffler Shops, Inc., 155 F.3d 331 (4th Cir. 1998), by finding that the alleged fraud occurred pre-agreement and would therefore invalidate the agreement, whereas the fraud alleged in Broussard concerned Meineke’s post-contract performance under the agreement. Trident, 2019 WL 441187, at *3.
theory that a duty exists, independent of any contractual duty, not to wrong-
fully induce another to enter into an agreement.80

This broad exception to the economic loss doctrine for fraud in the induc-
ment claims is illustrated in R. North Beach, Inc. v. Country Visions, Inc.81 There,
R. North Beach, a franchisee of Country Visions (a clothing boutique concept),
sued Country Visions for allegedly failing to provide materials and support
promised under the parties’ franchise agreement, including but not limited to
a distinctive and proprietary system, national advertising, and continuing busi-
ness feedback.82 In addition to breach of the franchise agreement, R. North
Beach alleged that Country Visions’s alleged failure to provide the promised
materials and support constituted, among other things, fraud in the induce-
ment.83 That allegation would seem to relate directly to Country Visions’s per-
formance under the parties’ franchise agreement and therefore only give rise
to breach of contract claims. However, applying California law, the federal
district court for the Eastern District of California held that R. North Beach’s
allegations of fraud in the inducement were an exception to the economic loss
document and denied Country Visions’s motion to dismiss the fraud claim.84

The second and most common approach to determining whether the
economic loss doctrine bars fraud in the inducement claims is to distinguish
between claims where the alleged fraud is “extraneous” to the underlying
agreement and claims where the alleged fraud is “interwoven” with the
agreement.85 Fraud that is “extraneous” to the contract is understood to con-

80. See, e.g., Formosa, 960 S.W.2d at 47 (“Allowing the recovery of fraud damages sounding in
tort only when a plaintiff suffers an injury that is distinct from the economic losses recoverable
under a breach of contract claim is inconsistent with this well-established law, and also ignores
the fact that an independent legal duty, separate from the existence of the contract itself, pre-
cludes the use of fraud to induce a binding agreement.”).
82. Id. at *1–2.
83. Id. at *2–3.
84. Id. at *3. In a decision addressing a counterclaim filed by Country Visions in a different
case, the federal district court for the Eastern District of California, again applying California
law, held that the economic loss doctrine did not preclude Country Visions from asserting a
claim for fraud in the inducement arising from its franchisee’s alleged breach of a franchise
agreement’s in-term covenant against competition. Joli Grace, LLC v. Country Visions, Inc.,
2016 WL 6996643 (E.D. Cal. Nov. 30, 2016). The court observed, “Since fraudulent induce-
ment is the violation of ‘a duty independent of the contract arising from the principles of tort
law,’ the economic loss rule does not apply.” Id. at *9 (citing Robinson, 102 P.3d at 273). But see
Oracle USA, Inc. v. XL Global Servs., Inc., 2009 WL 2084154, at *7 (N.D. Cal. July 13, 2009)
(“The allegations of the complaint describe a straightforward breach of a series of agreements
to make payment for services provided. Virtually any time a contract has been breached, the
party bringing suit can allege that the breaching party never intended to meet its obligations.
Businesses should not have to worry that simple disputes about bills and contract perform-
ance will routinely lead to the threat of punitive damages. To allow claims in actions such as this one
would collapse the carefully guarded distinction between contract and tort law.”).
86. Id. at 219 (citing Huron Tool & Eng’g Co. v. Precision Consulting Servs., Inc., 532
N.W.2d 541, 545 (Mich. Ct. App. 1995)).
“interwoven” with the contract is understood to concern misrepresentations “relate[d] to the breaching party’s performance of the contract.”87 Under the second approach, the latter class of claims is barred by the economic loss doctrine; the former is not.88

The Michigan Court of Appeals summarized the reasons for drawing such a distinction in Huron Tool and Engineering Company v. Precision Consulting Services, Inc.:

[W]e decline to adopt defendants’ position that the economic loss doctrine precludes any fraud claim. Fraud in the inducement presents a special situation where parties to a contract appear to negotiate freely—which normally would constitute grounds for invoking the economic loss doctrine—but where in fact the ability of one party to negotiate fair terms and make an informed decision is undermined by the other party’s fraudulent behavior. In contrast, where the only misrepresentation by the dishonest party concerns the quality or character of the goods sold, the other party is still free to negotiate warranty and other terms to account for possible defects in the goods.89

Adopting this distinction, courts will often apply the economic loss doctrine to bar fraud claims that, in their essence, attack a party’s performance under a contract (even if the alleged misrepresentation was made before the agreement was entered into), but not those that concern deceit independent of the contract.90

The reasoning of the Arizona Court of Appeals in Cook v. Orkin Exterminating Co., Inc. illustrates this at times uneasy distinction.91 In Cook, the Cooks alleged that Orkin had fraudulently induced them to enter into a contract for extermination services by falsely representing both the efficacy of the services that Orkin would provide and the terms of any required follow-up work (although none of the alleged misrepresentations was contained in the contract).92 The Arizona Court of Appeals agreed with Orkin and the trial court that Arizona’s economic loss doctrine barred the Cooks’ claims of fraud and negligence where they sought purely economic damages arising from Orkin’s “alleged failure to adequately perform its promises” under the parties’ contract.93

C. Negligent Misrepresentation

Courts have also employed several different approaches in applying the economic loss doctrine to claims that negligent misrepresentations induced

87. Id. at 219 (quoting Huron Tool, 532 N.W.2d at 545).
88. Id. at 219; Huron Tool, 532 N.W.2d at 545.
89. Huron Tool, 532 N.W.2d at 545.
90. See, e.g., RE/MAX, LLC v. Quicken Loans, Inc., 295 F. Supp. 3d 1163, 1170–71 (D. Colo. 2018) (distinguishing between alleged misrepresentations incorporated into the parties’ contract and those extraneous to the contract, and finding the former to be barred by the economic loss doctrine, while the latter were not); Napleton’s Arlington Heights Motors, Inc. v. FCA US LLC, 214 F. Supp. 3d 675, 693 (N.D. Ill. 2016) (applying Michigan law and holding economic loss doctrine barred franchisees’ fraud claims based on misrepresentations “interwoven” with the parties’ dealer agreement).
92. Id. at 150.
a party to enter into an agreement. One approach is to treat such claims the same as fraud claims are treated in the jurisdiction.\(^{94}\) The second approach is to treat negligent misrepresentation claims like those for negligence, rather than fraud, but to make an exception for negligent misrepresentation claims against a defendant “who is in the business of supplying information for the guidance of others in their business transactions.”\(^{95}\) At least one court has held that this exception is typically limited to “pure information providers” such as an accountant, a banker providing credit information to a lender, a real estate agent, a title company, or a stockbroker.\(^{96}\) That court declined to find that exception applicable to a franchisor and, thus, held that the economic loss doctrine barred a claim that the franchisor had negligently misrepresented the viability of a franchise site.\(^{97}\)

A third approach is to treat negligent misrepresentation claims like negligence claims. Under that approach, a negligent misrepresentation claim is barred where the claim concerns purely economic losses arising from frustrated commercial expectations.\(^{98}\)

### IV. Conclusion

The economic loss doctrine is a powerful but limited tool. At its core, it is meant to prevent a party from asserting claims in tort—specifically strict liability and negligence—where the only harm suffered is frustrated commercial expectations resulting from the quality of the product or services delivered being less than what was allegedly promised. Under those circumstances, courts are generally inclined to leave parties to their remedies in contract. But the doctrine is not a universal bar to all tort claims where the parties share contractual privity. The more attenuated relationship between the harm and the bargain, the less likely the doctrine is to apply. It may be said that the economic loss doctrine does not bar tort claims because there is a contract but, rather, bars tort claims brought despite a contract.

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\(^{94}\) Barton, supra note 75, at 1814–15; see, e.g., Napleton’s Arlington Heights Motors, 214 F. Supp. 3d at 693 (applying Michigan law to dismiss fraud and negligent misrepresentation claims premised on representations “made in or related to” the parties’ dealer agreements).

\(^{95}\) Barton, supra note 75, at 1816 (quoting Moorman Mfg. Co. v. Nat’l Tank Co., 435 N.E.2d 443, 452 (Ill. 1982)).

\(^{96}\) Ace Hardware Corp. v. Landen Hardware, LLC, 2011 WL 5979451, at *2 (N.D. Ill. Nov. 28, 2011).

\(^{97}\) Id. at *3 (“Ace’s business model extends far beyond providing advice to its franchisees about the desirability of potential store locations. Among other things, it is undisputed that Ace provides its franchisees with merchandise, credits under its contracts with the franchisees, the right to a non-exclusive license to use various Ace trademarks, and the right to receive patronage dividends under certain circumstances. Accordingly, it is not a pure information provider and its business does not center around providing location information to its franchisees.”).

\(^{98}\) Barton, supra note 75, at 1822–23; see, e.g., Yumilicious Franchise, LLC v. Barrie, 819 F.3d 170 (5th Cir. 2016) (affirming district court’s dismissal of negligent misrepresentation claim as barred by economic loss doctrine where the alleged misrepresentations were integrated into the parties’ franchise agreement, while noting that Texas’s exception to economic loss doctrine for fraud in the inducement claims would not bar identical allegations sounding in fraud).
Injunctive Relief Pending Arbitration: The Evolving Role of Judicial Action

Cheryl L. Mullin, Alyson Conwell & Christopher Howard

From a franchisor’s perspective, arbitration is a popular means of resolving franchise disputes for many reasons. First, because of the initial cost of filing an arbitration demand, arbitration may serve as a deterrent to legal action. Second, an agreement stating that arbitration must be conducted on an “individual” basis and may not be combined with other franchisee claims is likely to deter collective action by franchisees. Individual arbitration makes it harder to assert and prove claims that the franchisor engaged in a pattern of misconduct or that it treated franchisees differently, which are the types of claims likely to increase the scope of discovery, disrupt the franchise system, and influence arbitrator opinion. Third, arbitration proceedings are private, and the proceedings may be kept confidential by private agreement. Even if the proceedings are not “confidential” per se, submissions are not publicly available on databases such as PACER. Because of the lack of a public audience, submissions also may be more concise and less disparaging of the other party. Fourth, arbitration may provide a more predictable way for a franchisor to work with its preferred counsel because the rules that require attorney licensing or special permission to appear in a foreign state’s courts do not always apply to counsel’s participation in arbitration.1 Finally, arbitration awards are

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1. However, counsel must review a state’s local and state laws to determine whether a pro hac vice application is required. Under ABA Model Rule 5.5(c)(3), a lawyer admitted in one United States jurisdiction may provide legal services on a temporary basis in a different jurisdiction that “are in or reasonably related to a pending or potential arbitration, mediation, or other alternative resolution proceeding in this or another jurisdiction, if the services arise out of or are

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enforceable both under state law and by international treaty. ² In domestic actions, the ability to enter or transfer a judgment is no more onerous than entering and transferring a judgment entered by a court. In international actions, arbitration is the preferred method of resolving disputes because enforcing an international arbitral award is often far easier than enforcing a judgment entered by a court.

In choosing arbitration, parties generally have the freedom to choose which disputes will be subject to arbitration and which disputes, if any, will be resolved through the judicial system. In the franchise context, it is not unusual for a franchise agreement to designate arbitration for most disputes but to carve out claims for declaratory and injunctive relief. In such cases, a dispute may arise concerning the scope and applicability of the carve-out. In these cases, either the court or the arbitrator must determine, in the first instance, the arbitrability of the claim.

Even where a claim is subject to arbitration, however, courts have the discretionary power to grant injunctive relief in aid of arbitration—to preserve the status quo in order to prevent the arbitration proceeding from being a meaningless exercise. Therefore, historically, parties to an arbitration agreement routinely applied to the courts for injunctive relief pending the outcome in arbitration. In 2013, however, several of the major arbitral institutions amended their rules to include emergency measures, including appointment of an emergency arbitrator with the power to grant injunctive relief before the arbitrator is appointed. This paper examines the effect of emergency relief in arbitration and the desirability of judicial intervention if emergency relief is available through arbitration.

I. Emergency Measures in Arbitration

The International Chamber of Commerce (ICC) was one of the first arbitration organizations to adopt rules for emergency relief. ³ Adopted in 1990, the rules required parties to affirmatively “opt in” for the rules to

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apply.4 During the 1990s, the World Intellectual Property Organization (WIPO) also contemplated enacting its own emergency arbitration rules. Although WIPO ultimately decided not to do so at that time, it has recently adopted emergency relief rules.5 In 1999, the American Arbitration Association (AAA)6 adopted its Optional Rules for Emergency Measures of Protection, which, as the name suggests, required the parties’ express agreement to use the emergency rules as their chosen framework for seeking emergency relief.7

After the turn of the century, the “opt-in” approach was abandoned in favor of an “opt-out” approach. In 2006, the International Centre for Dispute Resolution (ICDR), AAA’s international division, adopted emergency rules that applied to disputes unless the parties contracted out of the rules.8 AAA and the International Institute for Conflict Prevention & Resolution (CPR)9 adopted mandatory rules for emergency measures in 2013.10 Judicial Arbitration & Mediation Services (JAMS) followed suit shortly afterward in 2014, adopting emergency relief measures of its own.11 Each of these new rules provides for the immediate selection of an arbitrator12 and prompt

4. Grant Hanessian & E. Alexandra Dosman, Songs of Innocence and Experience: Ten Years of Emergency Arbitration, 27 Am. Rev. of Int’l Arb. 215, 216 (2016). One could question the success of these measures, as they were reportedly used only fourteen times during the first twenty-four years they were in place. See Bose & Meredith, supra note 3.
8. Hanessian & Dosman, supra note 4, at 217.
9. The International Institute for Conflict Prevention & Resolution (CPR) was founded in 1977 as a way for corporations to lower the costs of litigation. CPR is well-known for having developed the CPR Pledge in the 1980s, which advocates for parties to engage in alternative dispute resolution prior to filing suit. Since the Pledge’s creation, over 4,000 companies and 1,500 law firms have signed.” History, CPR, https://www.cpradr.org/about/history.
11. JAMS was founded in 1979 and has over 350 neutrals arbitrators. Arbitration Services, JAMS, https://www.jamsadr.com/arbitration.
consideration of the matter in dispute. Today, most arbitral institutions worldwide have adopted emergency arbitration procedures that apply unless the parties’ agreement to arbitration expressly provides otherwise.

Whether parties are now actually choosing to use the emergency relief measures is somewhat uncertain, but the limited available data suggest otherwise. For example, according to information provided by AAA in June 2015, only twelve “emergency arbitrations” were conducted in the twenty-one month period after its emergency relief rule was adopted in October 2013. According to the 2017 Annual Report published for the ICDR, that agency administered seventy-six emergency arbitrations since adopting its emergency relief rules in 2006. And according to the most recent JAMS statistics, which are through 2016, emergency arbitration under JAMS had been invoked only twelve times since the inception of its emergency relief rules in July 2014. And as of January 2019, CPR reported only five requests for interim or emergency arbitration relief since it first adopted its non-administered rules in 2007, including the more recent 2013 rules. The published success rates of parties seeking emergency relief are much lower, although it is unknown what percentage of initiated proceedings were settled or abandoned.

13. AAA requires the emergency arbitrator to establish a schedule for consideration of the application for emergency relief, “as soon as possible, but in any event within two business days of appointment.” Am. Arb. Ass’n, Commercial Arb. Rules r. 38(d) (2016). JAMS also requires the emergency arbitrator to establish a schedule “within two business days, or as soon as practicable thereafter.” JAMS, JAMS Comprehensive Arb. Rules & Procedures r. 2(c)(iii) (July 1, 2014). CPR does not have requirements for a schedule but requires that the emergency arbitrator “conduct the proceedings as expeditiously as possible.” Int’l Inst. for Conflict Prevention and Resolution, 2014 CPR Rules for Administered Arb. of Int’l Disputes r. 14.8 (Mar. 1, 2019).

14. Hanessian & Dosman, supra note 4. A number of other international arbitral institutions have adopted emergency rules, including the Singapore International Arbitration Centre (SIAC), Stockholm Chamber of Commerce (SCC), and London Court of International Arbitration (LCIA).


18. Email from Helena Tavares Erickson, Senior Vice President, Dispute Resolution Services & Corporate Secretary, CPR (on file with author).

19. Blankley & Silverman, supra note 15. Author Pete Silverman received information from JAMS on April 11, 2016. As of 2016, JAMS provided information on nine of the emergency arbitrations, although not of the applicant’s success. Of the nine matters that JAMS had statistics on, “five requests did not go forward for various reasons.” In the other four:

• “An emergency arbitrator was appointed, issued a ruling, and then the parties settled the matter.

• An emergency arbitrator was appointed and issued a ruling. The parties stipulated to moving forward with the arbitration, and asked for the emergency arbitrator to serve for all purposes.
Parties may be reluctant to seek emergency relief in arbitration for several reasons. First, cost may be a consideration. Judges and court personnel are paid with taxpayer dollars; arbitrators and arbitral institute staff are paid by the parties. Second, an arbitration tribunal lacks the power to hold parties in contempt. Third, the arbitration rules likely require advance notice to the other party, which may deprive the moving party of the ability to obtain relief before the damaging act has occurred; court-ordered injunctions may be obtained, in some instances, without advance notice. Finally, and significantly, unless the arbitration clause specifically provides for appeal, there is no right to appeal the grant or denial of injunctive relief by an arbitration tribunal; in comparison, under federal law, orders “granting, continuing, modifying, refusing or dissolving injunctions” are appealable as a right.

II. Where Claims for Injunctive Relief Are Excluded from Arbitration

The Federal Arbitration Act does not confer an absolute right to compel arbitration—it only places agreements to arbitrate on the same footing as other contracts and confers a right to obtain an order directing that “arbitration proceed in the manner provided for in [the parties’] agreement.” As the United States Supreme Court has recognized, arbitration is a matter of contract, and, consistent with that oft-stated admonition, courts must “rigorously enforce arbitration agreements according to their terms.”

For CPR, out of the five requests to invoke the rules, one request resulted in the grant of emergency relief, two resulted in the denial of emergency relief, one resulted in a stipulation, and one request was withdrawn. Email from Helena Tavares Erickson, Senior Vice President, Dispute Resolution Services & Corporate Secretary, CPR (on file with author).

20. See, e.g., AM. ARB. ASS’N, COMMERCIAL ARB. RULES r. 38(b) (2016) (noting that a party in need of emergency relief prior to the constitution of the panel shall notify the AAA and all other parties in writing of the nature of the relief sought. . . . Such notice . . . must include a statement certifying that all other parties have been notified or an explanation of the steps taken in good faith to notify other parties.”); INT’L INST. FOR CONFLICT PREVENTION AND RESOLUTION, 2014 CPR RULES FOR ADMINISTERED ARB. OF INTERNATIONAL DISPUTES r. 14.3 (Mar. 1, 2019) (“Emergency measures . . . are requested by written application to CPR . . . and shall certify that all other parties affected have been notified of the request or explain the steps taken to notify such parties”); JAMS, JAMS COMPREHENSIVE ARB. RULES & PROCEDURES r. 2(c)(i) (July 1, 2014) (“A Party in need of emergency relief prior to the appointment of an Arbitrator may notify JAMS and all other Parties . . . . The Notice must include a statement certifying that all other Parties have been notified. If all other Parties have not been notified, the Notice shall include an explanation of the efforts made to notify such Parties.”).

21. 28 U.S.C § 1292(a)(1); see also TEX. CIV. PRAC. REM. CODE § 51.014(a)(4).


When seeking injunctive relief that relates to an arbitrable substantive claim, the language of the arbitration agreement must be examined to determine whether it excludes *claims* in which injunctive relief is sought or the *remedy* of injunctive relief. In either case, if the carve-out is explicit and clearly applies to the type of relief sought, then the court will likely decide the merits of the claim. If the opposing party can establish a plausible argument that the carve-out does not apply (i.e., that the claim or remedy of injunctive relief must be submitted to arbitration), then the question of arbitrability must be resolved before the merits of the application may be reached.

Questions of arbitrability generally are for the court to decide, unless “the parties have themselves ‘clearly and unmistakably agreed’ that the arbitrator should decide whether an issue is arbitrable.”

A broad arbitration provision (such as a referral of “any and all” controversies) may be construed as a “‘broad grant of power to the arbitrators’ as to evidence the parties’ clear ‘intent’ to arbitrate issues of arbitrability.”

Incorporating the rules of an arbitration tribunal (such as AAA, which provides that “[t]he arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope, or validity of the arbitration agreement or to the arbitrability of any claim or counterclaim”) in the arbitration provision also may constitute a “clear and unmistakable agreement to arbitrate arbitrability.”

An example of a well-drafted carve-out provision is found in *Mr. Rooter LLC v. Akhoian*, in which the franchisor sought injunctive relief against the franchisee for enforcement of the franchise agreement’s non-compete provisions and for protection of its trademarks. The franchise agreement contained a broad arbitration clause but also contained the following carve-out:

> During the course of a Dispute, should a situation arise relating to the Marks or relating to a situation in which Franchisor will suffer irreparable loss or damage

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25. *Benihana, 784 F.3d 887* (2d Cir. 2015) (citing Shaw Grp., Inc. *v. Triplefine Int’l Corp.*, 322 F.3d 115, 121 (2d Cir. 2003)).

26. *See Am. Arb. Ass’n, Commercial Arb. Rules r. 7(a).*


unless Franchisor takes immediate action, including but not limited to threatened or actual conduct in violation of Sections 9 and 12 of this Agreement [dealing with non-competition, franchisor’s marks, trademarks, system and trade secrets]. Franchisor shall be free to seek declaratory relief, restraining orders, preliminary injunctive relief and/or other relief; and such actions or lawsuits shall not be considered in violation of the provisions of this Section 13.

The franchisee moved to compel arbitration of the injunctive relief claim, arguing that claims of arbitrability should be determined by the arbitrator. The district court rejected this argument, stating that “the matter of arbitrability should be arbitrated where there are plausible arguments both in favor of, and against, the arbitrability of a claim,” and that “[i]f the argument supporting arbitrability is ‘wholly groundless,’” then a motion to compel arbitration should be denied.29 Because the franchisor laid out a highly plausible basis against arbitrability of the injunctive relief claim, and because (1) the contract plainly permitted bypassing arbitration for an injunction and (2) Fifth Circuit precedent has upheld contract provisions that provide for injunctive relief even where the underlying dispute is subject to arbitration, the district court denied the franchisee’s motion to compel arbitration.30

An example of problematic carve-out language (which led to an undesired result) was addressed in Plump Engineering, Inc. v. Westshore Design Engineers, PC, where the U.S. District Court for the Northern District of New York examined language in an “Agreement to Arbitrate Claims” relating to an employment relationship.31 The agreement stated that it was to be construed “as broadly as possible” and required that the parties arbitrate “all disputes, claims or controversies of any kind between them, including but not limited to all disputes arising out of Employee’s employment with Employer and/or termination of employment, to the fullest extent allowed by law [except as otherwise provided in the agreement].”32 The agreement also identified claims that were not arbitrable, stating that “the Agreement [to arbitrate] does not cover . . . claims brought by either party for injunctive relief” and that any such claims “may be presented in the appropriate forum.”33 The agreement further provided that “[i]n addition,’ . . . ‘either party may apply to a court for any provisional remedy, including a temporary restraining order or preliminary injunction.”34

The employee subsequently gave notice and informed his employer he was starting a competing business in violation of his non-compete obligations, causing the employer to preemptively terminate the employment

29. Mr. Rooter LLC, 2017 WL 5240886, at *2.
30. Id.
32. Id. at *2.
33. Id.
34. Id.
and seek injunctive relief through the court system to enjoin the prohibited activity.35 The employee moved to compel arbitration.36

In construing the agreement “as broadly as possible” and “in accord with the parties’ intent,” and considering the “presumption in favor of arbitration,” the court found that the employer’s substantive claims must be arbitrated.37 The court also found, however, that the remedy of injunctive relief was not subject to arbitration. Accordingly, the court compelled arbitration of all substantive claims between the parties, noting that the arbitrator may award whatever non-injunctive relief, if any, he or she saw fit, and the court stayed the employer’s claims for injunctive relief pending the outcome of arbitration.38

At the other end of the spectrum, the U.S. District Court for the District of Columbia had an opportunity to opine on an arbitration agreement that was entirely silent on the issue of injunctive relief. In TK Services, Inc. v. RWD Consulting, LLC, the plaintiff argued that the court should consider the merits of his motion for a preliminary injunction because the arbitration clause neither addressed injunctive or other equitable relief nor stated that arbitration was the sole and exclusive forum for interim injunctive relief.39 The court rejected this argument, finding that “the fact that claims for injunctive relief are not specifically mentioned does not lead to the conclusion that they were carved out; the plain reading of the provision suggests that any carve-out had to be explicit.”40 Bolstering its conclusion was the “fact that an exception for injunctive relief was not necessary because the rules of the arbitral forum provide for interim and injunctive relief.”41

In light of the case law, the following drafting rules should be observed when drafting an arbitration agreement: (1) any carve-out from arbitration must be explicit and should apply to all claims in which injunctive relief is sought (i.e., not just to the remedy of injunctive relief), and (2) any dispute whether the carve-out applies must be resolved by the court and not the arbitrator, notwithstanding any contrary provision of the arbitration agreement or the rules of the chosen arbitral institution.

III. Where Claims for Injunctive Relief Are Subject to Arbitration, but Interim Relief Is Necessary to Protect the Integrity of the Arbitration Proceeding

Even where there is no carve-out for injunctive relief, courts have long-recognized that “the congressional desire to enforce arbitration agreements would frequently be frustrated if the courts were precluded from

35. Id.
36. Id.
37. Id. at *4.
38. Id.
40. Id.
41. Id.
issuing preliminary injunctive relief to preserve the status quo pending arbitration and, *ipso facto*, the meaningfulness of the arbitration process.\textsuperscript{42} Courts often will step in, therefore, to preserve the status quo “where the withholding of injunctive relief would render the process of arbitration meaningless or a hollow formality because an arbitral award, at the time it was rendered, could not return the parties substantially to the status quo ante.”\textsuperscript{43} As a result, even where a contract has a broad arbitration clause a district court may grant injunctive relief to preserve the status quo pending arbitration.\textsuperscript{44} This is sometimes referred to as injunctive relief in aid of arbitration.

A court-ordered injunction in aid of arbitration is issued at the court’s discretion, and it may remain in place pending the outcome of arbitration or may be narrowly tailored to consider emergency measures that may be available in arbitration. One such example is in *Sauer-Getriebe KG v. White Hydraulics, Inc.*, which involved a dispute between a motor manufacturer and an exclusive distributor under a distribution agreement that granted the distributor certain rights to acquire the manufacturer's trade secrets and patent rights.\textsuperscript{45} The parties’ agreement provided for arbitration before the ICC of Court of Arbitration before it adopted its emergency rules. There, the Seventh

\textsuperscript{42} See, e.g., Teradyne v. Mostek Corp., 797 F.2d 43, 51 (1st Cir. 1986).

\textsuperscript{43} Id. (preliminary injunction designed to freeze the status quo pending arbitration was an appropriate form of relief when it was shown that the defendant was likely to be insolvent at the time of judgment); Roso-Lino Beverage Distribrs., Inc. v. Coca-Cola Bottling Co., 749 F.2d 124, 125 (2d Cir. 1984) (That a dispute is to be arbitrated does not absolve the court of its obligation to consider the merits of a requested preliminary injunction; the proper course is to determine whether the dispute is “a proper case” for an injunction.); Ortho Pharm. Corp. v. Amgen, Inc., 882 F.2d 806, 811–12 (3d Cir. 1989) (noting that the court does not construe an arbitration agreement as a “waiver” by either party of the right to seek preliminary injunctive relief necessary to prevent one party from unilaterally eviscerating the significance of the agreed-upon procedures); Aggarao v. MOL Ship Mgmt. Co., 675 F.3d 355, 377 (4th Cir. 2012) (explaining that the district court has the authority to grant a preliminary injunction and that the “hollow-formality test” should be used to assess whether the claimant’s injunction request should be entertained); Janvey v. Alguire, 647 F.3d 585, 592 (5th Cir. 2011) (district court can grant preliminary relief before deciding whether to compel arbitration); Performance Unlimited v. Questar Publishers, 52 F.3d 1373, 1377–80 (6th Cir. 1995) (holding that, in a dispute subject to mandatory arbitration under the FAA, a district court has subject matter jurisdiction under § 3 of the Act to grant preliminary injunctive relief provided that the party seeking the relief satisfies the four criteria that are prerequisites to the grant of such relief); Sauer-Getriebe KG v. White Hydraulics, Inc., 715 F.2d 348, 352 (7th Cir. 1983) (remanding case to district court with directions to enjoin manufacturer from repudiating distribution agreement and from transferring claimed contractual rights to a third party until arbitration was completed); Toyo Tire Holdings of Ams., Inc. v. Cont’l Tire N. Am., Inc., 609 F.3d 975, 982 (9th Cir. 2010) (holding that the district court abused its discretion in “finding as a matter of law that it lacked the power to grant injunctive relief”). But see Merrill Lynch, Pierce, Fenner & Smith, Inc. v. Howe, 726 F.2d 1286, 1292 (8th Cir. 1984) (holding that because “the judicial inquiry requisite to determine the propriety of injunctive relief necessarily would inject the court into the merits of issues more appropriately left to the arbitrator, a “district court err[s] in granting injunctive relief” in the absence of “qualifying contractual language” providing for or contemplating the injunctive relief sought).


\textsuperscript{45} Sauer-Getriebe KG, 715 F.2d at 352.
Circuit held that the district court erred in denying the distributor’s motion for a preliminary injunction, and it directed the district court to enjoin the manufacturer from repudiating the contract and from transferring any of the distributor’s claimed contractual rights to a third party until completion of the arbitration and termination of the lawsuit.\textsuperscript{46}

An example of a narrowly tailored remedy taking into account the availability of emergency relief through arbitration appears in \textit{Pre-Paid Legal Services, Inc. v. Kidd}, which involved claims of misappropriation of trade secrets and a request for injunctive relief.\textsuperscript{47} On the day that the action was filed, the court entered a temporary restraining order (TRO) enjoining the defendant (Kidd) from:

1) contacting any person or organization he knows or suspects to be a Pre-Paid associate and, directly or indirectly, soliciting or encouraging the associate to join [Kidd] in a new company or organization, or to leave Pre-Paid for the eventual purpose of joining another company, 
2) disparaging Pre-Paid in an attempt to solicit Pre-Paid associates, and
3) using trade secret information of Pre-Paid for any other purpose.\textsuperscript{48}

The defendant removed the case to federal court and filed a motion to stay pending arbitration, asking the district court to enforce the arbitration provisions contained in the parties’ agreements and to stay the action until a motion for preliminary injunction could be heard.\textsuperscript{49} The court granted Pre-Paid’s request to extend the TRO until such time as it ruled on the request to stay the action pending arbitration.\textsuperscript{50}

In granting the motion to stay arbitration and to extend the TRO, the court recognized:

Under Tenth Circuit precedent, this Court clearly has the authority to issue injunctive relief preserving the status quo pending the initiation of arbitration. The most appropriate avenue for the extended injunctive relief sought herein by Pre-Paid would appear to be a further extension of the TRO set to expire on this Court’s ruling on the motion to stay pending arbitration. Such an extension would preserve the status quo while the emergency measures of protection subsumed within the TRO are addressed in the arbitration setting.\textsuperscript{51}

The U.S. District Court for the Eastern District of Michigan imposed a similar remedy in \textit{Blue Cross Blue Shield of Mich. v. MedImpact Healthcare Systems, Inc.}\textsuperscript{52} There, Blue Cross Blue Shield of Michigan (Blue Cross) filed a lawsuit seeking injunctive relief, specific performance, and declaratory relief

\textsuperscript{46} Id.\textsuperscript{47} 2011 WL 5079538, at *6 (E.D. Okla. Oct. 26, 2011) (order granting defendant’s motion to stay pending arbitration and extending the expiration date of the TRO to a date certain “or until an emergency arbitrator hears and determines an application for emergency measures relating to preserving the status quo as set forth under the TRO whichever date first occurs”).\textsuperscript{48} Id. at *1.\textsuperscript{49} Id.\textsuperscript{50} Id.\textsuperscript{51} Id. at *2 (citations omitted).\textsuperscript{52} Blue Cross Blue Shield of Mich. v. MedImpact Healthcare Sys., Inc., 2010 WL 2595340 (E.D. Mich. June 24, 2010).
requiring that MedImpact continue providing pharmacy benefit managing services under an agreement between the parties.\textsuperscript{53} The court granted Blue Cross’s motion for preliminary injunction, requiring that MedImpact continue to provide certain services “until such time as an arbitrator enters an alternative order regarding temporary injunctive or final relief.”\textsuperscript{54} The court’s order also directed Blue Cross to immediately demand arbitration under the agreement, and that the parties “initially proceed under the Optional Rules for Emergency Measures of Protection of the Commercial Arbitration Rules of the American Arbitration Association and then expeditiously pursue a final resolution of the issue in arbitration.”\textsuperscript{55}

The concept of designing a narrowly tailored remedy that preserves the status quo while leaving undecided claims that are subject to arbitration is illustrated in \textit{Benihana, Inc. v. Benihana of Tokyo, LLC}, which involved an agreement pursuant to which Benihana, Inc. (Benihana America) granted Benihana of Tokyo (Benihana Tokyo) the right to operate Benihana restaurants in Hawaii.\textsuperscript{56} Benihana Tokyo allegedly exceeded the scope of the license by selling hamburgers and other unauthorized menu items. After extended cure periods, Benihana America sought to terminate the license and successfully petitioned the district court for injunctive relief to enjoin Benihana Tokyo from (1) selling hamburgers or other unauthorized food items on the premises of, or in any manner in connection with, the Benihana restaurant it operates in Hawaii; (2) using or publishing advertisements, publicity, signs, decorations, furnishings, equipment, or other matter employing in any way whatsoever the words “Benihana of Tokyo” or the Benihana “flower” symbol that have not been approved in accordance with the parties’ license agreement; and (3) arguing to the arbitration panel that it be permitted to cure any defaults if the arbitrators ruled that Benihana Tokyo breached the license agreement.\textsuperscript{57} On appeal, the Second Circuit upheld the injunction against the sale of unauthorized menu items and misuse of the Benihana trademarks, but it found that the district court abused its discretion in enjoining Benihana Tokyo from arguing to the arbitrator for an extended cure period, stating that “the district court, rather than independently assessing the merits, should have confined itself to preserving the status quo pending arbitration. Restricting the relief Benihana of Tokyo could seek in arbitration undermined rather than aided the arbitral process.”\textsuperscript{58}

Courts also have denied injunctive relief where it was otherwise available through arbitration on grounds that the availability of such relief in arbitration negated the element of irreparable harm. This was the result in \textit{Gold v. Maurer}, where the court declined to issue a TRO because the plaintiff failed requiring that MedImpact continue providing pharmacy benefit managing services under an agreement between the parties.\textsuperscript{53} The court granted Blue Cross’s motion for preliminary injunction, requiring that MedImpact continue to provide certain services “until such time as an arbitrator enters an alternative order regarding temporary injunctive or final relief.”\textsuperscript{54} The court’s order also directed Blue Cross to immediately demand arbitration under the agreement, and that the parties “initially proceed under the Optional Rules for Emergency Measures of Protection of the Commercial Arbitration Rules of the American Arbitration Association and then expeditiously pursue a final resolution of the issue in arbitration.”\textsuperscript{55}

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\textsuperscript{53}. Id. at *1.  
\textsuperscript{54}. Id.  
\textsuperscript{55}. Id.  
\textsuperscript{56}. Benihana, Inc. v. Benihana of Tokyo, LLC, 784 F.3d 887 (2d Cir. 2015).  
\textsuperscript{57}. Id. at 893–94.  
\textsuperscript{58}. Id. at 902.
to seek the appointment of an emergency arbitrator after filing a demand for arbitration with the AAA.\textsuperscript{59} The plaintiffs argued they would suffer irreparable harm without judicial intervention, but the court disagreed, holding partly that proper invocation of AAA’s emergency relief rule (Rule 38) was a factor when considering irreparable harm.\textsuperscript{60} Specifically, the process of selecting an arbitrator “could have begun even earlier had Plaintiffs pursued an emergency arbitrator appointment pursuant to Rule 38. As a result, there is . . . no clear likelihood that the specific harm that the injunction is meant to preclude . . . will actually come to pass.”\textsuperscript{61}

A party’s failure to request emergency relief in arbitration led to a similar result in \textit{Smart Technologies ULC v. Rapt Touch Ireland Ltd.}\textsuperscript{62} There, the U.S. District Court for the Northern District of California denied an application for a TRO where the underlying breach of contract action was subject to arbitration, notwithstanding that the contract allowed the parties to seek emergency relief from a court in certain limited circumstances. According to the court:

> With the parties having agreed that their underlying dispute should be arbitrated, [the plaintiff] has offered no explanation for why a federal court (rather than an arbitrator) should adjudicate the request for emergency relief. Indeed, the only justification [the plaintiff’s] lawyer gave at the hearing for asking a federal court rather than an arbitrator to dive into this dispute at the preliminary stage was his belief that that a federal court would be more likely to issue a TRO automatically. Even if that were true (and it certainly shouldn’t be), it would not be a good reason for a federal court to get involved in a dispute whose merits both parties agree should be arbitrated.\textsuperscript{63}

Important to the court’s decision was the fact that the arbitration rules allowed [the plaintiff] to request emergency relief from an arbitrator as well as from the court. The court recognized that, under the arbitration rules, “an emergency arbitrator would be assigned within a day, and a schedule would be set for considering the application for relief within a handful of days.” The court further recognized that “[t]he [arbitration] rules also allow for procedures (such as giving notice to the opposing party by email, and the use of video conferencing instead of in-person hearings) that are not necessarily available in court.”\textsuperscript{64}

When seeking injunctive relief in aid of arbitration, therefore, a party should consider the availability the interim relief in arbitration and be prepared to explain to the court why such relief is insufficient or inappropriate.

\textsuperscript{60} Id. at 135–36.
\textsuperscript{61} Id.
\textsuperscript{62} Smart Techs. ULC v. Rapt Touch Ireland Ltd., 197 F. Supp. 3d 1204 (N.D. Cal. 2016).
\textsuperscript{63} Id. at 1205.
\textsuperscript{64} Id.
IV. Enforceability of Interim Arbitration Awards

The court’s authority and willingness to review and enforce final arbitration awards (FAA) issued under traditional arbitration rules is well-established. However, enforcement of an arbitration award under the FAA or the New York Convention requires that the award in question be “final” in order to be eligible for judicial confirmation. Nonetheless, interim awards for injunctive relief have been held judicially enforceable as final dispositive orders on issues concerning the parties’ obligations pending the outcome of the arbitration proceeding.

In a 2017 unpublished decision, the U.S. District Court for the Northern District of Oklahoma noted a body of case law in which the courts have considered interim arbitral awards final and thus subject to judicial review. There, the defendant, a business that manufactured, marketed, and sold endodontic products for the dental industry sought to enforce a non-compete agreement against a former consultant. The U.S. District Court for the Northern District of Oklahoma compelled all claims to arbitration and stayed the lawsuit pending arbitration. The defendant moved for a preliminary injunction in arbitration, which the arbitrator granted prohibiting plaintiff from competing with defendant, revealing any of defendant’s confidential information, or intentionally taking action inconsistent with defendant’s best interests. In the ruling, the arbitrator stated that a final evidentiary hearing would take place later that year, that the ruling was tentative and based on the record presented thus far, and that all conclusions were subject to revision after the final, evidentiary hearing.

The defendant moved to confirm the arbitrator’s ruling, which plaintiff opposed on a number of grounds, including that, because the arbitrator characterized the ruling as “tentative” and “subject to revision,” it was not ripe for judicial review. In rejecting this argument, the court considered a “non-binding but persuasive body of case law in which district and circuit courts have considered interim arbitral awards final and thus subject to judicial enforcement.”

68. Id. at *1.
69. Id. at *2.
70. Id. at *3.
71. Id.
72. Id. at *4–6.
judicial review.”73 The court also noted this was “not the type of “relatively inconsequential ‘procedural decision’ or ‘preliminary ruling’ of which judicial review, in the interest of retaining the efficiency that is the raison d’être of our arbitration system, is disfavored.”74 The court confirmed the arbitrator’s ruling on the basis that it “finally and definitely enjoins plaintiff from breaching the [agreement’s] confidentiality and non-compete provisions during the pendency of the arbitration,” further stating that “if the Ruling is not enforced, a subsequent award of injunctive relief to defendant may be rendered meaningless.”75

In a 2013 decision, Yahoo, Inc. v. Microsoft Corp., the U.S. District Court for the Southern District of New York confirmed an arbitrator’s ruling that required a party to a contract to perform its obligations during the pendency of arbitration. In this case, Microsoft sought to enjoin Yahoo from breaching a “Search and Advertising Services and Sales Agreement” entered into as part of a joint venture designed to help Yahoo and Microsoft compete against Google’s Internet search engine.76 The agreement required Yahoo to transition its Internet search results from its “Panama” platform to Microsoft’s “Bing” platform on a region-by-region basis over a specified timeline.77 Just before the time to transition in Taiwan and Hong Kong, Yahoo indicated it would not move forward.78 Ultimately, Microsoft initiated an emergency arbitration in accordance with the rules of the AAA.79

After extensive briefing and a two-day evidentiary hearing, the Emergency Arbitrator issued a seventeen-page reasoned decision, concluding that Yahoo’s unilateral refusal to proceed with the transition in Taiwan and Hong Kong was a breach of the parties’ agreement.80 He also concluded that the evidence established the existence of an emergency within the meaning of the AAA’s Emergency Rules, as well as that Yahoo’s prolonged delay or refusal to complete the transition in Taiwan and Hong Kong would cause severe and irreparable damage to Microsoft.81 The Emergency Arbitrator ordered Yahoo to “use all efforts” to complete the Taiwan and Hong Kong transitions by a date certain, pending a full-scale arbitration by a three-member panel.82

Yahoo filed a petition to vacate the arbitration award in the U.S. District Court for the Southern District of New York, and Microsoft moved to confirm the award.83 The district court denied Yahoo’s petition and granted Microsoft’s cross-petition to confirm, finding that Yahoo had not carried

73. Id. at *6.
74. Id.
75. Id. at *7.
77. Id. at 313.
78. Id.
79. Id. at 314.
80. Id.
81. Id.
82. Id.
83. Id. at 312.
its heavy burden of showing that the Emergency Arbitrator exceeded his authority, and further holding that the arbitral award was ripe and could be confirmed.84

Yahoo appealed the district court’s decision and filed motions to stay enforcement of the arbitral award pending appeal.85 The district court denied Yahoo’s motion to stay, holding that “the stay Yahoo has requested would entirely deny Microsoft the emergency relief, which was granted to Microsoft by the Emergency Arbitrator and which was confirmed by the [District Court].”86

A similar result was reached in Blue Cross Blue Shield of Michigan v. MedImpact Healthcare Systems, Inc where, after successfully seeking a preliminary injunction from the district court, Blue Cross sought and obtained confirmation of an order for interim emergency measures issued by the arbitration tribunal.87 In confirming the order, the district court acknowledged that “arbitration awards are subject to confirmation or vacatur in federal district courts only when the arbitrator’s decision is final, and not interlocutory, but explained that “under certain circumstances, interim awards can qualify as “final” and be eligible for confirmation.”88 According to the court:

An “interim” award may be sufficiently final to warrant review in federal district court when it “finally and definitely disposes of a separate independent claim.” In this case, [Blue Cross Blue Shield] seeks confirmation of the interim award as a final determination on the issue of preliminary injunctive relief while MedImpact maintains that the order is not final and remains subject to modification by the arbitrators.

Analyzing the same issue about confirmation of interim awards of preliminary injunctive relief, the Sixth Circuit affirmed a district court’s observation that “[t]he interim award disposes of one self-contained issue, namely, whether [a party] is required to perform the contract during the pendency of the arbitration proceedings. Th[is] issue is a separate, discrete, independent, severable issue.” Similarly, another judge in the district observed that interim awards tend to be viewed as resolving “separate independent” claims subject to confirmation when they involve “the sort of prejudgment relief that a court might award to preserve the status quo during the ensuing proceedings, or to otherwise ensure that the arbitrator’s final award on the merits is capable of meaningful enforcement.” The interim award of injunctive relief in this case falls squarely within these descriptions of interim awards subject to confirmation.89

Interim arbitral awards that finally dispose of claims relating to the parties’ actions during the pendency of arbitration, therefore, haven been considered “final” and thus ripe for confirmation.

84. Id. at 319.
85. Id.
88. Id. at *2.
89. Id. (citations omitted).
V. Conclusion

While the availability of emergency relief in arbitration has not changed the law concerning arbitrability, it has changed the way courts view applications for injunctive relief in aid of arbitration and how remedies are fashioned to take into account the availability of emergency measures. Nonetheless, strategic advantages may exist to seeking injunctive relief from a court. For example, judicial relief may be necessary if the arbitration provision strips the arbitrator of certain powers (such as enjoining termination of a franchise agreement), or it may be preferable if providing advance notice to the other party could have an undesired result. In these situations, however, the franchisor should inform the court of the arbitration provision and why judicial intervention is needed. Nonetheless, unless there is a plausible argument against arbitrability, or a compelling reason not to seek relief through emergency measures, the parties should be prepared to seek relief in arbitration to avoid judicial irritation and increased costs.
Professional Franchises: The More Things Change, the More They Stay the Same

Nicole Liguori Micklich & Lauren Lyngholm Crowe

I. Introduction

For decades, franchising has included business and professional franchise systems. The reasons business people turn to franchises to own and grow a business may have changed, but the pressures on franchisees and franchisors have not. Traditionally, franchisors of professional concepts have looked to bring already-trained professionals into their systems. Well-known tax preparation service H&R Block began franchising in 1956,¹ and more than sixty-years later the system still looks for “entrepreneurs who currently have a tax business.”² The pool of potential franchisees who fall into this category is almost exclusively licensed professionals because individuals cannot prepare tax returns for compensation unless they already have a preparer tax identification number from the United States Internal Revenue Service (IRS).³

The current allure to professional franchises, however, may be the ability to own a professional franchise without any prior professional experience or licensure. Happy Tax Service is one of H&R Block’s competitors. Happy Tax Service was founded in 2014 and was a Franchise 500 Fastest Growing Franchise in 2017 and 2018.⁴ It is a mobile tax preparation franchise whose franchisees do not prepare taxes themselves. Instead, the franchisees focus

on sales, marketing, and business development, while an “in-house network of US-based licensed CPAs handle the tax prep.”5 The Happy Tax Service homepage touts “TAX EXPERIENCE NOT REQUIRED” as one of the advantages to owning a Happy Tax franchise.6

Because of the popularity of professional franchise concepts, and the sometimes unique issues that exist with them regarding state licensure, it is worth examining whether professional franchise concepts and other franchise concepts have similar pressures in the franchisor-franchisee relationship. This article examines various issues relating to professional franchises and concludes that the legal playing field for professional franchises is very similar to that for other franchised concepts. Professional franchisors include provisions in their franchise agreements that are like those included in other franchise agreements. Like all franchises, professional franchises are governed by the Federal Trade Commission’s (FTC) Franchise Rule and certain state- and industry-specific franchise laws. As a result, the disputes between professional franchisees and franchisors are not unlike the disputes in other franchise systems. Professional franchise systems do have additional considerations that other systems do not, due to regulatory administrations and related rules that govern professional industries. The bottom line is simple: professional franchisors usually must take extra care to identify and comply with applicable regulations in their fields, but this extra layer of regulation does nothing to ameliorate the inherent tensions between franchisors and franchisees.

II. Professional Franchises and Regulatory Requirements

A. The Parties

Today, interested investors can find many concepts in which prior experience is not necessary. Through franchising, entrepreneurs are finding the ability to own a professional business without advanced education or licensing. These business opportunities are in many fields, including restoration and cleanup, staffing, real estate, leadership and other training, business advisers, and, of course, healthcare. The “No Experience Necessary” tag draws prospective franchisees to professional business that may otherwise be unattainable without extensive education or other licensing requirements.7

7. For example, more than half of the states within the United States have home inspector licensing requirements. State-by-State Home Inspector Licensing Requirements Map, Spec- tora, https://www.spectora.com/r/home-inspector-license-requirements-map (last visited Nov. 23, 2018). In Connecticut, qualifications for such a license include earning a home inspector intern permit, performing not less than 100 home inspections in accordance with the relevant state statute, and passing a competency exam administered by the Connecticut Department of Consumer Protection, CONN. GEN. STAT. § 20-492 et seq. However, Pillar to Post Home Inspectors does not require that prospective franchisees already be home inspectors, although
Another attraction for prospective franchisees is professional concepts that assure prospective franchisees that the franchisor will manage legal compliance. Consider Caring Transitions, a franchise system which “provides seniors and their families with senior relocation assistance, downsizing and managing estate sales.” Starting such a business without experience and certifications in law, or personal property appraisal, would be foreboding to most. Specifically, estate sale companies appraise, price, and sell personal property. As a result, in some states, estate sale companies are required to be bonded. But for prospective franchisees of Caring Transitions there is “No experience necessary!” The franchisor provides all needed training.

Similarly, franchising also provides a means for the unlicensed or inexperienced investor to share in the growth of the healthcare industry. Healthcare is a lucrative and growing industry. The healthcare segment is expected to add about 2.4 million new jobs between 2016 and 2026, so it is not surprising that franchising is facilitating that growth. An astute business person, lacking the education and licenses necessary for healthcare practitioners, can tap into the healthcare industry through franchising.

The startup fee may be reduced if the franchisee is already licensed. Franchise Information Page, Pillar to Post, https://franchise.pillartopost.com/who (last visited Nov. 23, 2018).

8. Real Property Management, part of the Neighborly group of brands, is one such concept. “Real Property Management is the largest single-family property management organization in North America, with more than 300 offices in forty-six states and Canada. Real Property Management specializes in franchising a system to manage single-family homes, townhomes, condos, multiplexes and small apartment buildings without onsite management. Its services include finding and screening tenants, completing the lease agreements, collecting rent, arranging for any necessary repairs, and processing evictions when necessary. Real Property Management offices also manage the legal compliance for local, state and federal real estate law.” Real Property Management Information Page, Neighborly, https://www.neighborlybrands.com/our-brands/real-property-management (last visited Nov. 22, 2018).


12. Id.


14. For example, offering home healthcare and more, ActiKare Responsive In-Home Care franchisees “manage a staff of caregivers that help our clients live happier, more active lives.” ActiKare Information Page, Entrepreneur, https://www.entrepreneur.com/business-opportunities/198039 (last visited Nov. 22, 2018). They offer senior care, family care, including child care for children with special needs and programs for moms and moms-to-be; personal injury care; recovery care; and even pet care. Id. The ActiKare franchisor manages a call center and responds to incoming calls during business hours and in most cases the franchisee does not need to maintain a physical office, keeping overhead costs low. Id.

Other examples of healthcare franchises include:

The Joint Chiropractic franchises, whose franchisees do not need to be chiropractors. According to the franchisor’s website, “The franchise has equal numbers of chiropractic and non-chiropractic owners.” Do I Have to Be a Chiropractor?, The Joint Chiropractic, https://thejointfranchise.com/research/simple-business-model (last visited Nov. 23, 2018).
For example, Accessible Home Health Care, with the feel-good motto, “We Guarantee Compassionate Care,” has been “providing multi-dimensional, full-service personal health care” since 2001. The company has “[g]reat territories available,” and “[h]ealthcare experience [is] not required!” As the company asks, “Why settle for a non-medical/staffing franchise with a restricted revenue stream?” Regardless of the industry, the objective of both franchisees and franchisors is to make money. In turn, some conflict is inevitable because both parties to the franchise relationship have an economic interest in maximizing their returns.

B. The Franchise Relationship

The characteristic tension between franchisor and franchisee is present in professional franchises, just as it is in other concepts. The inherent control franchisors seek to exert over their franchisees’ businesses is often the strain on the relationship. Another reason for the tension is the fundamental difference in how franchisors and franchisees make money. Franchisees typically pay royalties to franchisors in the form of a percentage of sales. Therefore, if the franchisor can increase its franchisees’ revenues, the franchisor makes more money. More revenues do not always result in more profits for franchisees because sometimes the increased income is driven by discounting or pushing low margin or labor intensive items, which can result in increased expenses or diminished profit margins.

The size and experience of a franchisor does not eliminate these tensions or the disputes that arise from them. For instance, American Family Care

ARCpoint Labs, in the lab testing and medical screening sector, whose franchisees do not need prior knowledge of the lab testing business and may start without any knowledge of the drug/alcohol/DNA testing industry. Franchising, ARCPoiNT LAbS, https://www.arcpointlabs.com/franchising (last visited Nov. 23, 2018).


Serasana offers wellness yoga, acupuncture, healing remedies, and massage, and tells prospective franchisees they need “life experience” but “[p]rior experience, professionally or personally, in yoga, acupuncture, massage or tea is definitely a plus and is recommended to help ensure each franchise is familiar with at least part of the Serasana franchise concept.” Frequently Asked Questions, Serasana, https://serasanafranchise.com/faq (last visited Nov. 23, 2018).

American Family Care (AFC), which provides access to non-emergency urgent care and minor emergency treatment through more than 200 facilities across the United States, and whose franchisees “don’t necessarily need experience in medical care.” Frequently Asked Questions, Am. Family Care, https://afcfranchising.com/the-opportunity/faq (last visited Nov. 23, 2018).


16. Id.
17. Id.
(AFC) now provides access to non-emergency urgent care and minor emergency treatment through more than 200 facilities across the United States.\textsuperscript{18} In 2013, AFC acquired the Doctors Express franchise system and became the only franchisor operating in the areas of urgent care, accessible primary care, and occupational medicine in the United States.\textsuperscript{19} AFC acquired a concept seemingly organized with a vision and understanding of both the healthcare industry and franchising. That did not insulate AFC from disputes with franchisees.\textsuperscript{20} In short, professional franchisors face the same types of challenges as other franchisors, including franchisees who regret making what they later believe to have been a bad business decision.\textsuperscript{21} As will be discussed later in Section III, professional franchisors face many of the same typical considerations and disputes as their traditional franchisor counterparts.

C. The Franchise Agreement

In professional franchise businesses, as with virtually all other franchises, the franchise agreement includes not only the franchisor's permission to use the trademarks but also permission to use the system or know-how created by the franchisor to allow the franchisee to establish and operate its business, restricted by the franchisee's obligation to use the marks and the system in accordance with the franchisor's business format. While it has long been held that the trademark is the cornerstone of a franchise system,\textsuperscript{22} the Fourth Circuit has written: "[T]he modern franchisee pays not only for the right to use a trademark but for the right to become a part of a system whose business methods virtually guarantee his success. It is often unrealistic to view a franchise agreement as little more than a trademark license."\textsuperscript{23} The franchise agreement describes the rights and duties of the franchisee and franchisor. It is the contract from which many of the tensions between franchisor and franchisee arise. The franchise agreement usually also dictates the way disputes are resolved when those tensions are insurmountable.

Typically, the franchise agreement (1) restricts the goods and services with which the mark may be used; (2) requires the goods and services to meet a quality standard prescribed or adopted by franchisor; and (3) permits the franchisor to inspect the franchisee's operations to ensure compliance. The franchisee also agrees to pay a franchise fee, and royalties. When the franchise agreement takes the form of a distributorship agreement, it will

\textsuperscript{21} See id.
\textsuperscript{23} Principe v. McDonald's Corp., 631 F.2d 303, 309 (4th Cir. 1980).
typically grant the franchisee permission to market and service the franchisor's branded products.

The franchise agreement will often dictate the type of territory granted to the franchisee, including whether the territory is exclusive or protected and whether others can operate, market, sell, or service products or customers in the territory. Other important provisions in a professional franchise agreement, as in most franchise agreements, are (1) the term or length of the agreement; (2) the franchisee’s renewal rights; (3) the right of the franchisee to transfer the agreement and any limitations on such right, including any right of first refusal retained by the franchisor; (4) site selection provisions; (5) training and other assistance provided by the franchisor and the cost of the same; (6) software requirements and licenses; (7) advertising regulations and contributions to advertising funds; (8) dispute resolution requirements; (9) limitations on damages; (10) limitations on the parties ability to bring legal claims or actions; (11) limitation on class actions; (12) forum selection; (13) governing law; and (14) financing restrictions or possibilities.

In professional franchises, special attention must be given to drafting and reviewing certain of those common provisions. The scope of how these special provisions must be drafted is beyond the scope of this article.24 That said, unique provisions a franchisor of a professional business may have in the agreement include: (1) representations regarding licensure, revocation, suspensions, and claims; (2) advertising restrictions and arrangement; (3) legally required limitations on control, and where added controls might be needed; (4) insurance and indemnification; and (5) other specialized ongoing requirements, such as continuing education and training.

III. In Professional Franchises, Typical Franchise Agreement Provisions Mean Typical Franchise Disputes

A recent case demonstrates that professional franchise disputes can arise from the same contract interpretation and breach of contract issues typically litigated in franchise disputes. BrightStar Franchising, LLC is an Illinois-based company that franchises a home-based health services business to franchisees in thirty-seven states. The types of services offered include companion care, personal care, skilled nursing, wound care, post-operative care, infusion therapy, and various other forms of home-based health-related services.25 BrightStar franchisees are granted zip-code based territories designed using statistical information about the population and, specifically, the number of residents aged over sixty-five and eighty-five years old.26

26. Id. at *2.
Franchisees Stephen and Teresa Neff co-owned Northern Nevada Care, Inc. (NNC), a company incorporated in Nevada, which entered into a franchise agreement with BrightStar to provide health-related homecare to “frail, vulnerable people in [their] community.” On June 2, 2015, NNC entered into a ten-year franchise agreement with BrightStar to operate as an in-home medical services provider in and around Carson City, Nevada. The franchise agreement at issue included provisions typical of other franchise agreements in professional and other franchise systems. The franchise agreement included an addendum confirming the franchisees’ understanding that any representations made to the franchisee before the execution of the franchise agreement was not binding. “Although the franchise agreement covered a franchisor/franchisee relationship between BrightStar and NNC, the Neffs personally guaranteed all NNC obligations under the franchise agreement; essentially making them individual parties” to a lawsuit eventually brought against NNC and the Neffs by BrightStar in late 2017. After signing the franchise agreement, NNC became licensed and subsequently operational by the end of 2015. “During the set-up period in 2015 up to and through October 2017, NNC’s Carson City franchise lost money, with the Neffs investing over $300,000 of personal savings to keep the company operating.”

27. Id.
28. Id.
29. Relevant provisions of the franchise agreement included a confidentiality provision, a non-disclosure provision, non-compete covenants, a statement of the franchisee’s obligations upon termination or expiration of the franchise agreement, and arbitration and venue provisions. Id. at *2–4.
30. Specifically, Exhibit G to the franchise agreement, titled “Acknowledgement Addendum To BrightStar Franchising, LLC Agency Franchise Agreement” included the following:

The purpose of this Acknowledgment Addendum is to determine whether any statements or promises were made to you that we have not authorized or that may be untrue, inaccurate or misleading, and to be certain that you understand the limitations on claims that may be made by you by reason of the offer and sale of the franchise and operation of your business. Please review each of the following questions carefully and provide honest responses to each question.

. . . .
10. Do you understand that the Agreement and Disclosure Document contain the entire agreement between you and us concerning your BrightStar franchise rights, meaning that any prior oral or written statements not set out in the Agreement or Disclosure Document will not be binding? Check one: (x) Yes (_) No. If no, please comment: ____________________

YOU UNDERSTAND THAT YOUR ANSWERS ARE IMPORTANT TO USE AND THAT WE WILL RELY ON THEM. BY SIGNING THIS ADDENDUM, YOU ARE REPRESENTING THAT YOU HAVE CONSIDERED EACH QUESTION CAREFULLY AND RESPONDED TRUTHFULLY TO THE ABOVE QUESTIONS. . . .

Id. at *4.
31. Id. at *2.
32. Id. at *4.
33. Id. at *2.
Eventually, BrightStar learned that NNC was servicing a patient in a neighboring territory in Reno, Nevada. Therefore, in July 2017, BrightStar informed NNC that its Carson City franchise had defaulted on the franchise agreement. BrightStar directed NNC to turn over its franchise operation patient-clinic to the BrightStar Reno franchisee and demanded NNC pay restitution to the Reno franchisee in the amount of $32,009.

“Instead of paying restitution, NNC informed BrightStar that it was terminating its operations as a BrightStar franchise in October 2017.” NNC told BrightStar that it had vacated the premises of its clinic and that all of its clients “successfully transitioned to other care providers.” “BrightStar immediately sent NNC a notice terminating the Franchise Agreement.” Shortly thereafter BrightStar learned that NNC had opened a new in-home health care service provider by the name of Allevia Living . . . in the same area where they previously operated the BrightStar franchise.

BrightStar filed a complaint seeking an order permanently enjoining NNC from operating Allevia Living in violation of the franchise agreement’s non-compete and confidentiality provisions. In response, NNC defended and asserted counterclaims based on fraud, which the BrightStar contended belonged in arbitration.

The U.S. District Court for the Northern District of Illinois used a standard analysis to consider BrightStar’s application for injunctive relief, the request to compel arbitration, and NNC’s fraud defense and counterclaims. The court granted the franchisor’s motion for preliminary injunction and its motions to compel arbitration of the franchisees’ counterclaims. The court explained that “[p]reliminary injunctions are a form of equitable, interlocutory relief—utilized only in cases demanding its application—implemented only after the district court engages in a two-part analysis: a threshold phase and a balancing phase.” On a motion for a preliminary injunction a party must first show: (1) she will suffer irreparable harm in the interim prior to a final resolution; (2) there is no adequate remedy at law; and (3) she has a reasonable likelihood of success on the merits.” “Upon making meeting [sic] the threshold, the court must next consider: (4) the irreparable harm the moving party will endure if the preliminary injunction is wrongfully denied versus the irreparable harm to the nonmoving party if it is wrongfully denied.

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34. Id.
35. Id.
36. Id.
37. Id.
38. Id.
39. Id.
40. Id.
41. Id.
42. Id. at *6.
43. Id. at *5 (citing Girl Scouts of Manitou Council, Inc. v. Girls Scouts of United States of Am., Inc., 549 F.3d 1079, 1085–86 (7th Cir. 2008)).
44. Id. (citing Girl Scouts, 549 F.3d at 1085–86 and Ezell v. City of Chicago, 651 F.3d 684, 694 (7th Cir. 2011)).
granted; and (5) the effects that the grant or denial of the preliminary injunction would have on nonparties. . . .”45 “The district court ‘weighs the balance of potential harms on a “sliding scale” against the movant’s likelihood of success: the more likely he is to win, the less the balance of harms must weigh in his favor; the less likely he is to win, the more it must weigh in his favor.’”46

The court found that BrightStar was likely to succeed on the merits.47 The court concluded that the foundation of NNC’s fraud defense and counterclaims was oral promises allegedly made by a representative of BrightStar48 but that the evidence showed that the franchisees did not take time to review the franchise agreement, or its addendum, before affirming their understanding that the franchise agreement and franchise disclosure document (FDD) contained the entire agreement concerning their BrightStar franchise rights, meaning that any prior oral or written statements not set out in the franchise agreement or FDD would not be binding.49

The court also held that “[f]or a variety of reasons, BrightStar will suffer irreparable harm sans the issuance of an injunction.”50 These reasons included damaged customer and business relationships.51 In weighing the harms, the court acknowledged, “Clearly the irreparable harm to NNC is the forced termination of operations.”52 However, the court concluded that, “[b]ased on the evidence before the Court, although there is assuredly some hardship placed upon nonparties in that they would have to transfer services, the harm does not outweigh the irreparable harm to BrightStar were the Court to deny a preliminary injunction.”53 Therefore, the court ordered preliminary relief in favor of BrightStar.54

Finally, the court reviewed the arbitration provision in the franchise agreement and found that the claims asserted by the franchisee for fraud were covered by the franchise agreement’s arbitration clause.55 The court granted BrightStar’s motions to compel arbitration.56 Those who litigate franchise disputes regularly will easily note that the disputes litigated by this healthcare franchisor and franchisee are no different from the disputes typically litigated in a variety of franchise systems. In addition, the analysis by

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45. Id. (citing Turnell v. Centimark Corp., 796 F.3d 656, 661–62 (7th Cir. 2015)).
46. Id. (quoting Turnell, 796 F.3d at 662).
47. Id. at *6–7.
48. Id. at *6.
49. Id. at *7.
50. “Particular irreparable harms that are ongoing and will continue unless the [c]ourt issues a preliminary injunction are BrightStar’s inability to establish another franchise in the Carson City area, the damaged customer and business relationships, as well as harm in the form of lost proprietary information. Each harm directly impacts BrightStar’s revenue stream presently and will continue to do so moving forward.” Id. at *8.
51. Id.
52. Id. at *9.
53. Id. at *10.
54. Id.
55. Id. at *10–12.
56. Id. at *13.
the court was not affected by the fact that underlying franchised business was a professional one.

In addition to claims and defenses that arise under the franchise agreement, there are other disputes typical to franchising that also arise in the context of professional franchises. Those include common law tort claims and others that can be anticipated by franchisors and franchisees during the drafting and negotiation of the franchise agreement. The following subsections describe contract and tort-based claims that transcend traditional and professional franchises.


Dispute resolution provisions are litigated in all kinds of franchise systems. Professional franchise systems may travel the same tortured paths to resolution as other franchise disputes. Another case involving BrightStar began in the U.S. District Court for the Northern District of California when BrightStar franchisees sued the franchisor and its employees, alleging violations of the California Franchise Investment Law, fraud, and negligent misrepresentations arising out of their negotiation and purchase of a BrightStar franchise.57 BrightStar and its individual employees named as defendants in the case, who were the officers and directors of BrightStar who negotiated the franchise agreement with plaintiffs, moved to dismiss, or in the alternative, to transfer the case. The defendants successfully argued that the case should be transferred to the U.S. District Court for the Northern District of Illinois because the franchise agreement included an Illinois choice-of-law and venue provision that included the franchisee's consent to personal jurisdiction of the courts of Illinois.58 Conversely, the plaintiffs could not establish “exceptional circumstances” to cause the court to disregard that provision. However, the provisions of the franchise agreement did not apply to the individual defendants who were not parties to that contract.59 The district court then analyzed whether to transfer the plaintiffs’ claims against the individual employee defendants under 28 U.S.C. § 1404(a), which gives federal courts the ability to transfer civil actions to other federal districts for the convenience of parties and witnesses, in the interest of justice. The court concluded that transfer was warranted and that transferring the entire action would “efficiently utilize judicial resources and promote consistency.”60

Even though the federal court transferred the entire action, the plaintiffs brought an action in Illinois state court, which the defendants removed to federal court.61 Once in the federal court, the defendants filed another

58. Id. at *2.
59. Id. at *4.
60. Id. at *8.
motion to dismiss and in the alternative, to compel arbitration.\textsuperscript{62} The parties agreed that the franchise agreement included a broad arbitration provision, however, the plaintiffs claimed that because they were seeking rescission of the franchise agreement, an equitable relief exception in the arbitration provision applied.\textsuperscript{63} The court determined that it was “clear from the terms of the [f]ranchise [a]greement that claims relating to the [f]ranchise [a]greement such as those presented in this case fall within the [agreement’s] Mediation Provision and Arbitration Provision and not within the equitable relief exception.”\textsuperscript{64} The court went on to say that “[t]he parties clearly envisioned that such disputes would first be presented before a mediator and then an arbitrator.”\textsuperscript{65} Therefore, the court granted the defendants’ motion to compel arbitration.\textsuperscript{66}

B. Royalty Disputes

In another recent case, the franchisor of the Interim Healthcare home and hospice care system brought claims for breach of contract against a franchisee in a dispute over royalty payments.\textsuperscript{67} In that case, the court determined Florida law applied and performed a basic breach of contract and expectation damages analysis.\textsuperscript{68} The franchisor alleged that its franchisee, Healthcare@home (HCH), owed nearly $400,000 in past due royalties under the franchise agreement and that it was also entitled to nearly $1,500,000 in “future royalties,” which it had calculated by multiplying the number of weeks remaining on the ten-year franchise agreement by the “average weekly service charge due” from the franchisee.\textsuperscript{69} The franchisor also sought attorneys’ fees, costs, and expenses pursuant to a prevailing party provision in the parties’ franchise agreement.\textsuperscript{70}

The U.S. District Court for the Southern District of Florida denied the franchisee’s motion to dismiss, citing two often-cited cases, \textit{Burger King Corp. v. Agad}, where the fast-food franchisor successfully brought an action against a former franchisee to permanently enjoin the former franchisee’s use of the Burger King marks, and \textit{Burger King Corp. v. Hinton, Inc.}, in which Burger King, successfully sued a franchisee for failure to make payments due under the franchise agreement.\textsuperscript{71} As the court explained, “[U]nder Florida law, franchise agreements are considered personal service contracts,”\textsuperscript{72} and

\begin{itemize}
  \item \textsuperscript{62} Id.
  \item \textsuperscript{63} Id. at *2.
  \item \textsuperscript{64} Id.
  \item \textsuperscript{65} Id.
  \item \textsuperscript{66} Id.
  \item \textsuperscript{67} Interim Healthcare Inc. v. Healthcare@home, LLC, 2018 WL 830113 (S.D. Fla. Feb. 12, 2018).
  \item \textsuperscript{68} Id. at *3.
  \item \textsuperscript{69} Id.
  \item \textsuperscript{70} Id. at *1.
  \item \textsuperscript{71} See id. at *3 (citing Burger King Corp. v. Agad, 911 F. Supp. 1499, 1506 (S.D. Fla. 1995) and Burger King Corp. v. Hinton, Inc., 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002)).
  \item \textsuperscript{72} Id. (citing Agad, 911 F. Supp. at 1506).
\end{itemize}
“To state a claim for breach of a franchise contract, a plaintiff must allege: (1) a valid contract; (2) a material breach of that contract; and (3) damages resulting from the breach.” As it related to remedies, “[t]he non-breaching party may ‘choose between being placed in the position it would have been in had the contract been fully performed by seeking an award of lost profits or the position it would have been in prior to the breach, which would be accomplished through an award of reasonably foreseeable damages.”

Interim Healthcare alleged a breach of the franchise agreement and that, in turn, it experienced lost profits as a proximate cause of that breach, which, it further alleged, were reasonably contemplated by the parties based on the ten-year term of the franchise agreement, such that the losses were not too speculative. The court noted that to recover at trial, Interim would have to demonstrate its anticipated lost profits with reasonable certainty by competent proof and would be required to establish in specific dollar amounts the expenses incurred to produce the net profits. However, at the pleading stage, Interim Healthcare pleaded enough, and the breach of contract claim survived dismissal.

Again, that the dispute involved a professional franchise system had no impact on the court’s analysis.

C. Covenants Not to Compete

Another oft-litigated area in franchise law arises from the alleged violation of non-compete covenants by franchisees. Professional franchises are no exception. In the Complete Nutrition network, a franchisee of the nutritional supplement retail chain entered into two franchise agreements in 2015, but by 2017 had closed one store completely and unilaterally rebranded the other. Following a demand letter that the franchisee ignored, franchisor Complete Nutrition brought an action for injunctive relief to enforce a non-compete provision in the franchise agreement.

Similar to the Northern District of Illinois BrightStar case discussed earlier, the U.S. District Court for the District of Nebraska undertook a typical non-compete analysis. The court weighed the “Dataphase factors” set forth by the Eighth Circuit in Dataphase Systems, Inc. v. C L Systems, Inc. “When deciding whether to issue a preliminary injunction, the [c]ourt weighs the four Dataphase factors: (1) the threat of irreparable harm to the movant; (2) the state of the balance between this harm and the injury that granting the injunction will

73. Id. (citing Vega v. T-Mobile USA, Inc., 564 F.3d 1256, 1272 (11th Cir. 2009)).
74. Id. (quoting Hinton, 203 F. Supp. 2d at 1366).
75. Id.
76. Id.
77. Id.
79. Id.
inflict on other parties; (3) the probability that the movant will succeed on
the merits; and (4) the public interest.”

The court held that Complete Nutrition showed a threat of irreparable
harm because the effect on Complete Nutrition’s goodwill and reputation
and the degree to which the defendants would be unjustly enriched by their
use of the Complete Nutrition system were not easy to quantify. The
court also concluded that Complete Nutrition showed a sufficient likelihood of
success on the merits. Complete Nutrition was denied the benefit of its
bargain and denied the market presence for which it had contracted. The
Complete Nutrition franchise agreement included a two-year, twenty-five
mile restriction from competition, and, under the circumstances, there
was “little reason to doubt” that the defendants were violating the provi-
sion. Under Nebraska law, franchise agreements like these are akin to the
sale of a business for purposes of determining the enforceability of a post-
termination covenant not to compete. “So, the primary issue” for the court
was “whether the covenants are reasonable in both space and time so that
the restraint imposed is no greater than necessary to achieve their legitimate
purpose.” Citing a case involving another professional franchise concept,
the court noted that the Nebraska Supreme Court previously upheld a one-
year restraint in a franchise agreement within a forty-five mile distance from
the location of the franchise. Thus, Complete Nutrition was “at least rea-
sonably likely to succeed in showing that” its restraints were reasonable.

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84. The district court wrote:

Alpha Nutrition’s business has been built, at least in part, on Complete Nutrition’s
goodwill, which Alpha Nutrition is now arguably misappropriating. Alpha Nutrition’s
business was also built, at least in part, on education and instruction provided to its
employees by Complete Nutrition, as consideration for services that are no longer
being provided. Alpha Nutrition’s sale of Complete Nutrition’s products alongside
new products of unknown provenance, along with Alpha Nutrition’s use of its own
trade dress along with remaining elements of Complete Nutrition’s trade dress, cre-
ates a likelihood of the sort of confusion that has often been held to establish an
irreparable injury.

Complete Nutrition’s evidence also suggests that its efforts to reestablish a fran-
chise in the market will be impaired by the presence in the market of a former
franchise. And it is difficult to assess the effect on Complete Nutrition’s reputation
and goodwill in the relevant market while Alpha Nutrition uses the springboard it
received from Complete Nutrition as a basis to build its business, and Complete
Nutrition is denied the presence in the market for which it contracted. It is also
difficult to quantify the degree to which the defendants will be unjustly enriched by
their use of the support they received from Complete Nutrition. The Court finds
that these damages are not satisfactorily remediable by money damages, and that
Complete Showing [sic] has sufficiently shown a threat of irreparable harm

Id. (internal citations omitted).
85. Id. at *3.
86. Id. at *1–2.
87. Id. at *3 (citing H&R Block Tax Servs., Inc. v. Circle A Enters., Inc., 693 N.W.2d 548,
556 (Neb. 2005)).
88. Id.
89. Id. (citing Circle A, 693 N.W.2d at 556).
90. Id.
The court granted Complete Nutrition’s motion for preliminary injunction, although the court noted that “[t]he effect of the non-solicitation provisions of the [a]greements is also far from clear, given the family-owned-and-operated nature of the stores.”

Similarly, in *H&R Block v. Clayton*, the tax preparation franchisor satisfied the necessary elements to obtain preliminary injunctive relief where the franchisor properly terminated the franchise agreement for the franchisee’s failure to pay royalties, and the franchisee then failed and refused to turn over to the franchisor clients lists and records as required by the franchise agreement and also failed to discontinue use of the H&R Block marks. Again, the mere fact that the dispute involved a professional franchise system made no difference to the legal analysis.

Courts called upon to analyze these questions consider the goodwill associated with the businesses at issue. As described previously, many professional franchises do not require the franchisee to have any prior experience in the industry. Therefore, as the franchisee came into the chain with no licenses, special skills, or unique experience, the franchisee builds its business on the back of the franchisor’s goodwill. In a professional franchise in which the franchisee owned and operated an established location with an individual reputation, clients, experience, skills developed over time, and perhaps certifications and licenses before joining the franchise system, the question arises: Will the franchisor enjoy the same deference to its goodwill when the relationship between that franchisee and the franchisor dissolves? Does that professional franchisee own the goodwill established before its affiliation with the franchisor?

The short answer to these questions is that, regardless of the factual background, courts will almost always enforce covenants if a franchisee misappropriates the franchisor’s proprietary information or continues to use the franchisor’s marks without authorization. Perhaps the best example is from a case involving H&R Block. There, the tax preparation franchisor obtained a temporary restraining order after its franchisee failed to return all client lists, client files (electronic or paper), and proprietary business information, including but not limited to signage. By way of background, the franchisee in the case, William Thomas, was paid $250,000 by H&R Block to con-

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91. *Id.* at *4*.
92. *H&R Block Tax Servs. LLC v. Clayton*, 2016 WL 1247205, at *1 (W.D. Mo. Mar. 24, 2016). In that case, the court found that:

> The post-termination covenants to which Defendants agreed protect important interests of Block, including: Block’s investment in the parties’ transaction and the client lists and information it acquired; Block’s established brand, goodwill, and confidential business information; and Block’s interest in preventing Defendants from using such assets to compete with Block, diverting away its clients and obtaining an undue advantage for the Taxserv Competing Business.

*Id.* at *3*.
vert his tax preparation office in New York City to an H&R Block franchise office.94 But when Thomas was in arrears to H&R Block for over $100,000 due to failure to pay royalties, the franchisor provided notice of the default and an opportunity to cure.95 When Thomas failed to remedy the breach, H&R Block terminated his franchise agreement and reminded the franchisee of his post-termination obligations.96

In the franchise agreement, Thomas had agreed that a breach of the covenants would cause irreparable injury.97 Thomas continued to operate a tax preparation business at his location, and H&R Block brought an action for injunctive relief.98 The court enforced the covenants in the franchise agreement despite the franchisee’s prior operation at the location.99

The court employed the *Dataphase* factors and considered H&R Block’s rights to its customers and its goodwill.100 The Court focused on H&R Block’s “intangible assets, such as reputation and goodwill,” the loss of which “can constitute irreparable harm.”101 The court concluded that the franchise agreement protected appropriate interests under Missouri law and that those interests were H&R Block’s to protect.102 “By enforcing the [agreement’s] covenants,” the court reasoned, “the restraints placed on Thomas are no greater than those to which he already agreed. Having accepted significant financial and other benefits from his agreements with H&R Block, Thomas should not be relieved of his own obligations.”103 Regardless of Thomas’s previous tax preparation business and prior experience at the location in New York City, he was bound by the covenants contained within his franchise agreement with H&R Block. Notably, despite the different circumstances giving rise to the relationship (the franchisee’s prior professional business), the court treated the case as it would any other franchise-franchisor dispute.

D. *Tortious Interference*

Tortious interference is a common law tort that is often the basis for franchisee claims against franchisors. These claims arise in the context of professional franchises, just as in other types of franchise actions.

94. Id. at *1.
95. Id.
96. Id.
97. Id. at *3.
98. Id. at *1.
99. Id. at *5.
100. Id. at *2.
101. Id. at *3.
102. “The [agreement’s] post-termination covenants protect interests recognized in Missouri as legitimate and protectable. Those interests include, but are not limited to, H&R Block’s investment in the parties’ transactions; H&R Block’s goodwill; H&R Block’s confidential business information; and H&R Block’s interest in preventing Thomas from using such assets to compete with H&R Block, diverting away its clients, and obtaining an undue advantage for a competing business.” Id. at *2 (citing Whelan Sec. Co. v. Kennebrew, 379 S.W.3d 835, 845 (Mo. 2012)); see also Safety–Kleen Sys., Inc. v. Hennkens, 301 F.3d 931, 937 (8th Cir. 2002).
Gossard v. Adia Services is a case about a franchisor’s alleged tortious interference with an oral promise made by its predecessor and never memorialized in the four corners of the written franchise agreement. In the case, plaintiff Gossard and defendant Nursefinders, Inc. (Nursefinders), a franchisor of a system that provided nurses to healthcare facilities and other private clients, entered into a written franchise agreement that granted Gossard an exclusive territory on Florida’s west coast. The written franchise agreement signed by Gossard and Nursefinders “provided that neither Nursefinders’ nor any person or firm authorized or licensed by it shall establish an office for the purposes of providing competing services within the franchise territory.” The founder of Nursefinders and Gossard both testified that regardless of the language in the franchise agreement, “during negotiations” of the franchise agreement it was agreed that neither Nursefinders nor its parent or affiliates would provide competing services within Gossard’s franchise territory.

Not long after Gossard purchased his franchise, Nursefinders, was acquired by Adia Services, Inc. (Adia). Adia thereafter acquired a company, Star-Med, that competed against Nursefinders in the same part of Florida. Gossard sued Adia, alleging that it had acquired Star-Med knowing that Star-Med’s operations would breach the promise of exclusivity made to Gossard when he negotiated his franchise agreement with Nursefinders. Responding to a certified question from the Eleventh Circuit, the Florida Supreme Court held that Adia, by purchasing Star-Med, had “knowingly caused Nursefinders to be in breach of its ‘promise’ to Gossard that neither a parent nor affiliate of Nursefinders would provide similar healthcare services within Gossard’s territory.” The opinion is said to have expanded the responsibility of a corporation that engages in a merger or acquisition of diverse subsidiaries. Regardless, it serves as a cautionary tale to franchisors who make oral promises to franchisees.

E. Vicarious Liability

Franchisors take various steps to exert control over franchisees to protect their marks and brand and to ensure that franchisees adhere to a uniform system. As a result, courts have, depending on the circumstances of the case, found a basis in that control to impose vicarious liability on franchisors for the torts of their franchisees. The modern “instrumentality test”

104. Gossard v. Adia Servs., 120 F.3d 1229, 1230 (11th Cir. 1997).
106. Id.
107. Gossard, 120 F.3d at 1231.
108. Id.
109. Gossard, 723 So.2d at184.
demands that liability for the acts of a franchisee does not belong vicariously to the franchisor, unless the franchisor controlled the thing or instrumentality that caused the harm. Conventional wisdom dictates that professional franchisors are no more immune to vicarious liability claims than other franchisors.

Franchisors should be cautioned by a recent decision from the Delaware Superior Court in which a customer of a RE/MAX agency brought a claim against the agency franchisee and the professional real estate franchisor, RE/MAX, arising from an alleged fraud committed by a real estate broker once employed by the franchisee agency. In Patel v. Sunvest Realty Corp., the plaintiff alleged that the broker formerly employed by the Sunvest RE/MAX agency embezzled the plaintiff’s money that the employee should have held for a real estate purchase. The plaintiff’s claims against the franchisor sounded in vicarious liability. The vicarious liability count was held to have been adequately pled and survived the franchisor’s motion to dismiss, because the court found that while actual agency was not sufficiently pled, the complaint sufficiently alleged that the franchisor had apparent authority over the franchisee.

The complaint in this case did not allege that RE/MAX exerted control over Sunvest’s daily operations. Despite this fact, the court focused on apparent agency, stating that “the principle of apparent agency focuses on the apparent relationship between a principal and an agent.” The court also cautioned that “[a]n agent’s apparent authority is a question of fact typically left to the jury.” The court then held that Patel’s complaint “sufficiently alleges that RE/MAX had apparent authority over Sunvest.” It noted that “RE/MAX’s logo and trademark was featured prominently in the office and on Sunvest’s website. Sunvest’s signs, email signatures, and documents all bore RE/MAX’s name and/or trademark.” It further explained that “Plaintiffs relied on RE/MAX’s name and brand quality. Accordingly, it is reasonable to infer from the complaint that Sunvest was RE/MAX’s apparent agent.”

111. Kerl v. Dennis Rasmussen, Inc., 682 N.W.2d 328, 340 (Wis. 2004).
112. “Franchisor vicarious liability—that is, a franchisor’s liability for the actions of its franchisees—has always been a concern for franchisors. . . . There is no reason to think that health-care franchise systems will be immune from these types of claims.” Jesse A. Berg, § 43:25. Franchisor’s Vicarious Liability for Franchisee, 3 Health L. Prac. Guide § 43:25 (2018).
114. Id. at *5.
115. Id.
116. Id. (citing Billops v. Magness Const. Co., 391 A.2d 196, 198 (Del. 1978)).
117. Id.
118. Id.
119. Id.
120. Id.
F. Class Actions

Another area where professional franchisors should be guided like their counterparts in other types of franchises is the threat of class action litigation. The Jackson Hewitt tax preparation franchisor was unsuccessful in striking a class action in a recent federal district court decision.121 In Lomeli v. Jackson Hewitt, Inc., the U.S. District Court for the Central District of California held that the plaintiff customer of a Jackson Hewitt franchised office sufficiently alleged that the franchisor controlled the instrumentality that caused the harm—the hiring and training of tax preparers who then fraudulently prepared his returns and opened a bank account without his consent.122 The plaintiff also alleged that the franchisor reviewed, approved, and submitted tax returns through its mandatory computer systems. The court held that these allegations sufficiently alleged a theory of vicarious liability because Jackson Hewitt retained a high level of control over its franchisees and franchisees’ employees’ actions.123 Thus, the court denied Jackson Hewitt’s motion with respect to plaintiff’s fraud claim on a vicarious liability theory.124

The plaintiff’s fraud claims based on Jackson Hewitt advertising also survived the motion to dismiss.125 The plaintiff claimed that Jackson Hewitt committed fraud by advertising a one hundred percent guarantee for accurate returns and the “preparers’ pledge” to handle customers’ tax returns like their own.126 The plaintiff also specifically alleged that Jackson Hewitt received thousands of complaints that tax returns it prepared were inaccurate.127

Although the franchisor moved to strike the plaintiff’s class allegations, the court noted that it is rare for a court to strike class allegations before a motion for class certification has been filed.128 The court foresaw likely problems at the class certification stage, in light of the individual modes of proof that would likely be required, but declined to address those issues on the motion to strike without the benefit of discovery and briefing on the issue.129

IV. Conclusion

Professional franchises are subject to the same inherent discourse, the franchise agreement provisions, and many of the same regulations as traditional franchises. As a result, they are also subject to the same types of

122. Id. at *7.
123. Id.
124. Id.
125. Id. at *9.
126. Id.
127. Id. at *3.
128. Id. at *10.
129. Id.
disputes between franchisors and franchisees. Thus, the considerations for those entering into a professional franchise relationship are many of the same as those engaging in traditional franchise systems. And, case law shows that courts do not tend to view professional franchises differently than other franchises.
I. Australia Welcomes Franchising

Australia is a popular market for foreign franchise systems, with many prominent U.S.-based brands. No single market entry method has been the key to success—direct entry, direct franchising, master franchising, and area development models have all underpinned successful Australian networks for foreign-based brands.

Franchising is a well-established and credible business method in Australia. Australia’s twenty-five million people are served by approximately 1,120 different franchise systems. The Australian franchise sector has an annual turnover of A$146 billion and employs more than 470,000 people. A key reason for the popularity of franchising in Australia is Australia’s geography—as a vast country, and one of the most sparsely populated countries in the world, franchising has provided a mechanism for goods and services to be provided across the nation. However Australia’s geography provides challenges to franchisors in terms of the provision of field support as well as coordination of franchise network meetings and activities.

Foreign franchise systems entering the Australian market typically find Australia to be a high-cost market. Labor rates are high by international standards, with high minimum wages and penalty rates for overtime, often surprising

1. E.g., McDonalds, KFC, Pizza Hut, Snap-On Tools.
2. E.g., Minuteman Press, Sign-a-rama.
3. E.g., 7-Eleven, Kwik-Kopy, Mrs. Fields.
4. E.g., Subway, although their model is not traditional area development.
6. Id.
unsuspecting franchisors. Real estate can be difficult to secure, with property rentals and energy costs high by international standards, particularly in major shopping centers. Foreign franchise systems seeking to enter the market should carefully review their cost structures as part of their market due diligence. Australia is very multicultural, with consumer behavior and franchisee composition influenced by European, Asian, sub-continental and African migration, in addition to historical influences by the United States and United Kingdom.

To conduct this due diligence, Australia has readily available demographic information, supported by specific market research companies including Frandata Australia. And the peak industry body, the Franchise Council of Australia, conducts regular franchising events and has produced a range of industry publications. As a result, ample information is available for franchisors that are interested in entering the Australian market.

II. The Australian Legal Framework

The purpose of this article is to provide a general introduction to the Australian market for U.S. counsel, including an outline of the laws that regulate the franchise sector or often have application to franchised businesses.

The Australian legal system is conceptually similar to the United States in that it is a common law system with three tiers of government—federal, state, and local. Most of the laws that impact franchised businesses—franchise legislation, intellectual property laws, taxation, corporations law, workplace laws, data privacy and competition and consumer laws—are federal laws. State laws cover real estate and retail leasing, workplace health and safety, and state taxation. Local laws typically deal with local matters, with the most relevant matters likely to be real estate zoning and local property-based rates and charges.

The principle of freedom of contract underpins business contracts in Australia, albeit with a significant level of statutory intervention, similar to that seen in U.S. states such as California. The Australian court system is sophisticated, and the preferred means of dispute resolution alongside the statutory mediation framework enshrined in Australia’s franchising law—the mandatory Competition and Consumer (Industry Codes – Franchising) Regulation 2014 (Franchising Code). Arbitration is used in Australia, and Australia is a signatory to key international arbitration treaties. However arbitration is hardly ever used in franchising in Australia, probably due to the relatively low incidence of disputes, the success of the Franchising Code mediation process, and the fact that Australian courts rarely award punitive damages.

7. For more information see www.franchise.org.au.
8. For a more detailed analysis, refer to Stephen Giles, Michael J. Redfern & Andrew Terry, Franchising Law & Practice (1998), which is the authoritative legal text for the Australian franchise sector.
9. State taxes are not separate income taxes, but rather taxes imposed on payroll, as a means to fund workers’ compensation or as a duty on some transactions.
10. Competition and Consumer (Industry Codes—Franchising) Regulation 2014 (Cth) reg 168 (Austl.).
Australia is a highly regulated market, featuring specific franchise legislation and a range of general competition and consumer law provisions that have regular application to franchising. Australia is also the first country in the world to make franchisors potentially liable for the workplace law breaches of franchisees. This section provides a general overview of the laws most relevant to Australian franchising. The specific franchise legislation—the Franchising Code—is then discussed in more detail, and an outline is provided of the Australian taxation system.

A. Intellectual Property/Trademarks

International franchisors with established and registered intellectual property in their home country still need to seek separate protection of their intellectual property assets in Australia if they are doing business here. If there is an online presence, which is by its nature international, the franchisor will need to seek protection in all markets where the franchisor’s goods and services are available for purchase.

As in the United States, enforcement of intellectual property rights is still technically possible without registration, typically on the basis of the common law, unfair competition, or some analogous concept. However, protection afforded under such laws is much less predictable, and normally more costly. Franchisors should register their trademarks as soon as possible and well before any entry into the local market. With the extent of international travel, and the reach of the Internet, international trademark protection ought to be an early priority for any business with international aspirations.

Australia is fundamentally a “first to use” jurisdiction, rather than a “first to file” jurisdiction. In Australia, proposed use or intent to use by the applicant is sufficient to allow at least the filing of an application for registration. However, the trademark must be used in the Australian market, as otherwise another party using or registering in Australia at an earlier point in time will gain priority.

The case of *Taco Co of Australia Inc. v. Taco Bell Pty Ltd* (Taco Bell case) is a cautionary tale of an existing overseas franchised business moving into the
Australian market without first checking whether its key brand was available for use in Australia. In the *Taco Bell* case, an American company (related to Taco Company of Australia Inc.) operated a well-known chain of over 1,000 fast-food restaurants throughout North America. When the Taco Company of Australia Inc. commenced business in Australia, the Australian company (Taco Bell Pty Ltd), which was not related to the American business, successfully obtained an injunction against the American company, which restrained it from opening or conducting restaurants in Sydney under the name “Taco Bell.” This was because the Australian company could demonstrate that it had for some time operated Mexican restaurants in Sydney under that name.

On appeal, the American company was unsuccessful despite claiming that “Taco Bell” was the trademark under which its related American company had conducted restaurants in the United States since 1962. The Australian company claimed that any use of the trademark by the American company would constitute misleading or deceptive conduct under section 52 of the *Trade Practices Act 1974* (Cth) (TPA) (Austl.), and passing-off at common law. The court agreed with the Australian company. The overseas use, registrations and substantial reputation of the American company were insufficient to overcome the existing rights of a smaller Australian business.

The authors are aware of other instances where a local Australian party has registered a well-known brand in Australia and then purported to prevent the foreign-brand owner from operating in Australia without the payment of substantial compensation. This has even occurred during aborted negotiations in relation to Australian master franchise rights. The absence of a registered trademark will also impinge on the ability of the brand owner to secure important local Internet domain names.

B. *Competition and Consumer Law*

The *Competition and Consumer Act 2010* (Cth) (Austl.) (CCA) regulates business conduct in Australia, promoting fair and effective competition and consumer protection. The CCA is administered by the Australian Competition and Consumer Commission (ACCC), which takes an assertive and quite public role in enforcement. This role is in addition to the supervision of compliance with the Franchising Code. This means that the ACCC may take action at any time against a franchisor for non-compliance with the Franchising Code. The ACCC will also be the first point of contact for reporting serious non-compliance by franchisors.

The CCA, and the *Australian Consumer Law* (ACL) which is incorporated in Schedule 2 of the CCA, makes certain conduct, including misleading or deceptive representations, unconscionable conduct, third line forcing, and resale price maintenance, illegal. Disclosing illegal conduct in the franchisor’s disclosure document will not prevent that conduct being a breach of

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17. Since repealed and replaced with the *Competition and Consumer Act 2010* (Cth) (Austl.), which incorporates the *Australian Consumer Law*.

18. *Competition and Consumer Act 2010* (Cth) sch 2 (Austl.).
the CCA. The important sections of the CCA and the ACL that must be kept in mind are principally:

- Section 18 of the ACL, which prohibits misleading or deceptive conduct. Section 4 of the CCA augments Section 18 by providing that a person making any statement as to a future event (such as a projection of revenues) must be able to prove they had reasonable grounds for making it;

- Section 21 of the ACL, which provides that a corporation must not, in trade or commerce, engage in conduct that is in all the circumstances “unconscionable,” and Section 22 which contains a list of relevant matters in determining whether the conduct has been unconscionable;

- Section 23 of the ACL, which prohibits unfair contract terms in standard form small business contracts; and

- Chapters 2, 3, and 4 of the CCA, which contain a whole range of prohibitions against restrictive trade practices, such as price fixing, misuse of market power, resale price maintenance, and covenants affecting competition.

1. Misleading or Deceptive Conduct

Most disputes and litigation concerning pre-contractual dealings are based upon allegations of misleading or deceptive conduct, in breach of Section 18 of the ACL. Misleading or deceptive conduct is essentially a statutory encapsulation of the common law of misrepresentation, although it is more comprehensive, and the ACL provides a broader range of remedies than would be available under the common law. The statutory obligations of disclosure contained in the Franchising Code of Conduct sit alongside the general prohibition on misleading or deceptive conduct.

Conduct will be misleading or deceptive if it induces or is capable of inducing error. In this respect, the courts examine the purportedly deceptive conduct and whether it induced the franchisee to enter into the franchise agreement. For example, in *Poulet Fais Pty Ltd v Silver Fox Co Pty Ltd*, the franchisee acquired a fresh chicken retail franchise. The franchised business did not perform to the franchisee’s expectation, and the franchisee sued, claiming that it had been misled about the revenues of the business and the suitability of the site from which it had operated. The court rejected the franchisee’s claim, noting that the franchisee had been appropriately placed...
on notice of the extent to which it needed to undertake its own assessment and due diligence in relation to the franchised business opportunity.

Similarly, in *SPAR Licensing Pty Ltd v MIS QLD Pty Ltd (No 2)*, the court addressed a claim of misrepresentation by the franchisee. Prior to entering a franchise agreement, the franchisor had indicated to the franchisee that it would be permitted to leave the franchise group and join another group if it wished to do so. However, the franchisor subsequently refused to permit the franchisee to leave. The court held that the franchisor engaged in misleading conduct—conduct that the franchisee had relied upon to its detriment.

2. Unconscionable Conduct and Good Faith

Most disputes concerning the post-sale franchise relationship are framed around claims of breach of explicit Franchising Code disclosure obligations, allegations of unconscionable conduct, or breach of the good faith obligation contained in the Code.

The term “unconscionable conduct” is not defined in the ACL. However, it has been determined by courts as meaning conduct that is not in good conscience by reference to the norms of society, irreconcilable with what is right and reasonable, and conduct that is commercially reprehensible in all the circumstances. To assess whether conduct is unconscionable, all of the conduct and surrounding circumstances need to be considered. Section 22 of the ACL sets out a non-exhaustive list of matters to which the courts may consider in determining whether conduct is unconscionable. However, these matters are not solely determinative, and their presence does not automatically result in a finding of unconscionability.

For example, in *ACCC v Seal-A-Fridge Pty Ltd*, the Court held that a franchisor had engaged in unconscionable conduct when it demanded increases in franchise fees when it was not contractually entitled to do so and when the franchisor required purchasers of existing franchised businesses to enter into franchise agreements which required payments based on business revenues when such payments were not required under the existing franchise agreements.

Likewise, in *ACCC v Simply No-Knead (Franchising) Pty Ltd*, the Court determined that the franchisor had engaged in unconscionable conduct by reason of a range of behavior that included refusal to deliver product, deleting franchisee telephone numbers from the directory, refusing to negotiate matters in dispute, and selling product in franchisee territories.

The good faith obligation contained in the Code encompasses similar notions of reasonableness and fairness. Clause 6 of the Franchising Code

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provides that each party to a franchise agreement must act towards another party with “good faith.” Good faith includes the following:

- an obligation on the parties to cooperate in achieving the contractual objectives;
- compliance with honest standards of conduct; and
- compliance with standards of conduct which are reasonable, having regard to the interests of the parties.28

However, the duty of good faith will not typically operate so as to impose restrictions on actions designed to promote or protect the legitimate interests of the party. A party is permitted to act in its legitimate commercial interests and exercise its contractual rights even if that is to the detriment of the other party. Provided that the party exercising the power acts reasonably in all the circumstances, the duty to act in good faith will be ordinarily satisfied.29

3. Unfair Contract Terms

The prohibitions on unfair contract terms apply only to agreements entered into on or after November 12, 2016, and are yet to have much practical impact. The Treasury Legislation Amendment (Unfair Contract Terms) Act 2015 (Cth) (Austl.) prohibits “unfair” terms in standard form small business contracts. As a “small business” is defined as a business with fewer than twenty employees,30 and a typical franchise agreement would exhibit many of the characteristics of a “standard form contract,” the legislation has significant potential application to franchise agreements.

There are some exclusions—agreements where the upfront fee is more than $300,000 (AU) (or $1,000,000 (AU) for a contract with a term of more than a year), and certain special types of contracts.31 Further, where a franchise agreement is negotiated and there are genuine opportunities for amendment, it may not be considered a “standard form” contract presented on a “take it or leave it” basis.

A detailed analysis of the legislation is beyond the scope of this paper. Suffice to say that if a franchise agreement is found to be a standard form small business contract, many of the typical provisions found in franchise agreements will need to be carefully scrutinised to determine if they are “unfair” terms. The legislation provides that a provision in a small business contract will be “unfair” if:

- it would cause a significant imbalance in the parties’ rights and obligations arising under the contract; and
- it is not reasonably necessary to protect the legitimate interests of the party who would be advantaged by the term; and

28. For Horizons Pty Ltd v McDonald’s Australia Pty Ltd [2000] VSC 310 (Austl.).
29. Video Ezy International Pty Ltd v Sedema Pty Ltd [2014] NSWSC 143 (Austl.).
30. Treasury Legislation Amendment (Unfair Contract Terms) Act 2015 (Cth) sch 1 para 8 (Austl.).
31. Id., sch 1 para 8(4)(b).
• it would cause detriment (whether financial or otherwise) to a party if it were to be applied or relied on. 32

For a court to declare that a term is unfair, all three of the above elements must be proven. 33 The burden of proof is on the party advantaged by the term to prove it is reasonably necessary to protect their legitimate interests. 34 In determining whether a term is unfair, the court may take into account such matters as it thinks relevant, but must take into account the extent to which the term is transparent, and the context of the provision in the contract as a whole. 35

If the court declares a provision of a contract “unfair,” that provision will be void. 36 The contract will however continue to bind the parties if the contract can operate without the unfair term.

C. Regulatory Enforcement, Penalties and Sanctions

The CCA (which incorporates the ACL) is administered by the ACCC, which is one of Australia’s most active and effective regulatory bodies. The Franchising Code was enacted pursuant to the CCA, so a breach of the Franchising Code is, in effect, a breach of the CCA. Breach of the CCA (including breach of the Code) will entitle a party that has suffered loss or damage to compensation, and enable a court to grant an injunction, require specific performance, declare void in whole or part any agreement, vary any contract or arrangement, or make such other orders as a court thinks appropriate. In addition, substantial specific penalties of up to $63,000 (AU) apply for breaches of key provisions of the Franchising Code. Serious breaches of the Franchising Code is likely to prompt an investigation if brought to the attention of the ACCC and may result in the institution of proceedings by the ACCC or the issuance by the ACCC of Infringement Notices of up to $10,500 (AU) per breach, with additional cost and possible adverse publicity. 37

Similarly, a breach of the ACL—such as by engaging in misleading or deceptive conduct or unconscionable conduct—entitles a party which has suffered loss or damage to compensation and enables a court to grant an injunction, require specific performance, declare void in whole or part any agreement, vary any contract or arrangement or make such other orders as a court thinks appropriate. 38 Substantial penalties apply, depending on the specific nature and seriousness of the breach. 39

There are currently no penalties for including an unfair contract term in a franchise agreement, although this may change. As a key part of its submission to the Franchising Inquiry, the ACCC has recommended that specific

32. Far Horizons Pty Ltd v McDonald’s Australia Pty Ltd [2000] VSC 310 (Austl.).
33. Competition and Consumer Act 2010 (Cth) sch 2 para 24(1) (Austl.).
34. Id., sch 2 para 24(4).
35. Id., sch 2 para 24(2).
36. Id., sch 2 para 23(1).
37. Id., pt XI div 2 para 134.
38. Id., sch 2 paras 232, 236; id., sch 2 pt 5-2 div 4; id., sch 2 pt 5-2 div 5.
39. Id., sch 2 paras 224, 232, 236–37, 239.
penalties apply to the inclusion of an unfair contract term in a standard form small business contract.  

Contravention of the provisions of the CCA dealing with anticompetitive conduct, cartels, pricing, and supply matters, and more serious instances of false or misleading conduct, can result in severe penalties. In the case of breaches of some provisions in Chapters 2, 3, and 4, including the price-fixing provisions, these can include fines up to $500,000 (AU) for individuals and in the case of corporations of up to the greater of (1) $10 million (AU); (2) where the value of the benefit attributable to the breach can be ascertained, three times the value of that benefit; or (3) where the value of the benefit attributable to the breach cannot be ascertained, ten percent of the annual revenue in the preceding twelve months. However, it is possible for certain types of market sharing and collective conduct to be authorised, or enforcement action avoided, by using the ACCC’s authorisation or notification processes. These processes can be helpful in tied supply situations, or where there is a technical breach of the CCA, but the conduct has no substantial effect on competition in the market, or there is a public benefit associated with the conduct.

III. The Franchising Code of Conduct

A. Application of the Franchising Code

Australia has comprehensive federal franchise legislation that is disclosure-based, but also covers some aspects of the franchise relationship. The law, called rather misleadingly the Franchising Code of Conduct, is black letter law and was promulgated pursuant to Section 51AE of the CCA. The Franchising Code was been amended four times between 1998 and 2014, and after a comprehensive review in 2013 it was amended again in 2014. The old Franchising Code was withdrawn and simultaneously replaced with a substantially revised Franchising Code that took effect January 1, 2015. This Franchising Code is the Competition and Consumer Act 2010 (Cth) pt IV div 1 sub-div B paras 44ZZRF-44ZZRG (Austl.).
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Code, and exposes franchisors and franchisees to the remedies available under the CCA. The Franchising Code applies to all businesses that are bound by the CCA. With some limited exceptions, the Franchising Code applies to franchise agreements that are entered into, renewed extended or transferred on or after January 1, 2015, and to conduct occurring on or after January 1, 2015.44

The application of the Franchising Code is largely determined by the core definition of a “franchise agreement,” which is very broad, and includes an agreement that takes the form, in whole or in part, of a written agreement, an oral agreement or an implied agreement.45 It applies to any form of franchise, master franchise, licence, or distribution agreement “in which a person (the franchisor) grants to another person (the franchisee) the right to carry on the business of offering, supplying or distributing goods or services in Australia under a system or marketing plan substantially determined, controlled or suggested by the franchisor or an associate of the franchisor.”46

The definition simply requires that under the agreement

• the operation of the business will be substantially or materially associated with a trademark, advertising or commercial symbol owned, used or licensed by the franchisor or an associate of the franchisor; or specified by the franchisor or an associate of the franchisor; and

• before starting the business or continuing the business the franchisee must pay or agree to pay to the franchisor or an associate of the franchisor an amount, including for example an initial capital investment fee, a payment for goods and services or a fee based on a percentage of gross or net turnover whether or not called a royalty or franchise service fee, or a training fee or training school fee.47

There are no exemptions to the application of the Franchising Code,48 although there are some exemptions from the requirement to annually update the disclosure document,49 and the Franchising Code does not apply to a franchise agreement to which another mandatory industry code

44. Competition and Consumer (Industry Codes – Franchising) Regulation 2014 (Cth) sch 1 pt 1 div 1 para 3 (Austl.). The previous Franchising Code covers the period from October 1, 1998, to January 1, 2015, so the legislation effectively applies to franchise agreements entered into after October 1, 1998.

45. Id. at sch 1 pt 1 div 2 para 5(1)(a).

46. Id. at sch 1 pt 1 div 2 para 5(1)(b).

47. Id. at sch 1 pt 1 div 2 para 5(1)(c)–(d).

48. An earlier version of the Franchising Code provided that the Franchising Code did not apply “to a franchise agreement if the franchisor is resident, domiciled or incorporated outside Australia and grants only 1 franchise or master franchise to be operated in Australia.” Competition and Consumer (Industry Codes – Franchising) Regulation 1998 (Cth) sch 1 pt 1 div 1 para 5(3) (Austl.). This exemption, known as the foreign franchise exemption, was deleted from the previous Franchising Code with effect from March 1, 2008, and does not exist in the current Franchising Code.

49. An exemption from updating is available to franchisors that have granted no more than one franchise agreement in the year, and do not intend to grant a franchise in the following year. See Competition and Consumer (Industry Codes – Franchising) Regulation 2014 (Cth) sch 1 pt 1 div 1 para 8(7) (Austl.). The benefit of this exemption is somewhat limited, however, in that the
applies, or if the franchise agreement is for goods or services totalling no more than twenty percent of the franchisee’s revenue. Importantly, the transfer or renewal of a franchise agreement, the extension of the scope or term of a franchise agreement, or a motor vehicle dealership agreement are taken to be a franchise agreement.

Most master franchise agreements entered into between foreign franchisors and a master franchisee for any part of Australia will be caught by the Franchising Code. This has implications for the form of the master franchise agreement and means that foreign franchisors will need to comply with the disclosure requirements under the Franchising Code.

1. Registration and Pre-contractual Dealings

Franchisors are not required to register with any statutory authority prior to franchising, although there is a voluntary registry called the Australian Franchise Registry. There is currently no State regulation of franchising in Australia other than legislation in the State of South Australia that relates to the resolution of disputes in franchise agreements connected to that State.

However, the Australian franchise sector has been the subject of much media and political criticism during the past few years, culminating in the establishment of the Franchising Inquiry. As part of industry initiatives to restore public confidence in franchising, it is likely that the nationally recognized franchise industry trade association, the Franchise Council of Australia (FCA), will make registration with an approved registry a pre-condition of membership in the FCA, possibly from July 1, 2019.

Franchisors are able to conduct meetings and generally undertake preliminary marketing and prospecting in Australia, but may not enter into a binding agreement or take any non-refundable monetary amount from a prospective franchisee or master franchisee without complying with the Franchising Code’s disclosure obligations described in more detail later.

A unique requirement, intended to be an early alert mechanism for prospective franchisees, is that franchisors must also provide an Information Statement in the prescribed form to a prospective franchisee at the earliest opportunity after the prospect formally expresses interest in a franchise.
This is usually done if a prospect completes an application form, or makes any other clear expression of specific interest.

The Information Statement is essentially an information brochure on the risks and rewards of franchising, and contains advice and information on the following topics:

- Recommending due diligence, advice, reading documents and understanding the Franchising Code;
- Suggesting educational courses, noting a source for some online courses;
- Explaining franchising, including the potential benefits and the nature of the franchise relationship;
- Warning of unexpected expenses and the risks of franchising;
- Providing a list of some issues to consider in evaluating a franchise;
- Warning about end of term arrangements; and
- Suggesting where to obtain further information. 58

2. Disclosure

Franchisors are required to produce a disclosure document that strictly complies in form and content with the terms of Annexure 1 (full form) of the Franchising Code. 59 The disclosure document is required to be “in the form and the order and under the numbering” and “under the titles” set out in the annexures to the Franchising Code. 60 Although some of the information contained in existing disclosure materials will assist in the preparation of the Australian document, foreign systems will need to instruct local counsel to undertake a comprehensive re-draft to meet the format requirements of the Franchising Code.

A franchisor must, under the Franchising Code, give a disclosure document to a prospective franchisee or a franchisee proposing to renew or extend a franchise. A franchisor must give a copy of the Franchising Code and a disclosure document to a prospective franchisee at least fourteen days before the prospective franchisee enters into a franchise agreement, or an agreement to enter into a franchise agreement, or pays non-refundable money to the franchisor or an associate of the franchisor in connection with the proposed franchise agreement. 61 The franchisor must also provide at this time a copy of the franchise agreement “in the form in which it is to be executed.” 62

58. See id., Annexure 2.
60. Competition and Consumer (Industry Codes – Franchising) Regulation 2014 (Cth) sch 1 pt 2 div 2 para 8 (Austl.)
61. Id., sch 1 pt 2 div 2 para 9(1). Franchisor are also required to provide a copy of their current disclosure document to an existing franchisee within fourteen days of a written request. Id., sch 1 pt 3 div 2 sub-div B, para 16(1).
62. Id.
which means that the document has to contain all commercial terms and be essentially ready to be signed. Failure to comply with this requirement can invalidate disclosure and is a trap for foreign franchisors used to providing more of a template franchise agreement with the disclosure material.

A foreign franchisor entering into a master franchise agreement with a master franchisee that has the right to grant unit franchises/sub-franchises in Australia will also need to give a disclosure document relating to the terms of the master franchise agreement to the master franchisee. Beginning on January 1, 2015, a franchisor is required to give a disclosure document to a master franchisee, but the franchisor is not required to give a disclosure document to a sub-franchisee of the master franchisee. These disclosure requirements can create potential liability for foreign franchisors, so it is important that franchisors seek out legal advice from an experienced franchise attorney regarding the form of these documents before entering into the Australian market.

Franchisors are required to update their disclosure document annually within four months of the end of their fiscal year. However, there are some exemptions from updating for franchisors that have granted no more than one franchise agreement in the year and that do not intend to grant a franchise in the following year.

The disclosure requirements are complex and highly prescriptive. The disclosure document must be in the prescribed form and layout and under the prescribed headings. Although a franchisor’s current foreign disclosure document will be useful as to content, it will not be able to be used for compliance and, indeed, significant additional information is typically required in Australia.

3. Other Franchising Code Requirements

a. Advice

The franchisor must not, by virtue of the Franchising Code, enter into, renew, or extend a franchise agreement unless the franchisor has received from the franchisee or prospective franchisee a written statement that the franchisee or prospective franchisee has received, read, and had a reasonable opportunity to understand the disclosure document and the Franchising Code. Before a franchise agreement is made, the franchisor must have received from the prospective franchisee the signed statements that the prospective franchisee has been given advice about the proposed franchise business, from at least an independent legal adviser, business adviser, or accountant, or has been told that that kind of advice should be sought but has decided not to seek it.

63. Id., sch 1 pt 2 div 2 para 8(6).
64. Id., sch 1 pt 2 div 2 para 8(7).
65. Id., sch 1 pt 2 div 2 para 10(1).
66. Id., sch 1 pt 2 div 2 para 10(2).
b. Cooling Off

A franchisee may terminate an agreement (being either a franchise agreement or an agreement to enter into a franchise agreement) within seven days after the earlier of entering into the agreement or paying any money under the agreement. If the franchisee terminates such an agreement, the franchisor must, within fourteen days, repay all money paid by the franchisee to the franchisor under the agreement less reasonable expenses, provided those expenses have been disclosed in the disclosure document provided to the franchisee.

c. Marketing Funds

If, as part of the franchise offering, the franchise agreement provides that a franchisee must pay money to a marketing or other cooperative fund, the franchisor must prepare an annual financial statement of the fund’s receipts and expenses for the last financial year, including the percentage spent on production, advertising, administration, and other stated expenses, and have the statement audited by a registered company auditor within four months after the end of the financial year to which it relates. The franchisor must give to the franchisee a copy of the statement, within thirty days of preparing the statement, and a copy of the audit report (if applicable), within thirty days after preparing the report. The requirement for the franchise statement to be audited does not apply for a financial year if seventy-five percent of the franchisees in Australia that contribute to the fund agree and such agreement is made within the period prescribed by the Franchising Code.

The Franchising Code requires that the marketing statement must contain sufficient detail of the fund’s receipts and expenses so as to give “meaningful information” about sources of income and “items” of expenditure. The ACCC has announced that it expects franchise systems to provide significant detail, and has taken enforcement action where it considers information to be insufficiently particularised.

67. Id., sch 1 pt 3 div 5 para 26(1).
68. Id., sch 1 pt 3 div 5 para 26(3).
69. Id., sch 1 pt 3 div 2 sub-div A para 15(1)(a)–(c).
70. Id., sch 1 pt 3 div 2 sub-div A para 15(1)(d).
71. Id., sch 1 pt 3 div 2 sub-div A para 15(2).
72. Id., sch 1 pt 3 div 2 sub-div A para 15(1)(b).
73. For example on September 10, 2018, the ACCC issued a media release advising it had investigated the marketing fund financial statement and disclosure document of Luxottica Franchising Australia (Luxottica). Press Release, ACCC, Luxottica to Improve Transparency for Franchisees (Sept. 10, 2018), https://www.accc.gov.au/media-release/luxottica-to-improve-transparency-for-franchisees. Luxottica cooperated with the ACCC’s inquiries and voluntarily committed to change the documents to give franchisees a more open and transparent account of the business. Id. The ACCC sought more detail concerning the marketing fund’s receipts and expenses, including who contributes to the fund and what the money is spent on. Id. The ACCC felt that Luxottica’s statement did not provide enough information about how much money Luxottica corporate stores paid for marketing, what marketing services were purchased using money contributed by company-owned stores, specifics about marketing expenses, such as brands the marketing funds were being spent on, or in what geographic locations the advertising was run. Id.
d. End of Term Arrangements

In Australia, the law is very clear that at the end of a franchise agreement, a franchisee has no legal right to an extension of the agreement, and no right to compensation.74 The January 1, 2015, amendments to the Franchising Code moderate this position slightly, in that franchisors have additional disclosure obligations intended to clarify for franchisees what, if any, conditions apply at the end of the franchise term. In addition, franchisors must give at least six months’ notice of their decision to renew or not to renew a franchise agreement or enter into a new franchise agreement.75 Where a franchise agreement is less than six months, the notice period is at least one month.76

Furthermore, the Franchising Code was amended to provide that a restraint-of-trade clause in a franchise agreement has no effect after the agreement expires if the franchisee wishes to continue, is prepared to sign the then-current franchise agreement, is not in breach of the agreement, and has not infringed the intellectual property or confidentiality of the franchisor during the term of the agreement, and the franchisor declines to extend the agreement and does not pay genuine compensation to the franchisee for goodwill.77

e. Continuous Disclosure of Materially Relevant Facts

The disclosure document is to be updated annually within four months of the end of the fiscal year, unless the franchisor did not enter into more than one franchise agreement during the year and does not intend to enter into another franchise agreement in the following fiscal year.78

However, a franchisor is required to disclose to all existing franchisees within a reasonable time, but not more than fourteen days after the franchisor becomes aware of certain materially relevant facts.79 The Code defines a “materially relevant fact” as including (1) any change in majority ownership or control of the franchisor or associate or of material intellectual property; (2) certain proceedings by a public agency such as the ACCC; (3) a judgment or arbitration award in criminal or civil proceedings in Australia against the franchisor alleging breach of a franchise agreement; (4) contravention of trade practices law or the CCA; (5) unconscionable conduct, misconduct, or an offence of dishonesty; (6) a judgment against the franchisor under certain workplace relations and industrial relations laws; or (7) civil proceedings in Australia against the franchisor or an associate of the franchisor by ten
percent or ten of the franchisees in Australia of the franchisor (whichever is the lower).80

f. Provide Current Disclosure Document

The Franchising Code requires franchisors to provide an updated disclosure document if the franchisee makes a request for a current disclosure document under clause 16(1) of the Franchising Code. However a franchisee can only make such a request once every twelve months.81

g. Transfer

The Franchising Code provides that a franchisor cannot unreasonably withhold consent to a franchisee's request to assign a franchise agreement.82 However, the Franchising Code sets out a significant number of circumstances where it would be reasonable for a franchisor to withhold consent, covering most of the usual circumstances a franchisor would wish to do so.83

The Franchising Code also requires disclosure of whether the franchisor will amend the franchise agreement prior to, or on transfer of, a franchise agreement.84

h. Termination

The Franchising Code curtails somewhat a franchisor's ability to terminate a franchise agreement. Immediate termination is only available in very limited circumstances, such as insolvency, abandonment, conviction of a serious offence, danger to public health or safety, or fraud.85 To terminate for breach a franchisor must give a franchisee written notice of the breach and an opportunity (of not more than thirty days) to cure the breach.86 If the breach is cured, the franchisor cannot terminate the agreement.87

i. Ancillary Prohibitions

The Franchising Code provides that a franchisor must not require a franchisee to undertake “significant capital expenditure” during the term of the franchise, but the term “significant capital expenditure” is quite narrowly defined.88 For example, it excludes, among other things, expenditures disclosed in the disclosure document, agreed by the franchisee, or justified by a written statement to each affected franchisee as a necessary capital investment in the franchised business.89

80. Id., sch 1 pt 3 div 2 sub-div A para 17(3).
81. Id., sch 1 pt 2 div 2 para 8(8).
82. Id., sch 1 pt 3 div 4 para 25(2).
83. Id., sch 1 pt 3 div 4 para 25(3).
84. Id., Annexure 1, Item 19.1.
85. Id., sch 1 pt 3 div 5 para 29(1).
86. Id., sch 1 pt 3 div 5 para 27(2)–(3).
87. Id., sch 1 pt 3 div 6 para 27(4).
88. Id., sch 1 pt 3 div 6 para 30(1).
89. Id., sch 1 pt 3 div 6 para 30(2).
A franchisor must not engage in conduct that restricts or impairs a franchisee from forming an association or to freely associate.\(^{90}\) A franchise agreement cannot require a franchisee to sign either a general release from liability or a waiver of any verbal or written representation.\(^ {91}\)

j. **Dispute Resolution**

The Franchising Code contains a mediation process, which, if activated by a party, is mandatory.\(^ {92}\) Mediation is a process involving the resolution of disputes by consensus. The mediation process has been extremely successful in resolving disputes, with a success rate in excess of eighty percent.\(^ {93}\)

k. **Record keeping**

Franchisors must keep a written copy of all documents and Franchising Code records for six years after the document or record was created.\(^ {94}\)

### IV. Fair Work Act Liability of Franchisors

The U.S. debate on joint employment has manifested itself in Australia as a debate over the extent to which franchisors should have responsibility for the workplace law breaches of franchisees. Unlike the United States, Australia has in fact created a new and specific statutory liability for franchisors for the workplace law breaches of a franchisee.\(^ {95}\) Although stopping short of creating joint-employer liability, the legislation does create direct franchisor exposure to regulatory penalties and civil claims by employees of franchisees.

The legislation provides that a “responsible franchisor entity” is liable for certain contraventions of the *Fair Work Act* by an employer that is a “franchisee entity” where the franchisor, or an officer of the franchisor, “knew or could reasonably be expected to have known that the contravention by the franchisee entity would occur, or a contravention of the same or similar character was likely to occur.”\(^ {96}\) Section 558(3) and (4) set out a defense for a person (which would include a responsible franchisor or an individual that aids and abets a breach) that takes reasonable steps to prevent the franchisee’s contravention of the law.

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90. *Id.*, sch 1 pt 3 div 6 para 33.
91. *Id.*, sch 1 pt 3 div 3 para 20.
92. *Id.*, sch 1 pt 4 div 2 para 39.
93. In its report to the Franchising Code Review Secretariat in February 2013, the Office of Franchise Mediation Adviser noted that the franchise mediation service enjoyed an 81% mediation settlement rate, and 80% of participants were satisfied with the mediation process. This report remains on file with the author.
94. *Competition and Consumer (Industry Codes – Franchising) Regulation 2014* (Cth) sch 1 pt 3 div 2 sub-div C para 19(1)–(3) (Austl.).
95. Section 558B of the *Fair Work Act 2009* (Cth), introduced by the *Fair Work Amendment (Protecting Vulnerable Workers) Act 2017* (Cth).
96. *Fair Work Amendment (Protecting Vulnerable Workers) Act 2017* (Cth) sch 1 para 558(1) (Austl.).
A “responsible franchisor entity” is a franchisor that has “a significant degree of influence or control over the franchisee entity’s affairs,” with a “franchise” very broadly defined as “an arrangement under which a person earns profits or income by exploiting a right, conferred by the owner of the right, to use a trademark or design or other intellectual property or the goodwill attached to it in connection with the supply of goods or services.” The legislation also contains increased penalties for breach, stronger enforcement powers for the Fair Work Ombudsman and a new offence of a “serious contravention” with even higher penalties.

Franchise systems looking to do business in Australia will need to obtain specific advice on the extent of their potential liability, and the steps they will need to take to ensure they can either escape the ambit of the legislation or satisfy the test of taking “reasonable steps.”

In practical terms, franchisors face exposure on three fronts:

1. Risk of regulatory prosecution under the legislation. The practical reality is now that any workplace law breach by a franchisee will invite almost automatic regulatory scrutiny of the franchisor’s role. The Fair Work Ombudsman has new enforcement and investigative powers and has publicly stated on several occasions that she regards franchisors as having a legal and moral responsibility to the workers of franchisees.

2. Risk of civil claim by employees of franchisees based on new legislative obligations. Employees can now sue franchisors directly, asserting that the franchisor failed to take reasonable steps to prevent a breach by a franchisee. Although this risk is manageable in the context of individual employee claims, there is a significantly increased risk of class actions if any form of endemic or systems-related issue arises. For example, cases currently before the court have raised financial viability of the business model as a possible basis for franchisor liability for worker underpayments. In other words, because the franchise model was not financially viable for the franchisee, the franchisee had no alternative but to underpay employees.

3. Risk of adverse media publicity. The media have been particularly active, and indeed highly critical of franchise systems, and it does seem that community and media expectations of brand owners extend beyond even the revised legal obligations. In many cases, adverse publicity is a major risk for major brand owners, and the most difficult to manage.

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97. Id., sch 1 para 558A(2).
98. Corporations Act 2001 (Cth) Ch 1 pt 1.2 div 1 para 9 (Austl.). The Corporations Act definition of a franchise is much broader than the definition contained in the Franchising Code. As a result, many license and distribution arrangements that would not normally be considered to be a franchise arrangement come within the ambit of the legislation.
99. Fair Work Amendment (Protecting Vulnerable Workers) Act 2017 (Cth) sch 1 para 557A (Austl.).
Most franchise systems have taken at least some additional measures to demonstrate they have taken “reasonable steps” to prevent a breach. These include providing training and educational materials, strengthening agreements, monitoring compliance, and taking stronger action in the event of breach by franchisees of workplace laws. It is recommended that franchisors focus on the issue as part of an overall risk assessment, and design an appropriate compliance program that has regard to the nature of the franchise model, the size and resources of the franchisor, the capacity of the franchisee, and any other relevant factors. The real challenge is to ensure that any compliance program does not impose unreasonable compliance costs or destroy the synergistic collaborative relationship between franchisor and franchisee.

V. Other Laws Relevant to Franchising

State-based retail tenancy legislation is likely to be relevant to retail franchise systems, as are State-based motor vehicle and road traffic laws for mobile businesses. Australia is also at the forefront of legislation relating to anti-terrorism, money laundering, data privacy, modern slavery, health and obesity, and other issues familiar to U.S. businesses. A detailed discussion of all laws relevant to franchising is beyond the scope of this paper. Suffice to say most Australian laws are at least conceptually similar to equivalent U.S. laws.

VI. Litigation and Dispute Resolution in Australia

A. General Comments

Australia has a robust and effective court system for resolving disputes, as well as a variety of mechanisms by which disputes can be resolved by alternative means. In the franchising context, the more substantial and serious franchise disputes are typically litigated in the Commonwealth Federal Court or in the state- and territory-based Supreme Courts. All courts typically require mediation to be conducted throughout the litigation case management process. The Franchising Code also provides for a mandatory mediation process upon the activation of that process by a franchisor or franchisee.100 This is the most common manner in which franchise disputes (where lawyers have been engaged) are resolved. Under the Franchising Code, an Office of the Franchising Mediation Adviser (OFMA) has been established which facilitates the appointment of mediators and arrangements to be made for mediations. However, other statutory and non-statutory mechanisms for mediation exist that are independent of the Franchising Code and that are utilised by franchisees from time to time.101

100. See Competition and Consumer (Industry Codes – Franchising) Regulation 2014 (Cth) sch 1 pt 4 div 2 paras 34–45 (Austl.).
101. For example, the Victorian Small Business Commissioner’s office offers a mediation service which is regularly used in franchising disputes.
B. Incidence of Disputes and Typical Claims

As noted in the introduction to this paper, the number of disputes in the franchising sector remains very low. But the authors have anecdotaly noted an increase in the level of disputes in our practice over the past three years. We attribute this increase to the following matters:

• As a result of high levels of media and regulatory scrutiny of the franchise sector, franchisees have never been more aware of their “rights” and the claims available to them. For similar reasons, lawyers (and litigation funders) acting for franchisees have been emboldened to take action against franchisors.

• There appears to be an increased expectation by franchisees of “guaranteed” success/profitability in franchised businesses; where a franchised business is struggling or has failed, the franchisee often considers that someone other than the franchisee is to blame.

• The highly competitive retail environment in Australia in the past few years has placed greater pressure on franchised businesses and has exposed any weaknesses in the operations of individual franchisees. This has adversely impacted the performance and profitability of franchised businesses.

• Franchisees have a greater ability and willingness to mobilise as a group to raise disputes with franchisors and to take legal action, where necessary. The rise of social media platforms such as Facebook and WhatsApp have been embraced by franchisees and used to share information and galvanise support for claims against franchisors.

In the authors’ experience, the typical claims made by franchisees against franchisors focus on (1) allegations of pre-contractual misleading conduct (typically manifesting in complaints about the projected performance of the franchised business and suitability of the site from which it is operated); (2) breach of contract (typically manifesting in complaints about inadequate training, assistance, support and marketing); and (3) unconscionable/bad faith conduct (typically manifesting in complaints about the manner in which the franchisor is taking action to enforce compliance with the franchise agreement in circumstances where it is alleged by the franchisee that the franchisor is ultimately responsible for the circumstances in which the franchisee is non-compliant—often in the context of non-compliance by the franchisee with payment obligations). The authors’ experience appears to be reflected in the top three reported disputed issues raised with OFMA in 2017.102

102. See Commonwealth Department of Jobs and Small Business, Inquiry into the operation and effectiveness of the Franchising Code of Conduct ¶ 4.1.17 (May 4, 2018), https://www.aph.gov.au/DocumentStore.ashx?id=d2597a27-4fb5-4ce8-9ba8-666efbf6d6c73&subId=565813 (citing alleged breaches of the franchise agreement (22%), the obligation to act in good faith (18%), and disclosure/misrepresentation (10%) as top three types of claims brought during the year).
C. **Legal Costs**

In Australian courts, an award of costs will generally follow the result of litigation with the successful party being entitled to an order for costs against the unsuccessful party. Practically, this imposes a de facto fetter on parties issuing legal proceedings as a degree of caution needs to be exercised given the prospect of an adverse costs order for an unsuccessful plaintiff. However, there are numerous exceptions to this general rule, such as where an offer of compromise has been made during the course of the litigation or where aspects of the “successful” party’s case or conduct have been unsuccessful or open to criticism.

D. **Class Actions**

Consistent with the increased incidence of civil lawsuits discussed earlier, a number of class actions have been brought by franchisees in recent years in Australia against franchisors. These include the following:

- **Bank of Queensland**: the bank successfully defended claims of misleading and deceptive conduct, unconscionable conduct and negligence brought by franchisees as a result of the alleged failure of their franchised businesses.

- **Pizza Hut**: Pizza Hut successfully defended a multi-million dollar damages case arising from the impact of its marketing strategy to require franchisees to discount the price of pizzas.

- **7-Eleven**: a claim is currently being litigated by franchisees in the Federal Court alleging (among other things) misleading and deceptive conduct and unconscionable conduct. 7-Eleven is strongly defending the class action.

For all the reasons discussed earlier, the authors anticipate that class actions will continue to increase in frequency in the years to come.

D. **Regulatory Investigations and Enforcement**

As noted above, the ACCC takes an assertive and quite public role in enforcement of franchisors’ obligations under the CCA and ACL.

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104. See GPN – Costs, supra note 103, para 2.1; see also Federal Court Act 1976 (Cth) Part VB para 37M-37N (Austl.).

105. Litigation funders have played a role at various stages in each of these matters.


107. *Diak Pty Ltd v YUM! Restaurants Australia Pty Ltd 3* (2016) FCA 43 (Austl.).

On its website,\textsuperscript{109} the ACCC notes that it uses a range of compliance and enforcement tools to encourage compliance with the Franchising Code. In deciding which approach to adopt in this respect, the ACCC takes into account a broad range of factors, which are outlined in the ACCC’s Compliance and Enforcement Policy.

Enforcement tools for resolving concerns include:

- administrative resolutions (e.g., the party in breach agrees to stop the conduct and compensate those affected);
- court enforceable undertakings under section 87B of the CCA;
- infringement notices; and
- initiating Court action.\textsuperscript{110}

The ACCC can initiate Court action where it considers that there has been a breach of the Franchising Code. The Court then has a range of powers to address breaches of the CCA which include:

- injunctions to stop the conduct or to require some action to be taken;
- compensation; and
- orders which impact the ability of officers of corporations to continue to hold such office or be involved in the management of corporations in the future.\textsuperscript{111}

Franchisors that run afoul of the ACCC face the same legal peril in civil lawsuits and administrative enforcement as they do with their own franchisees.

\section*{VII. Future Regulatory Changes}

It seems rarely a year passes without some form of review or scrutiny of franchising, or matters relevant to franchise systems.

As noted earlier, there is currently a federal parliamentary review of the effectiveness of the Franchising Code, as well as a departmental review of the recent amendments to the CCA. A predicted change of federal government in 2019 is likely to lead to a further focus on workplace law reform, and federal modern slavery legislation is likely to have expanded application.

Future franchise industry developments may include mandatory registration of franchise systems, changes to rules relating to rebates received by franchisors, mandating legal and business advice for prospective franchisees, and the introduction of independent rating of franchise systems. On the positive side, industry initiatives to establish potential new pools of franchisees,


\textsuperscript{110} The \textit{Competition and Consumer Act 2010} (Cth) pt VI para 76 (Austl.) confers wide power on a court to make remedial orders, including damages, declaring a contract void in whole or part, varying contracts, refusing to enforce a contract and specific performance.

\textsuperscript{111} \textit{Id.}, pt. VI para 86E.
and government initiatives to enhance small business access to finance, are also under consideration.

**VIII. Conclusion**

The Australian franchise sector continues to prosper, albeit with increasing media and political scrutiny. The regulatory framework supports good franchising practice, and the mediation-based dispute resolution framework is highly effective. Non-compliance results in strong sanctions, and the ACCC is an active and well-resourced regulator with extensive investigative and enforcement powers that supplement private rights action. The Australian economy is strong and well-managed. U.S. franchise systems will find strong conceptual similarities between Australia and the United States across most relevant areas of business, and issues relevant to business, and a country that is open for business.
A Primer on Franchising in India

Srijoy Das, Anup Kumar & Harsahib Chadha

India is home to over 1.34 billion people and has the sixth largest economy in the world with the gross domestic product of $2.6 trillion (USD). Market studies in this area suggest that India may become the third-largest consumer economy in the world by the year 2025 and the second-largest economy in terms of purchasing power parity by the year 2050.

With the liberalization of India’s economy in 1991, a large number of international brands have ventured into India using the franchise model. The franchise industry in India is estimated to be at $47–48 billion (USD) and is growing at approximately thirty percent year-on-year.

This article discusses the important legal issues that the potential franchisor should know before making the decision to expand into India using the franchise model.

I. The Legal System in India

There are no franchise specific laws in India. The relationship between the franchisor and franchisee is governed by a contract. The franchisor is not required to

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make any specific disclosures to the franchisee or to any government authority prior to grant, transfer, and renewal of a franchise business under Indian law. Although there are no franchise specific laws, franchise arrangements are regulated by various other laws in India. This includes foreign exchange control regulations, antitrust laws, intellectual property statutes, tax laws, data privacy laws, and anti-corruption laws. Some key statutes impacting franchisor-franchisee relationships are discussed later in this article.

II. Entry Strategies

As the relationship between the franchisor and franchisee is governed by contract, foreign franchisors can select from multiple business structures that are commonly used for setting up a franchise business. This includes the grant of a single-unit franchise, a multi-unit franchise, an area-development agreement, or the grant of master franchise rights to Indian franchisees. Although there is no requirement for the foreign franchisor to have an entity in India, some franchisors incorporate a subsidiary or set up a joint venture to exercise better control over the franchised business.

A. Incorporation of a Subsidiary in India

Under this arrangement, the Indian subsidiary of the franchisor is granted a right to (1) sell sub-franchises in India; and (2) directly open and operate franchise units in India. The key advantage of using a subsidiary is that the franchisor retains maximum control over the franchise business. This structure is best suited for the franchisors willing to actively engage in day-to-day management of the franchisees in India.

B. Joint Venture Arrangement with an Indian Party

Under this model, the franchisor enters into a joint venture arrangement with an Indian party and subsequently grants master franchise rights to the joint venture entity. A joint venture arrangement is generally not a preferred structure for franchise arrangements because of the greater chance of disputes arising between the parties. A franchisor desirous of incorporating a subsidiary or entering into a joint venture should be aware of some key issues, namely compliance with foreign direct investment policy, transfer pricing requirements, and day-to-day legal compliance.

1. Compliance with Foreign Direct Investment Policy

A franchisor can incorporate a subsidiary company or set up a joint venture entity in India subject to India’s foreign direct investment policy (FDI Policy). The FDI Policy provides a detailed prescription on the types of

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entities that may be set up by a foreign national/entity in India and describes the required approvals, if any, for setting up an entity in India, along with conditions that must be adhered to by the Indian entity in the operation of its business. The existing FDI Policy prohibits a foreign national/entity from setting up an Indian company for carrying out certain specified business activities, such as gambling, betting, and casinos. Additionally, a foreign national/entity cannot have a stake beyond the prescribed limit in an Indian company engaged in certain prescribed business activities, such as “multi-brand product retail trading.” The structure of a joint venture arrangement—including the key provisions of the joint venture agreement that describe the duties of each party, the capitalization of the joint venture entity, the consequences of defaults, and the resolution of deadlocks—should be clearly framed in accordance with the FDI policy, the Companies Act (2013), and prevailing foreign exchange control regulations.

2. Transfer Pricing Requirements

A foreign franchisor, and its subsidiary or a joint venture entity in India, could be deemed to be “associated parties,” and transactions between them must be on an arm’s length basis. The franchise fees, royalty fees, and other fees to be charged by the franchisor under the franchise agreement should also be in compliance with transfer pricing regulations prescribed under the Income-tax Act, 1961 (IT Act).

3. Day-to-Day Legal Compliance

A franchisor’s subsidiary or joint venture entity will have to comply with all applicable laws of India while undertaking business. This includes compliance with company, employment and tax laws, foreign exchange control regulations, and privacy laws. In addition, the subsidiary or joint venture entity will have to comply with sector-specific laws, depending on their actual business activities. For example, a company that operates restaurants is additionally required to comply with the Food Safety and Standards Act, 2006. The legal landscape requires an understanding of the complex web of laws and statutes.

III. Considerations When Granting Franchise Rights in India

India is culturally and religiously diverse. People in different states have different cultures, lifestyles, and food habits. Therefore, the potential

6. Id. § 3.
7. Id. § 5.1.
8. Id. § 5.2.
9. Id. § 5.2.15.4.
10. The Companies Act, No. 18 of 2013, INDIA CODE (2013). The central legislation that deals, inter alia, with incorporation, compliance, and dissolution of companies in India.
12. Id.
franchisor should undertake extensive market research in India to determine (1) market conditions for the franchisor’s products and services in different regions of India and the extent to which product and service offerings need to be customized to suit the various segments of the Indian market; and (2) prospective franchisee’s qualifications, and ability to scale the franchise business profitably. Market research also helps to frame realistic minimum development schedules for the franchised business in India.

Due to vastly different cultural practices in different regions, a franchise business in India is largely dependent on the standing of local franchisees. Thus, the franchisor should carry out due diligence on the potential franchisee to determine if the franchisee (1) has adequate net worth and sound financial background to operate and scale the franchise business in India; (2) has a sound legal standing without a history of defaults; and (3) meets the franchisor’s eligibility criteria for the business specific to the Indian market conditions.

IV. Franchise Business and Taxation

Indian tax regulations are divided into two categories: direct taxation and indirect taxation. Direct tax is levied on income and profit of the taxpayer in India. The IT Act is the primary legislation regulating all income tax. Indirect taxes are levied on the provision of goods and services and are governed by goods and services tax laws (GST Laws).

A. Taxation of Franchised Businesses in India

A master franchisee and a sub-franchisee in India will have to pay direct tax under the IT Act and indirect taxes under GST Laws. The obligation to pay direct taxes depends on the residential status of a taxpayer in a particular financial year. The IT Act divides taxpayers in India into seven different categories and prescribes conditions for determination of residential status for various categories of taxpayers in India. All companies incorporated in India are deemed to be resident entities, even if they are owned or controlled by foreign companies or foreign residents. The income tax rate is subject to revision every financial year by the Government of India. In addition to

15. Different categories of taxpayers include (i) an individual, (ii) A Hindu undivided family; (iii) firm; (iv) company; (v) association of persons or body of individuals; (vi) local authorities; and (vii) all other persons not falling into the aforesaid categories.
17. Id.
18. Id. § 4.
income tax, Indian franchisees may have to also pay certain additional direct taxes such as capital gains taxes, or dividend distribution taxes, as the case may be, at the applicable rates.\footnote{Id. §§ 45 and 115-O.}  

Effective July 1, 2017, the Government of India revamped the previous indirect tax regime by scrapping a large number of indirect taxes that were levied by state and central governments and replaced them with the GST Laws. In general, all suppliers of goods and services, whose turnover exceed two million (INR)\footnote{The Central Goods and Services Tax Act, No. 12 of 2017, \textit{India Code} (2017) §§ 22, 24.} are required to obtain a registration under the GST Laws and pay goods and services taxes (GST) at the applicable rates on the goods and services supplied to their customers.\footnote{Id. § 9(1); see also \textit{The Integrated Goods and Services Tax Act, No. 13 of 2017, India Code} (2017) § 5(1).} As GST is an indirect tax, the supplier generally collects the GST from its consumers.\footnote{The Central Goods and Services Tax Act, No. 12 of 2017, \textit{India Code} (2017) §§ 31–32; see \textit{The Integrated Goods and Services Tax Act, No. 13 of 2017, India Code} (2017) § 20.}  

B. Taxation of Foreign Franchisor  

1. Withholding Taxes on Payments Made by the Franchisee to the Franchisor  

The IT Act requires Indian franchisees to deduct appropriate withholding tax on payments made to a foreign franchisor under the franchise agreement. Withholding tax must be deducted and deposited with the government as soon as the sum payable to the franchisor becomes due or at the time of actual payment, whichever is earlier.\footnote{The Income-tax Act, No. 43 of 1961, \textit{India Code} (1961) § 195.}  

The IT Act further provides that withholding tax shall be deducted at the rate prescribed in the IT Act or, alternatively, the double taxation avoidance agreement (DTAA) between India and the home country of the franchisor, whichever is more beneficial to the franchisor.\footnote{Id. § 90(2)1.} Under the IT Act and DTAA, different withholding tax rates are prescribed for different categories of services. Franchise agreements typically impose a wide variety of required payments on franchisees, such as royalties, fees for technical services, advertising fees, business support fees, and administrative fees. Thus, franchisors must analyze both the IT Act and the DTAA to determine the actual rate of withholding tax for each type of payment. The steps that an Indian franchisee must take for deduction of withholding taxes prior to remittance to the franchisor are discussed later.  

2. Goods and Services Tax on Payments Made by the Franchisee to the Franchisor  

In an international franchise arrangement, because the foreign franchisor is situated outside India, the obligation to pay GST on the services provided...
by the foreign franchisor is transferred to the Indian franchisee.\textsuperscript{25} Therefore, in an international franchise arrangement, the local franchisee will have to pay GST on the payments to be made to the foreign franchisor.

V. Payments and Cross-Border Remittances

Under a Franchise Agreement

The Foreign Exchange Management Act, 1999 (FEMA), along with the rules and regulations framed under the FEMA, regulates all financial transactions that involve remittance of foreign exchange from or into India.\textsuperscript{26} Together, these are generally referred to as the “foreign exchange control regulations.” The Reserve Bank of India (RBI) is India’s central bank that administers and enforces the foreign exchange control regulations.

These regulations list out permissible and prohibited foreign exchange transactions, and also prescribe the terms and conditions for permissible transactions. Although most fees (that are typically payable by franchisees under a franchise arrangement) can be remitted to the foreign franchisors without any prior permission of the RBI, in certain special circumstances, or for certain specific transactions, prior permission of the RBI may be required.\textsuperscript{27} In addition, even for those transactions that are permissible without RBI approval, franchisees must comply with all other terms and conditions of the foreign exchange regulations. Some of these conditions include prescribed Remittance procedures, the maximum interest rate that can be charged by the foreign franchisor on delayed payments, the maximum permissible time to settle payment, and restrictions on setting-off of payments between the parties.\textsuperscript{28}

It is crucial for franchisors to ensure that the terms of their franchise agreements comply with the foreign exchange control regulations.

A. Remittance Procedures

The existing procedures for remitting foreign exchange from India are fairly complex and time-consuming. The prevailing regulations require the Indian franchisees to comply with the applicable tax regulations prior to making an application with their bank for remittance of money to foreign franchisors. Indian franchisees must obtain a certificate from a qualified chartered accountant in India certifying the amount of withholding taxes to be withheld in India before making a payment to their foreign franchisor.\textsuperscript{29}

\begin{footnotesize}
\begin{itemize}
  \item 27. Id. §§ 3–9.
  \item 28. Master Direction—Import of Goods and Services, Reserve Bank of India, RBI/FED/2016-17/12
  FED Master Direction No. 17/2016-17 (Jan. 1, 2016) § C.2(i), https://rbidocs.rbi.org.in/rdocs/notification/PDFs/12MDFB8AD1B34BCB4D0A8F6869DA4A53082E.PDF.
  \item 29. Income-tax Rules, 1962, § 37BB.
\end{itemize}
\end{footnotesize}
To compute the applicable withholding tax, the franchisee must provide a copy of the invoice and the franchise agreement, a declaration from the franchisor that it does not have a permanent establishment in India, and a copy of the franchisor's tax residency certificate. Regulations also require that the Indian franchisee submit a declaration with the Indian Income Tax Department in relation to the proposed remittances and taxes withheld. Where the payment to be made is under five hundred thousand (INR), a declaration must include payment information in a pre-designated format. Where the payment to be made is over five hundred thousand (INR), a declaration must include a certificate from an assessing officer, an order from the assessing officer, or a certificate from an accountant, as the case may be, along with payment information in a pre-designated format. Where the payment to be made is not chargeable to tax, the declaration must include payment information in a pre-designated format. But, in some cases, franchisees do not need to submit any information. Upon completion of these procedures, the Indian franchisee can make an application to its bank to remit payment to its foreign franchisor. This entire process for effecting the remittances from India usually takes about seven to ten working days.

Therefore, the frequency of payments made by the Indian franchise, and their due dates, must be carefully determined, to ensure that the Indian franchisee is in a position to comply with the foreign exchange control regulations of India.

B. Payment of Interest

Foreign franchisors typically levy interest on any money unpaid by the Indian franchisee after the due date of payment. Although the applicable regulations permit payment of interest by an Indian party to a foreign party, there is a cap on the maximum interest that can be paid.

C. Payment of Damages

Foreign exchange control regulations neither expressly permit nor restrict an Indian party from paying damages and/or compensation to a foreign party for breach of a contract. Although it can be inferred that the FEMA permits remittance of compensation or damages by an Indian party without any prior RBI approval, some Indian banks may seek a confirmation from the RBI that a specific remittance is permissible before they will proceed with the requested transaction. An Indian party's payment of damages to a foreign party must arise out of a bona fide trade transaction and must not be for the purpose of illegally transferring funds outside India.

31. Income-tax Rules, 1962, § 37BB.
32. Id.
33. Master Direction supra note 28, § C.2(i).
34. Id. § B.2.
D. Loan by the Franchisor to the Franchisee

Some franchise arrangements contemplate financial assistance by the foreign franchisor to the Indian franchisee by way of loans. The Foreign Exchange Management (Borrowing or Lending in Foreign Exchange) Regulations, 2000 (ECB Regulation), prescribe eligibility conditions for foreign lenders and Indian borrowers for various categories of loans. In addition, ECB regulations also prescribe other conditions including due date for repayment, interest payable, and RBI approval requirements. If the franchise arrangement contemplates any financial assistance by the franchisor to the Indian franchisee, the parties’ agreement should be reviewed in light of ECB Regulation and prevailing foreign exchange control regulations.35

VI. Guaranteeing the Performance of the Indian Franchisee

Foreign franchisors often seek a guarantee from owners of Indian franchisees to safeguard the performance of the franchisees in India. In many transactions, Indian franchisees are required to provide a personal guarantee to the foreign franchisor.

The Foreign Exchange Management (Guarantees) Regulations, 2000 (Guarantee Regulations), framed under the FEMA, specifically list out the specific transactions that a resident Indian can provide a personal guarantee to a non-resident.36 The Guarantee Regulations also set forth the terms and conditions subject to which a guarantee can be provided by a resident in India to a non-resident.37 The RBI requires pre-approval of a personal guarantee for a transaction that is not covered under the Guarantee Regulations or where the terms and conditions of a guarantee to be given to a non-resident are different from those permitted under the Guarantee Regulations.38 Some examples of when an Indian resident can (in terms of the Guarantee Regulations) issue a personal guarantee to a non-resident are (1) guarantees for the performance of a project outside India; (2) bid guarantees; or (3) guarantees securing the performance of a wholly owned subsidiary or a joint venture entity set up by an Indian resident outside India.39

The Guarantee Regulations do not expressly permit a resident owner of the Indian franchisee to provide a personal guarantee or a bank guarantee to a non-resident for guaranteeing the franchisee’s performance of the franchise agreement in India. Thus, the owner of an Indian franchisee will have to seek prior approval of the RBI before executing a personal guarantee in favor of the non-resident franchisor.

37. Id. § 5.
38. Id. § 3.
39. Id. § 5.
Franchisors should be wary about the enforceability of a personal guarantee issued by an Indian resident to a foreign resident in contravention of Guarantees Regulation. Although very few judicial pronouncements have been made on this subject, the Delhi High Court in *SRM Exploration Private Limited v. N&S&N Consultants s.r.o.* addressed the issue of the enforceability of a personal guarantee signed by SRM Exploration in favor of N&S&N Consultants, a non-resident entity, to secure the performance of a potential joint venture. The court ruled that a guarantee issued by an Indian resident to a non-resident in violation of the Guarantees Regulations is not void or unenforceable. However, the court noted that any Indian party providing such a guarantee is liable to pay monetary penalties and face consequences because of violation of the FEMA. Nonetheless, the court upheld the guarantee, noting that a ruling otherwise would send a wrong signal overseas and dissuade foreign entities from relying on guarantees given by Indian entities, which could hamper international commercial transactions.

Although the court’s ruling in *SRM Exploration* is progressive, it cannot be considered as settled law on the subject unless the present ruling is upheld by other High Courts or India’s Supreme Court. Therefore, foreign franchisors should endeavor to have any guarantee given by an Indian resident conform to the Guarantee Regulations and, further, ensure that the guarantee contract is carefully drafted to protect the franchisor with contingencies, in case the guarantee provided by the Indian resident is deemed unenforceable in the future.

Considering that the owner of an Indian franchisee will have to seek prior approval from the RBI, which is a time-consuming exercise, foreign franchisors also may ask the owner of the Indian franchise to provide a bank guarantee instead of a personal guarantee. The Guarantee Regulations presently permit the Indian franchise to provide a bank guarantee to the foreign franchisor up to $5 million (USD).

**VII. Franchisors Rights After Termination of the Franchise Agreement**

Upon termination of the franchise agreement, foreign franchisors often have a right to either buy the entire franchise business, or to buy selected assets of the franchise business. These rights are generally enforceable by foreign franchisors in India subject to compliance with the applicable FDI Policy and other foreign exchange control regulations.
A. The Franchisor's Right to Acquire the Franchise Entity

Any provision of a franchise agreement relating to the foreign franchisor's right to acquire the Indian entity upon termination should be framed keeping in mind the various conditions that could be imposed under the FDI Policy. The FDI Policy provides for the following:

1. The Sectors in Which Foreign Investment in India Is Prohibited

Foreign investment is prohibited completely in certain sectors, including gambling, betting, and casinos.45

2. The Maximum Stake That Can Be Acquired by a Foreign Party in an Indian Business

The FDI Policy prescribes the maximum stake that can be acquired by foreign parties in an Indian business engaged in certain specific sectors, such as retail trading, insurance, and banking.46 For example, as per the current FDI Policy, foreign shareholding cannot exceed fifty-one percent in an Indian entity engaged in “multi brands product retail trading business.”47 “Multi brands product retail trading” describes the sale at one location of goods manufactured by different brands. For example, department stores selling goods manufactured by various companies would be considered “multi brands product retail trading business.”

3. The Approvals Required for Acquiring a Stake by a Foreign Party

Although the majority of the business sectors in India are now open for one hundred percent foreign investment without the need for government approval, entry into some sectors requires prior approval of the Government of India.48 For example, government approval is required for acquiring a stake in an Indian entity engaged in multi-brand product retail trading business.49

4. The Minimum Price That a Foreign Party Will Have to Pay for Acquiring a Stake in Indian Business

The FDI Policy states that a foreign entity cannot acquire any stake in an Indian entity at a price that is below the fair market price.50 The fair market price is calculated based on a formula and guidelines prescribed in the FEMA.51

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45. Consolidated FDI Policy, supra note 5, § 5.1.
46. Id. § 5.2.
47. Id. § 5.2.15.4.
48. Id. § 3.4; see § 5.2.
49. Id. § 5.2.15.4.
50. Consolidated FDI Policy, supra note 5, Annexure 2 § 1.
5. The Nature of the Entity in Which a Foreign Party Can Acquire a Stake

The FDI Policy specifically prescribes the nature of the entities in which foreign investment is possible in India. As per the FDI policy, a foreign party can generally acquire a stake in an Indian company or a limited liability partnership. With respect to the acquisition of an Indian company, a foreign party can acquire or subscribe to equity shares or fully and compulsorily convertible preference shares and debentures.

In addition to the conditions listed above, the FDI policy also prescribes various other conditions for foreign investment in India. Therefore, parties should carefully structure a franchise arrangement so that the rights of the franchisor to acquire the Indian business are in conformity with the applicable FDI Policy prevailing at the time that the parties execute the franchise agreement.

B. Right to Acquire Certain Assets of the Indian Franchise

In certain franchise arrangements, the franchisor has the right to acquire assets of the franchise business in certain circumstances. FEMA prohibits a foreign entity from acquiring any immovable property in India without setting up a local entity in India. If the franchise agreement confers rights on the franchisor to acquire any right in any immovable property of the Indian franchisee’s business, the franchisor will have to first set up an entity in India, subject to the regulations of the FEMA and the FDI Policy.

In cases where the foreign franchisor has the right to purchase any movable property of the Indian franchisee’s business, such rights can be enforced subject to compliance of the applicable trade policy of India, including requiring the franchisor to pay the fair price of the movable property.

VIII. Relief Available for Breaches of Indian Franchise Agreements

Franchisors can seek relief from a defaulting franchisee in certain cases, and this possibility depends on the terms of the franchise agreement as well as the local laws governing the agreement. If the franchise agreement is governed by Indian law, a party to a contract can seek relief in the form of damages, injunctions, and specific performance of contracts, depending on the nature of damage caused by the defaulting party.

52. Consolidated FDI Policy, supra note 5, § 3.2.
53. Id. § 3.4.1.
54. Id. § 3.
A. Damages

The Indian Contract Act, 1872 (Contract Act)\textsuperscript{57} states that a party that breaches its contractual obligations is liable to pay damages to the non-defaulting party for reasonable and foreseeable monetary loss caused to the non-defaulting party.\textsuperscript{58} The Contract Act does not provide for damages for non-monetary losses, such as for mental distress, or loss of reputation arising due to a breach of a contract. Some of the critical issues relating to the award of damages for breach of contract are discussed later.

1. Direct and Indirect Damages

The Contract Act provides that a non-defaulting party to a contract is generally entitled to damages for reasonable monetary loss arising in the normal course of business, but not for the extraordinary loss of profits due to any special circumstances.\textsuperscript{59}

A non-defaulting party in India can seek indirect damages under a contract only where both parties, at the time of execution of the contract, were aware of special loss that could be caused to the non-defaulting party for non-compliance of the contract.\textsuperscript{60}

2. Reasonable Damages

As per the Contract Act, a non-defaulting party to a contract is entitled to seek only reasonable damages for the actual monetary loss caused. The provisions relating to damages under the Indian Contract Act are based on the premise that the non-defaulting party should be placed in the same position that it would have been in had the contract not been breached. Indian courts generally do not award punitive or exemplary damages for breach of a contract.\textsuperscript{61} However, Indian courts award exemplary damages under the intellectual property laws of India in the case of blatant misuse or misappropriation of intellectual property.\textsuperscript{62}

3. Liquidated Damages

Parties to a contract can specify the quantum of liquidated damages that a defaulting party would have to pay to the non-defaulting party on breach of the contract. The Indian Contract Act requires that liquidated damages provisions should be a reasonable pre-estimate of the expected loss that could be caused to a party on breach of a contract.\textsuperscript{63} If the liquidated damages are found unreasonable or in the nature of a penalty, a court could refuse to award the liquidated damages mentioned in the contract. In such cases, the

\begin{itemize}
  \item \textsuperscript{57} The Indian Contract Act, No. 09 of 1872, India Code (1872).
  \item \textsuperscript{58} Id. § 74.
  \item \textsuperscript{59} Id. § 73.
  \item \textsuperscript{60} Id. § 73 Ill. (I).
  \item \textsuperscript{61} Id. § 74.
  \item \textsuperscript{62} Microsoft Corporation vs Ms. K. Mayuri and Ors., (2007) ILR 2 Delhi 976.
  \item \textsuperscript{63} The Indian Contract Act, No. 09 of 1872, India Code (1872), § 74.
\end{itemize}
court would assess the reasonable damages that should be awarded to the non-defaulting party.  

B. **Specific Performance of a Contract**

In certain special circumstances, where there are no prescribed standards for the determination of damages or where monetary damages cannot be an adequate remedy for breach of a contract, a non-defaulting party may approach the competent court to seek specific performance of a contract. But the Specific Relief Act, 1963 (Specific Relief Act) further clarifies that the court cannot order specific performance of a contract in cases where (1) the contract is determinable; (2) the performance of the contract involves continuous duty that the court cannot supervise; or (3) the performance of the contract is dependent on the personal qualifications of the parties that the courts cannot enforce in material terms.

C. **Interim Relief**

Indian courts are empowered to grant interim relief pending the final determination of substantive rights and liabilities of parties. Because of the length of the judicial process and the time taken for final determination of suits in India, interim relief is a significant remedy available to a party. Interim relief is commonly awarded in the form of injunctions, attachment of property, and award of security deposit.

In disputes between the franchisee and the franchisor, interim relief in the form of an injunction is crucial to prevent misuse of the franchisor’s intellectual property and franchise systems. Prior to granting injunctions, a court will weigh the loss that would be caused to the plaintiff on the refusal of an injunction request against the hardship that would be faced by the defendant in the case of granting the injunction. To secure an injunction, the plaintiff will have to prove that (1) the disputes between the parties are bona fide; (2) there is a prima facie case and balance of convenience in the plaintiff’s favor; and (3) the plaintiff would suffer an irreparable injury if interim injunction is not granted.

D. **Enforceability of Restrictive Covenants in a Franchise Agreement**

All franchise agreements have certain restrictive covenants relating to non-disclosure of confidential information, non-compete provisions, and non-solicit restrictions. These restrictions are aimed at protecting the franchisor’s trade secret and goodwill in the franchise business.

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64. Id.
66. Id. § 14.
Among other things, in a franchise arrangement, non-compete restrictions prevent the franchisees and their owners from (1) working with other enterprises that are engaged in a business similar to the franchise business and (2) starting a competing business during the term of the franchise agreement. Non-competes also typically extend for a specified duration after the termination of the franchise agreement. In many franchise arrangements, non-compete restrictions also apply to the key employees of the franchised business.

Under Indian law, non-compete restrictions on the franchisee and its owners during the term of the franchise agreement are generally considered enforceable.\(^6^9\) However, the enforcement of non-compete restrictions extending beyond the term of the franchise agreement could be a challenge as such restraint may be deemed as an undue restriction on the personal freedom of the Indian franchisee and its owners.\(^7^0\) Furthermore, non-compete restrictions on employees beyond the term of their employment are generally not enforceable in India.\(^7^1\)

Terms that provide for reasonable restrictions relating to non-solicitation of employees and non-disclosure of confidential information, even those that extend beyond the term of the franchise agreement, are generally enforceable in India.\(^7^2\)

IX. Dispute Resolution

Parties to an international franchise agreement have multiple options for resolving disputes. From the foreign franchisor’s perspective, dispute-resolution provisions should enable the franchisor to seek effective remedies against the franchisee in India. It is important to understand the various options for dispute resolution and their effectiveness in order to make the right decision when drafting the franchise agreement.

A. Resolution of Disputes in Indian Courts

India has a unified judicial system with a hierarchy of courts. India’s Supreme Court is the apex court of the country. Subordinate to India’s Supreme Court are the High Courts of each state. The district court is the highest civil court positioned below the High Court.

In addition to the district and subordinate courts, various tribunals have been set up for specialized matters, such as income taxes, goods and services taxes, debt recovery, intellectual property, and various others. Appeals from the orders of these tribunals/appellate tribunals lie in the High Court and

\(^{69}\) M/S Gujarat Bottling Co. Ltd. & Ors. v. Coca Cola Co. & Ors., AIR (1955) SC 2372.

\(^{70}\) The Indian Contract Act, No. 09 of 1872, India Code (1872), § 27.


the Supreme Court, as the case may be. The organization of the subordinate courts and tribunals varies slightly from state to state.

1. Jurisdiction

A suit should be filed in the appropriate court that has territorial as well as pecuniary jurisdiction over the matter. Courts in India have a defined territorial limit beyond which they cannot exercise their jurisdiction. Similarly, courts can exercise jurisdiction over a matter where the value does not exceed the pecuniary limit prescribed for that court. Subject to pecuniary limitations, a suit must be filed in the lowest court in whose jurisdiction the cause of action arose, or where the defendant resides or carries on a business, or where the defendant personally works for gain.73 However, suits relating to an immovable property should be generally filed in the court where the immovable property is situated.74

2. Appeals

Appeals from a district court can be filed with the High Court located in the district court’s region. India's Supreme Court is the ultimate interpreter of laws in India and is also the highest court of appeal. A party aggrieved from an order of a High Court may prefer an appeal before India's Supreme Court, provided that the concerned High Court has granted a “certificate to appeal.”75 Notwithstanding, India's Supreme Court exercises appellate jurisdiction over not only the High Courts, but all other subordinate courts and tribunals in India. A party may, at any stage of a suit, make an appeal to India's Supreme Court with its special permission.76


Often foreign franchisors tend to prefer laws of their home country as the governing law of a franchise agreement. Therefore, understanding the applicability and enforceability of such foreign governing law in India is paramount. Although there is no prohibition on Indian courts to adjudicate on disputes arising under a contract governed by foreign laws, in the authors' experience, Indian courts are not typically comfortable exercising jurisdiction in cases calling for the application of foreign law due to their unfamiliarity with foreign laws.

74. Id. § 16.
75. India Const. art 133.
76. Id. art. 136.
4. Timeframe for Disposal of a Case in India

On an average, it takes about three to seven years in disposal of a suit by the court of original jurisdiction and another one to three years in appeal cases.

B. Resolution of Disputes in Courts Situated Outside India

Some parties to an international franchise agreement prefer to adjudicate disputes arising under a franchise agreement before a court situated outside India. These types of provisions present challenges for enforcement of a final award against the losing party, so franchisors should be careful in selecting foreign tribunals as their preferred dispute resolution venue.

1. Foreign Judgment from a Reciprocating Territory

A “conclusive” foreign judgment passed by a “superior court” situated in “reciprocating territory” can be enforced in India by filing an execution petition before the appropriate court in India.77

A “reciprocating territory” means a foreign country that is notified as a reciprocating territory (for enforcement of foreign judgments) by the central government of India.78 At present, only thirteen countries have been notified by the Indian central government as reciprocating territories for this purpose.79 The term “Superior Courts” means courts situated in the reciprocating territory that are notified as superior courts by the central government of India.80

A foreign judgment will be considered “inconclusive” by Indian courts if:81
- it is not pronounced by a court of competent jurisdiction;
- it is not given on the merits of the case;
- it is based on an incorrect view of international law or the law of India wherever applicable;
- it is granted in a proceeding that was opposed to natural justice;
- it is obtained by fraud;
- it is founded on a breach of any law in force in India; or
- if any appeal is pending against it in a foreign court.

Despite these broad exceptions, a “conclusive” foreign judgment by a superior court of a reciprocating territory can be executed in India as if the

77. The Code of Civil Procedure, No. 05 of 1908, Code Civ. Proc. (1908), § 44A.
78. Id. §44A, Explanation I.
79. These include the following nations: United Kingdom, Aden, Fiji, Singapore, the United Arab Emirates, Malaysia, Trinidad and Tobago, New Zealand, the Cook Islands (including Niue) and the Trust Territories of Western Samoa, Hong Kong, Papua and New Guinea, and Bangladesh. Naresh Thacker & Rhia Marshall, Litigation: Enforcement of Foreign Judgments in India, LEXOLOGY (July 2, 2018), https://www.lexology.com/library/detail.aspx?g=681612a7-920-4ad5-8fbb-c37912bb8644.
81. Id. § 13.
foreign judgment was passed by an Indian district court. It takes one to three years to enforce a foreign judgment from a reciprocating territory in cases where the enforcement proceeding is not contested in India on the grounds of inconclusiveness.

Foreign judgments from a superior court of a reciprocating territory that impose punitive damages or penalties, quasi-judicial orders, or judgments from summary trials are generally not enforceable in India. Consequently, any action to enforce a judgment obtained in a jurisdiction outside of India is likely to be very time-consuming and difficult.

2. Foreign Judgment from a Non-Reciprocating Territory

Unlike judgments from a reciprocating territory, a foreign judgment passed by a court situated in a non-reciprocating territory cannot be enforced in India directly. A party desiring to enforce a foreign judgment passed by a court situated in a non-reciprocating territory will have to file a fresh civil suit in India with the foreign judgments as supporting evidence. Thus, from a practical perspective, resolution of disputes in a court situated in a non-reciprocating territory should be avoided. The foreign franchisor situated in a non-reciprocating territory, and not willing to subject disputes to the Indian courts, may consider opting for arbitration in a neutral country because it is the most efficacious method for resolving disputes.

C. Resolution of Disputes Through Arbitration

The government of India has enacted the Indian Arbitration & Conciliation Act, 1996 (Arbitration Act) to provide a framework for facilitating arbitration in India and for enforcing foreign arbitration awards.

The Arbitration Act confers special status to arbitrations involving commercial disputes between an Indian party and a foreign party. The Arbitration Act defines an “international commercial arbitration” as an arbitration involving commercial disputes arising out of a legal or contractual relationship between two or more parties, wherein one of the parties is either a foreign national, company, government, or association of person.

As one of the parties to an international franchise arrangement will be a foreign national/resident, the arbitration between the parties would be deemed an “international commercial arbitration” for purposes of the Arbitration Act. The parties to an international franchise arrangement may select a venue for their disputes either in India, or outside India, in any country that is a signatory to the United Nations Convention on the Recognition and Enforcement of Foreign Arbitral Awards (New York Convention) or the Geneva Convention on the Execution of Foreign Arbitral Awards (Geneva

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82. Id. § 44A, Explanation II.
85. Id., § 2(f).
Convention). The venue must also be in a country that has been notified by the Indian central government.86

Parties to an international franchise agreement that desire to hold their arbitrations in India can opt for either (1) ad-hoc arbitration or (2) institutional arbitration. Institutional arbitration refers to arbitration whose proceedings are governed by the rules of an arbitration institution, for example, Rules of the International Chambers of Commerce. Ad-hoc arbitrations are arbitration proceedings that are not administered by rules of any arbitration institution.

1. Non-Interference by Indian Courts Where Parties Have Agreed to Refer Their Disputes to Arbitration

Indian courts cannot assume jurisdiction or interfere in matters where the parties to a franchise agreement have agreed in writing to refer their disputes to arbitration seated in India or in a foreign country pursuant to an arbitration agreement.87 The terms of arbitration need not to be in a separate arbitration agreement between the parties. Instead, they can be incorporated into the franchise agreement itself.88

2. Interim Relief

For arbitrations seated in India, both the arbitrator and the jurisdictional court have the power to grant appropriate interim relief to a party.89 A party can seek interim relief in the form of a temporary injunction, or an order for detention, inspection, and preservation of any property that is the subject matter of a dispute.90 While awarding interim relief to a party, the arbitrator would be deemed to be discharging the function of a civil court.91

In respect of foreign venues for international commercial arbitration, the Arbitration Act confers jurisdiction on Indian courts to provide appropriate interim relief pending the arbitration, provided that the parties have expressly agreed in the arbitration agreement that they will have the right to approach Indian courts to seek interim relief.92 From the foreign franchisor’s perspective, it is likely that interim relief may be required against the Indian franchisee to prevent misuse of intellectual property, the franchise systems, and other assets. Thus, a franchise agreement should clearly mention that the foreign franchisor retains the right to approach Indian courts to seek interim relief in India pending conclusion of arbitration proceedings. In absence of such express provisions, the franchisor may lose its right to seek interim relief from Indian courts.

86. Currently, the Indian Government has notified fifty countries that are signatories to the New York Convention and the Geneva Convention.
88. Id. § 7.
89. Id. §§ 9, 17.
90. Id. § 17.
91. Id.
92. Id. § 2(2).
3. Choice of Governing Law

In a cross-border franchise arrangement where parties have decided to refer their disputes to arbitration, the parties are free to choose and incorporate the substantive law of any country that would govern the agreement. Franchise agreements with Indian franchisees need not be governed by the laws of India.93

4. Enforcement of Foreign Arbitration Award in India

A foreign arbitration award will be enforceable in India only if the arbitration tribunal is situated in a country which is a signatory to the New York Convention or the Geneva Convention and also notified as a reciprocating territory by the Government of India.94 Presently, these territories include the United States of America, Canada, France, and Switzerland.

Indian courts cannot review the merits of foreign arbitration awards. However, the enforcement of a binding foreign arbitration award could be challenged in Indian courts on very limited grounds that are expressly listed out in the Arbitration Act:95

• the parties to the agreement were under some incapacity under the laws applicable to them;
• the parties against whom the award is to be invoked were not given proper notice of the appointment of arbitration, or of the arbitration proceedings, or were unable to present their case;
• the award deals with matters that were not submitted to arbitration or outside the scope of the arbitration agreement;
• the composition of the arbitral tribunal, or the arbitral procedure, is not in accordance with the agreement or the law of the country where the arbitration took place;
• the award has not become binding or has been set aside by competent authority of the country in which, or under the law of which, the award was made;
• the subject matter of the dispute is not capable of settlement by arbitration under Indian law; or
• enforcement of the award would be contrary to the public policy of India.96

The Arbitration Act was also recently amended in 2015 to provide exactness to the term “public policy of India."97 As per the amendment, an award

93. Id. § 28(1)(b).
94. Id. § 44; id. § 53.
95. Id. § 48.
96. The grounds for challenging an arbitration award issued by in an international commercial arbitration seated in India are same as those for challenging the enforcement of foreign arbitration awards. Id. § 34.
97. Id. § 48, Explanation I.
would be deemed contrary to “public policy of India” only if it is in conflict with the most basic notion of morality and justice or is against the fundamental policy of Indian laws, or where the making of the award was induced by fraud or corruption.98 The courts are now interpreting “public policy of India” in a very narrow sense. For example, in a recent judicial decision, the court held that a foreign arbitration award that is in contravention of an Indian statutory provision does not in itself amount to a contravention of the fundamental policy of Indian law.99 Therefore, despite the breadth of the language in the Arbitration Act, the “public policy” defense is not readily available to every party challenging a foreign arbitration award in India. A franchisee would need to prove some patent illegality that goes to the root of the matter on which the award is founded. The court cannot decline to enforce an award merely on the ground of erroneous application of the law by the arbitrator.

A foreign arbitration award passed in an arbitration tribunal seated in a country that is not notified by the Indian central government as a county signatory to the New York Convention or the Geneva Convention may not be enforceable in India.

X. Conclusion

The rapidly growing Indian economy makes franchising in India seem very attractive to foreign franchisors. Therefore, it is crucial for franchisors to understand the various entry strategies into the Indian market. A wise franchisor must conduct general due diligence of entities in India to ascertain business viability, decide the most attractive entry strategy and structure the franchise arrangement to be compliant with Indian law.

98. Id.
Franchising & Distribution Currents

Earsa R. Jackson, Maral Kilejian & Matthew Gruenberg

ANTITRUST


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


After six years of litigation, the court approved a class action settlement in which it had been alleged that certain auto dealers and certain auto parts makers had conspired to fix the price of auto parts. The contentious price-fixing class action was brought on behalf of direct purchasers who were overcharged for various automotive parts, including wire harness products, heater control panels, instrument panel clusters, fuel senders, occupant safety restraint system products, bearings, air conditioning systems, starters, windshield wiper systems, and windshield washer systems.

The court granted preliminary approval of the class action settlement, finding it fair, adequate, and reasonable. The settlement provides $115 million in settlement funds that will benefit eligible automobile dealers who purchased the relevant component parts or new vehicles containing those parts during the specified class periods. Following Sixth Circuit precedent, the U.S. District Court for the Eastern District of Michigan noted that it considered a number of factors when determining whether a settlement should be granted final approval, including (1) the likelihood of success on the merits.

Ms. Jackson

Ms. Kilejian

Mr. Gruenberg

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weighed against the amount and form of the relief offered in the settlement; (2) the complexity, expense, and likely duration of further litigation; (3) the opinions of class counsel and class representatives; (4) the amount of discovery engaged in by the parties; (5) the reaction of absent class members; (6) the risk of fraud or collusion; and (7) the public interest. The court found an overwhelming number of these factors had been met. Specifically discussing the expense of continued litigation and the lack of opposition to the settlement, the court granted preliminary approval. Further, the court found that the settlements met the requirements of Rule 23(b)(2) and 23(b)(3) of the Federal Rules of Civil Procedure, and the settlement class was granted certification for settlement purposes only.

**Matthew Enter., Inc. v. Chrysler Grp., LLC, Bus. Franchise Guide (CCH) ¶ 16,264, No. 17-16010 (9th Cir. Sept. 26, 2018)**

Matthew Enterprise Inc. (Enterprise), a Chrysler, Jeep, Dodge, and Ram dealership in Northern California, unsuccessfully challenged dealership incentive programs offered to other nearby dealerships by Chrysler as a form of price discrimination under the Robinson-Patman Act. Reviewing the district court’s dismissal of Enterprise’s challenge to the rental assistance incentive de novo, the Ninth Circuit held that because there was a four-year difference in the commencement of business between Enterprise and the allegedly favored party, the claim was properly dismissed.

Further, the court also found that Enterprise’s request for a new trial was properly denied. Enterprise had requested jury instructions including a proposed addition of the concept of “evenhandedness.” However, the court noted that the notion of evenhanded treatment is subsumed within the given instruction’s requirement of a showing that the incentives would not have been practically available had Enterprise engaged in commercially reasonable efforts to achieve them. Because Enterprise had failed to take commercially reasonable steps to avail itself of the proposed incentive, the jury instruction was proper.

Finally, the court noted that the district court’s allocation of the burden of proof of price discrimination to plaintiff was not erroneous. Under the Robinson-Patman Act, a purchaser plaintiff must establish that the seller has engaged in price discrimination; the existence of functional availability, as it existed here, defeated the claim.

**ARBITRATION**


The United States District Court for the District of Connecticut rejected an argument by a Subway sandwich shop franchisee, Karlton Kirksey, that the entire arbitration provision in the agreement with the franchisor, Doctor’s Associates Inc. (DAI), was invalid.
DAI initiated arbitration proceedings against its franchisee, Kirksey, alleging that he was in default of the franchise agreement. In response, Kirksey filed suit in Louisiana state court seeking to enjoin the arbitration from being held.

The case was removed to the United States District Court for the Eastern District of Louisiana, which found that the arbitration provision was enforceable against Kirksey. Noting that the agreement between the two parties contained a “delegation provision,” which allows questions of arbitrability to be sent to arbitration so long as the parties clearly and unmistakably express their intent to do so, the court found that DAI and Kirksey had agreed to send all questions of arbitrability to the arbitrator rather than the courts. Even though Kirksey argued that this decision contravenes the Supreme Court’s holding in *Rent-A-Center, W., Inc. v. Jackson*, 561 U.S. 63, 68–69 (2010), the court noted, instead, that *Rent-A-Center* stands for the proposition that when the agreement contains a delegation provision, all challenges to the validity of that agreement’s arbitration provisions must be decided by the arbitrator.


This case is discussunder the topic heading “Definition of Franchise.”

**BANKRUPTCY**


The court determined that certain individual and corporate debtors did not file for bankruptcy in bad faith when a franchisor moved to dismiss and requested relief from the automatic stay. The franchisor failed to show that it was a secured creditor of the corporate debtors as separate legal entities, each of which owned collateral related to the franchise business.

Two individuals, Choudhry and Gulmeena Javaid (Individual Debtors), entered into three franchise agreements with General Nutrition Corporation (GNC). The Individual Debtors together owned three corporations, Meena, Inc., Desa of NY, Inc., and SDA, Inc. (collectively, Corporate Debtors), which conducted business from each of the franchises. In addition to the franchise agreements, the Individual Debtors and GNC entered into two purchase money security interests and filed four UCC-1 financing statements listing the Individual Debtors as the debtors and the collateral as the inventory in the franchises. Despite having no memorialized agreement with the Corporate Debtors, GNC regularly sold them merchandise and accepted payments from them.

On August 14, 2017, GNC attempted to terminate the three franchises due to a pattern of wholesaling in violation of the franchise agreements. The
following day, GNC sued the Individual Debtors in the Western District of Pennsylvania for breach of the franchise agreements and fraud. GNC and the Individual Debtors executed an agreement (Settlement Agreement), which administratively closed the district court action. After the Individual Debtors failed to comply with the Settlement Agreement, on June 13, 2018, GNC sought emergency relief from the district court. The court issued an order on consent of the parties (Consent Order) that required the Individual Debtors to make certain payments or GNC could immediately take control of the franchises.

Notably, the Corporate Debtors were not named in the franchise agreements, were not signatories to the security agreements, were not named as debtors on the financing statements, were not named as parties in the district court action, and were not signatories to the Settlement Agreement.

On July 12, 2018 (the date on which GNC was to receive payment from the Individual Debtors under the Settlement Agreement), the Corporate Debtors each filed Chapter 11 bankruptcy petitions, listing GNC as an unsecured creditor. On July 17, 2018, the Individual Debtors filed a bankruptcy petition, thereby staying the Pennsylvania district court case. The Individual Debtors’ bankruptcy petition did not list the inventory of the franchises as assets; rather, the Corporate Debtors’ petitions included the inventory in their schedules. GNC filed motions to dismiss, asserting that the Individual Debtors and Corporate Debtors filed for bankruptcy in bad faith. However, GNC did not differentiate between the Individual Debtors and the Corporate Debtors when describing its claim. As a result, GNC described itself as a secured creditor with a claim of almost $2 million, and it requested dismissal or relief from the automatic stay.

The court denied GNC's motions to dismiss. First, the court discussed the need to determine the legal relationships between the parties. Despite that GNC treated the Corporate Debtors as though they were parties to the franchise agreements, no relationship between GNC and the Corporate Debtors was memorialized in writing. Rather, the Corporate Debtors were each separate legal entities that were never mentioned in the parties’ various agreements. Unless the court pierced the corporate veil, the Corporate Debtors had no rights under the franchise agreements. As a result, the Corporate Debtors were not franchisees, and GNC was not a secured creditor of the Corporate Debtors. Therefore, GNC had no cash collateral rights with respect to the Corporate Debtors, and the bankruptcy petitions of the Corporate Debtors had no effect on the franchise agreements.

With respect to GNC’s secured status, GNC not only was an unsecured creditor of the Corporate Debtors, but it also did not perfect a security interest in the inventory owned by the Corporate Debtors. Aside from the fact that the Corporate Debtors were not signatories of the security agreements, GNC failed to name the Corporate Debtors on the financing statements and therefore did not have a perfected lien on any inventory owed by the Corporate Debtors. The fact that the Individual Debtors incorporated their
business did not extend the financing statements to cover inventory owned by the Corporate Debtors.

The court next held that the franchise agreements were not terminated and thus a franchisor-franchisee relationship still existed. The Settlement Agreement and Consent Order allowed the Individual Debtors to continue operating the franchises. Further, the court found that there was in fact a relationship between GNC and the Corporate Debtors, but the nature of that relationship was still unclear.

Finally, the court found that the bankruptcy petitions—filed by both the Individual Debtors and the Corporate Debtors—were not filed in bad faith, and therefore there was no cause to warrant dismissal. Though the timing of the filings could be construed as intent to delay or frustrate the efforts of creditors to enforce their rights, GNC failed to establish that it was a secured creditor, as GNC did not sell any inventory to the Individual Debtors and failed to perfect its interest in the inventory sold to the Corporate Debtors. All of the other factors regarding bad faith either did not exist or could not be determined based on the record before the court. Accordingly, the court left the automatic stay in place.


The court affirmed the right of a franchisee to continue operating its restaurants during bankruptcy. Because the franchisor failed to provide unambiguous notice of termination under Kansas law prior to the time at which the franchisee filed for bankruptcy, the franchises became property of the estate and could not be terminated due to the automatic stay.

Franchisor Dine Brands Global, Inc. (Dine Brands) sought control of various Applebee’s restaurants, all of which were operated by RMH Franchise Holdings, Inc. (RMH), the second-largest Applebee’s franchisee. Dine Brands claimed that RMH failed to pay royalty fees since June 2017 and owed Dine Brands more than $12 million. Dine Brands asserted that it terminated franchise agreements with RMH as a result of RMH’s default.

In September 2017, Dine Brands sent RMH a termination letter, with ninety days to cure the default in royalty payments. Over the next few months, Dine Brands sent various cure extension letters to RMH. On May 8, 2018, RMH and its affiliates filed Chapter 11 bankruptcy petitions. Also on May 8, 2018, Dine Brands (1) sent a forbearance letter with respect to RMH’s default; (2) sent a letter purporting to terminate the franchise agreements for franchises in Arizona and Texas, retroactively effective to April 27, 2018; and (3) filed suit against RMH in a district court in Kansas, seeking a declaratory judgment that the franchise agreements terminated before RMH’s bankruptcy petition was filed.

Both Dine Brands and RMH filed motions for summary judgment. Dine Brands contended that the franchise agreements automatically terminated when the final cure period expired, pursuant to the September 2017
termination letter. RMH, however, asserted that Dine Brands did not provide it with unambiguous notice of intent to terminate the agreements. Specifically, RMH argued that the cure extensions did not discuss termination and that a forbearance letter delayed the exercise of Dine Brands’ termination rights. Since termination could not have been exercised before the bankruptcy petition was filed, RMH claimed that the franchise agreements were property of the estate and could not be terminated as a result of the automatic stay.

The court granted RMH’s motion for summary judgment. Specifically, the cure extension letters did not reference termination and therefore could not have provided unambiguous notice of termination. Further, a forbearance letter, signed in April 2018, stated that Dine Brands would not enforce its rights or remedies until May 8, 2018. Dine Brands failed to exercise its rights on May 8, 2018, before RMH filed for bankruptcy. As a result, because termination could not have been exercised before the bankruptcy petition was filed, the franchise agreements became property of the bankruptcy estate and could not be terminated due to the automatic stay.

BREACH OF CONTRACT

*Mr. Gruenberg’s firm represented the plaintiff franchisor in this matter.*
franchise agreement. When BrightStar ordered NNC to turn the patient over to BrightStar Reno, the franchisee operating in the Reno territory, and pay restitution, NNC responded by terminating its operations as a Bright-Star franchise. Following the termination of the franchise agreement, the couple behind NNC began operating a similar home healthcare entity known as Allevia Living in the same area where the BrightStar franchise was operated. BrightStar subsequently sought an order permanently enjoining NNC from operating Allevia Living. NNC counterclaimed, alleging both consumer fraud and common law fraud.

The court found that BrightStar was likely to succeed on the merits of its breach of contract claim against NNC, despite NNC’s counterclaims that BrightStar fraudulently induced NNC into franchising the Carson City territory with repeated assurances that NNC would eventually be able to acquire the Reno territory. Because this argument was based on oral statements made by the franchisor that contradicted the language of the franchise agreement, the court did not find this argument compelling. Further, the court found that BrightStar would suffer irreparable harm to its customer base and business relationship if Allevia Living were allowed to continue operating. Finally, the court determined that any harm suffered by NNC was self-inflicted and that the public interest was served by granting the injunction.

BUSINESS OPPORTUNITY LAWS


On October 25, 2018, a federal judge in Texas granted franchisee’s motion to remand a case back to state court after finding that its complaint failed to raise a substantial issue of federal law.

Plaintiffs Kenneth and Marie Walls and KMCC Enterprises (collectively Plaintiffs) sued Jessica Chandler, Savvy Chic Management, Inc. and Sculpt Pod (collectively Defendants) in the Texas 393rd District Court for violations of the Texas Business Opportunities Act (TBOA), Tex. Bus. & Com. Code §51.302, and other state laws. Plaintiffs claim that Defendants induced them into entering a franchise agreement to operate one of Defendants’ nonsurgical weight loss franchises by making false and material misrepresentations about the liposuction process available to franchisees.

Defendants removed the action to the U.S. District Court for the Eastern District of Texas, arguing that the court may exercise federal jurisdiction because the claim for TBOA violations requires the interpretation of various federal statutes and regulations and arises under federal law. Plaintiffs subsequently filed a motion to remand the case and requested attorney’s fees and costs. In granting Plaintiffs’ motion, the judge reasoned that the court was unable to exercise its limited jurisdiction over the case unless the complaint raised a disputed and substantial federal issue. The court found that the
complaint, on its face, did not need any reference to or interpretation of federal law.

After granting the motion to remand, the court added that “[i]t would be reluctant to exercise federal question jurisdiction over this case even if the TBOA exemption in question were an element of Plaintiff’s TBOA claim. . . . In this case, if the Court were to exercise federal question jurisdiction, it would resolve federal issues that appear insubstantial—while also disturbing the congressionally approved balance of federal and state judicial responsibilities.”

CHOICE OF FORUM

The U.S. District Court for the District of Maine enforced a forum selection clause, finding that a heating and air conditioning repair business franchisee, Troy Williams Heating in Bangor, Maine, was required to litigate his suit against his franchisor, Aire Serv, LLC, in Waco, Texas. The court rejected all of the franchisee’s arguments, including his claims that the forum selection clause (1) was the product of unequal bargaining power; (2) would deprive him of his day in court; and (3) was against public policy. The franchisor’s motion to dismiss was thus granted in part, denied in part, and the case was transferred from the U.S. District Court for the District of Maine to the U.S. District Court for the Western District of Texas. The claim arose from a franchise agreement between the two parties in which the franchisee alleges that the franchisor was not fully transparent regarding the franchisee’s applicable zone.

Franchisee made three arguments that venue was appropriate in the District of Maine: (1) the franchise agreement is void, as a whole; (2) the forum selection clause is unenforceable under the factors set forth in *M/S Breman v. Zapata Off-Shore Co.*, 407 U.S. 1, 15 (1972); and (3) transfer is not warranted under the 28 U.S.C. § 1404(a) factors. The court rejected each of these arguments, in turn, finding that there was no fraud in the inducement of the contract, the bargaining power between the two parties was not fundamentally unfair, the expense on Franchisee to litigate in Texas was not too great, and the agreement itself did not contravene public policy. Finally, under Section 1404(a), Texas was still the appropriate venue for the suit, despite Franchisee’s arguments that Texas courts were more congested than Maine’s.

CHOICE OF LAW

This case is discussed under the heading “Jurisdiction.”

This case is discussed under the heading “Unfair Competition/Unfair and Deceptive Practices.”


The court denied a motion for reconsideration of its Order under Federal Rule of Civil Procedure 54(b), holding that a Tennessee choice-of-law provision in franchise agreements applied in a consolidated action by a franchisor against multiple cupcake franchisees from different states. The court, however, withheld ruling on the franchisees’ counterclaims under the franchise acts of their states until the record could be developed further, given that the case was in its early stages. The court did not initially have the facts to make a choice-of-law decision, and the court wanted to avoid causing an improper waiver of the protections of the various franchise statutes.

Franchisor Gigi’s Cupcakes, LLC (Gigi’s) sued ten of its franchisees from many different states seeking to have their respective franchise agreements enforced and declared valid. The Unit Franchise Agreements (UFAs) with each of the franchisees provided in substantially similar language that “any dispute between Franchisor and Franchisee shall be governed by and construed in accordance with the laws of the State of Tennessee.” The court initially held that Tennessee law applied because the franchisees did not argue their position based on Texas choice-of-law rules, by establishing either that (1) the chosen law of Tennessee had no relationship to the parties; or (2) applying Tennessee law would contradict the public policy of a state with a materially greater interest than Tennessee. The franchisees’ motion for reconsideration reframed the argument under Texas choice-of-law rules by asserting that the application of Tennessee law to the UFAs for the franchisees from Minnesota, North Dakota, Indiana, and Ohio would violate public policies of those states because those states have franchise acts that afford greater protections to franchisees than Tennessee law.

The court emphasized that choice-of-law provisions are enforceable by default in Texas, and overcoming the presumption of enforceability requires satisfying the standards set out in the Restatement (Second) of Conflicts of Laws § 187(2). The analysis under this Section is performed in three steps. The court will not enforce the choice-of-law provision if all of these questions are answered affirmatively: (1) Does another state have a more significant relationship with the parties and transaction than the chosen state? (2) Does another state have a materially greater interest than the chosen state in determining a particular issue? and (3) Does another state have a fundamental policy that would be contravened by the application of the chosen state’s law? Considering
the first question requires a factual inquiry into the contacts identified in Section 188 of the *Restatement* and the principles listed in Section 6. The court examines the quality, not quantity, of the following contacts: (1) the place of contracting; (2) the place of contract negotiation; (3) the place of performance; (4) the place of the contract's subject matter; and (5) the parties' domicile, residence, nationality, place of incorporation, and place of business.

Here, the court could not even make the initial inquiry under the Texas choice-of-law rules because it was not provided with enough factual information. The court cautioned that prohibiting a franchisee from asserting claims under its state franchise act that includes an anti-waiver provision is contrary to the fundamental policies in those states. Accordingly, the court held that the parties' choice of Tennessee law applied to all claims, except the franchisees' franchise act counterclaims, at this point, because the franchisees did not meet their burden to satisfy Section 187(2).


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


This case is discussed under the topic heading “Definition of Franchise.”

**CLASS ACTION**


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

**CONTRACT ISSUES**


This case is discussed under the heading “Unfair Competition/Unfair and Deceptive Practices.”

*Sleepy's LLC v. Select Comfort Wholesale Corp.*, Bus. Franchise Guide (CCH) ¶ 16,314, 779 F.3d 191 (2d Cir. 2015)

This case is discussed under the topic heading “Unfair Competition/Unfair and Deceptive Practices.”
DAMAGES


Court granted motion to strike affirmative defenses asserting that liquidated damages clauses in franchise agreements were an unconscionable and unenforceable penalty, noting that the defenses were untimely, having been raised for the first time almost a year after the case was filed, and further, were not in fact a penalty but rather a reasonable forecast of compensation for harm caused by the breach.

Red Lion sued First Capital Real Estate Investment, LLC and other defendants (together, Defendants) for breach of contract after Defendants failed to make payments due under an early termination provision under three Franchise Licensing Agreements (FLAs). Defendants admittedly signed the agreements that required payment of (1) past due licensing fees and (2) lost profits from the early termination of the twenty-year licensing agreement, based on a calculation of the hotels’ prior revenue. Defendants, however, challenged these liquidated damages clauses as unenforceable and unconscionable penalties. Red Lion asked the court to strike Defendants’ affirmative defense as untimely, given that Defendants waited to assert the defense until after the deadline for amending their answer and completion of discovery. The court addressed both the timeliness and merits of Defendants’ penalty defense.

The court held that Red Lion would be prejudiced by allowing Defendants to raise their affirmative defense more than one year after the case was filed. Defendants attempted to plead new facts that would require the court to reopen discovery and delay the trial to permit Red Lion to adequately prepare for Defendants’ penalty defense.

For the purposes of a complete record, the court also addressed the merits of Defendants’ penalty defense. The court enforced the liquidated damages clauses, noting that, under Washington state law, the amount fixed was a reasonable forecast of compensation for harm caused by the breach and the harm was difficult to ascertain prior to contracting. Both parties were sophisticated, knew of the risks associated with the hotels in question, and negotiated other terms in the FLAs. Plus, the state of Washington favors such liquidated damages clauses and rarely construes them as a penalty. Defendants argued that the liquidated damages clauses were unreasonable based on actual revenues at the time of early termination, but this is an incorrect touchpoint. Courts analyze the inherent risks and foreseeability of damages at the time of contracting. Here, the court found the clauses enforceable as written.
DEFINITION OF FRANCHISE


The U.S. District Court for the Southern District of New York granted in part and denied in part a motion to dismiss a franchisee’s counterclaims, asserting that the parties’ relationship did not constitute a franchise under state and federal law.

Through multiple agreements, Safe Step Walk in Tub Co. (Safe Step) granted CKH Industries, Inc. (CKH) a license to use Safe Step’s trademarks to market, sell, and install Safe Step’s tubs in particular geographic areas. Safe Step filed suit when CKH failed to pay marketing fees as required by the agreements. CKH filed counterclaims for violations of various state franchise laws, breach of contract, and unfair business practices including fraud, and Safe Step moved to dismiss these counterclaims for failure to state a claim.

In its complaint, Safe Step described the business relationship as a licensor-licensee or supplier-dealer based on CKH’s license to deal in its bathtub products. CKH, however, argued that the parties had a franchise relationship and that Safe Step intentionally tried to structure the relationship to avoid federal and state franchise laws. Using this deception, CKH alleged that Safe Step purposefully escalated costs to constructively terminate the franchise and unlawfully compete directly against CKH.

The court first examined whether the agreements constituted franchise agreements under federal and state laws. The Federal Trade Commission Act defines a franchise as “any continuing commercial relationship or arrangement, whatever it may be called,” where the contract specifies (1) the franchisee will gain the right to operate a business associated with the franchisor’s trademarks; (2) the franchisor will or has authority to exert a significant degree of control over the franchisee’s method of operation; and (3) the franchisee is required to make payments to the franchisor as a condition to obtain or commence operations.

After examining the parties’ agreements, the court had little difficulty finding the relationship plausibly constituted a franchisor-franchisee relationship under the FTC Rule. The court nevertheless held CKH did not have an actionable claim for alleged disclosure violations since there was no private right of action to enforce the disclosure requirements.

As a result, CKH turned to franchise laws under Connecticut, New Jersey, New York, and Rhode Island where it sold Safe Step’s products. Tennessee precedent does not allow a choice-of-law clause to trump statutory protections, and the court determined that Tennessee law would recognize the protections available under the franchise acts of those other states—each of which would have characterized CKH’s business as a franchise. While CKH’s claims for the failure to provide disclosures were barred in New York due to the state’s specific statute of limitations, the court held that claims for failure to renew and constructive termination survived.
New York and Rhode Island had also enacted so-called “Little FTC” Acts, which prohibited conduct that impacted consumers at large. The court dismissed CKH’s claims under these statutes because the claims arose out of the parties’ contractual relationship and not from an effect on consumers as a whole.

Even though CKH conceded that it had not requested renewal in writing ninety days prior to the end of the term, it argued that the agreements persisted after expiration based on the parties’ course of dealing and practice. Safe Step countered that Tennessee’s Statute of Frauds would bar any such “oral” agreement, but the court emphasized that the statute of frauds did not apply once partial performance occurred, as it did here. Because the agreements were enforceable, the court concluded the alleged breaches during the “original terms” of the agreements prior to modification were actionable but those occurring after modification largely failed as a matter of law.

The court construed CKH’s fraud-related claims to allege unfair competition and common law fraud. CKH’s unfair competition claim failed under Tennessee law because that claim was only proper for trademark infringement or intentional interference with business relationships. Neither situation applied because CKH was using the trademarks, which was governed by the parties’ agreements, and Safe Step could not interfere with its own contract with CKH. The court did find CKH had properly alleged fraud with regard to the negotiations and pre-agreement activities, but it rejected those rooted in the performance of the agreements’ terms because those claims sounded more like tortious breach of contract.

FINANCIAL PERFORMANCE REPRESENTATIONS


This case is discussed under the heading “Unfair Competition/Unfair and Deceptive Practices.”

FRAUD


This case is discussed under the heading “Unfair Competition/Unfair and Deceptive Practices.”

FTC FRANCHISING RULE


This case is discussed under the topic heading “Business Opportunity Laws.”
This case is discussed under the topic heading “Definition of Franchise.”

GOOD FAITH AND FAIR DEALING

In this case, the U.S. District Court for the District of New Jersey examined whether a franchisor violated its franchise agreement following Hurricane Sandy. The court dismissed the claims because the franchisee failed to plead facts sufficient to establish violation of the duty of good faith and fair dealing, breach of contract, or statutory violations.

Franchisee/plaintiff alleged various breach of contract claims, breach of the duty of good faith and fair dealing, and violation of the New Jersey Franchise Practices Act (NJFPA) when the franchisor attempted to constructively terminate the franchise agreement by failing to repair franchisee's store after Hurricane Sandy and imposing alleged unreasonable terms related to vendors, advertising, and marketing issues. Franchisee accused franchisor of engaging in a tactic that would drive franchisee to eventually terminate the agreement.

The court held that to succeed on a claim for breach of duty of good faith and fair dealing, the franchisee must show a bad motive or intent, which the franchisee failed to plead. The court also held that this claim could not arise out of the same conduct and facts used to support the breach of contract claim because the claims were mutually exclusive. As a result, the claim was dismissed.

The court also held that the franchisee's breach of contract claim must be dismissed because it did not sufficiently allege a breach or damages.

Finally, the court dismissed the NJFPA claim because the claim was not sufficiently pleaded, including the franchisee's failure to specify which section of the NJFPA was being violated and in what way. The court held that unreasonable demands upon the franchisee did not lead to a violation of this statute. As a result, the court dismissed all claims against the franchisor.

INJUNCTIVE RELIEF

The U.S. District Court for the District of Utah granted a franchisor's motion for preliminary injunction where the franchisor showed that the franchisee was operating a competing business after termination of its franchise agreements in violation of a restrictive covenant that prohibited competition within a fifty mile radius of the former franchised location for a period of two years after expiration of the agreements.

The plaintiff/franchisor entered into two franchise agreements with defendant/franchisee to run a property management service. When the agreements
expired, the parties continued to operate. Eventually the franchisor sent the franchisee a letter indicating that any “implied agreement” was terminated. The franchisee formed a new company providing property management services. The franchisor alleged that the franchisee violated the franchise agreement including the non-compete provision. The franchisor sought a preliminary injunction. Specifically, the franchisor asked the court to order franchisee to transfer property management accounts to the franchisor.

The court reiterated the high burden applicable to obtaining a preliminary injunction and found that the franchisor met the high burden. Applying Utah law, the court held that the franchisor met its burden to show likelihood of success on the merits. The court explained that the non-compete was necessary to protect the franchisor’s goodwill and to protect current franchisees from unfair competition by former franchisees. The court also found that the provision was reasonable in its geographical extent (a fifty-mile radius from franchisee’s location and a fifty-mile radius from any other system business), duration (two years), the nature of the franchisee’s duties, and the nature of the interest the franchisor sought to protect.

Furthermore, the franchisor met its high burden to show that, absent the preliminary injunction, it would be subject to irreparable harm. The court held that allowing the franchisee to operate without granting the injunction could lead to a domino effect of franchisees abandoning their franchise agreements and violating their non-compete obligations. The court also held that if the preliminary injunction was not granted, the franchisor would suffer irreparable harm to goodwill, customer loyalty, and brand recognition.

Finally, the court weighed the balance of harm and public interest and held that the preliminary injunction should be granted.

JURISDICTION


The court denied franchisor’s motion to dismiss, noting that the Minnesota Franchise Act (MFA) applied to claims brought by Texas-based hotel franchisee where a sale or purchase, or offer of sale or purchase, occurred in Minnesota. The court rejected the argument that the MFA cannot apply to out-of-state franchisees if the statute’s jurisdictional requirements are otherwise met.

In 2014, defendant HD Sunland Park Property LLC (HD) acquired a hotel in El Paso, Texas (Hotel). Shortly after acquiring the Hotel, HD learned that it could no longer operate the Hotel as a Holiday Inn and, therefore, it authorized its agent, defendant Vandenburg, to find another hotel brand of the same general quality. An employee of plaintiff County Inn & Suites by Radisson, Inc. (Country Inn & Suites) represented to Vandenburg that Country Inn & Suites had developed a plan that would make its brand comparable to the way in which the Hotel was previously operated.
Country Inn & Suites further proposed a licensing agreement whereby it would provide a franchise consultant and significant operational support to HD. Soon after, Country Inn & Suites prepared a franchise disclosure document and license agreement whereby defendant High Desert Investors 3 LLC (HDI)—which was the sole member of HD—was listed as “franchisee.” Country Inn & Suites also sent Vandenburg a Corporate Guaranty of License Agreement, which listed defendant MT Sunland Park Hotel LLC (MT Sunland)—a member of HDI—as the guarantor of HDI’s obligations under the license agreement. Without authority from HDI or MT Sunland, Vandenburg signed both the license agreement and the guarantee.

In 2016, after Country Inn & Suites failed to provide the promised services to HD under the license agreement and a subsequent agreement, HD stopped paying franchise fees. As a result, County Inn & Suites sued HD, HDI, MT Sunland, and other defendants for breach of the license agreement. In response, the defendants asserted various counterclaims, including, breach of the MFA. In response, Country Inn & Suites filed a motion to dismiss, asserting that the MFA was inapplicable because (1) the license agreement provided that, despite the Minnesota choice-of-law provision, the MFA would not apply, and (2) the MFA does not protect foreign corporations doing business entirely outside of Minnesota.

The court disagreed and held that the defendants sufficiently alleged that (1) the MFA applied to the license agreement; (2) Country Inn & Suites violated the MFA; and (3) County Inn & Suites fraudulently induced the defendants to enter into the license agreement.

First, the license agreement provided that the MFA would nonetheless apply—despite the parties’ waiver in the license agreement of its application—if the jurisdictional scope of the MFA was independently met. Here, evidence suggested that a sale or purchase, or an offer to sell or an offer to purchase, occurred in Minnesota. As such, the jurisdictional scope of the MFA was independently met. Further, despite Country Inn & Suites’ attempt to argue that a foreign franchisee may not assert the protections of the MFA, the Court found that case law indicates otherwise. The MFA was designed to protect potential franchisees within Minnesota from unfair contracts and previously unregulated abuses. As a result, Minnesota courts have found that an out-of-state franchisor may be held to the same standards of the MFA if the franchisor meets the jurisdictional scope of the MFA. The same principle applies to franchisees—courts look to the facts of each case to determine whether the franchisee meets the jurisdictional scope of the MFA.

Accordingly, depending on the facts of the case, the MFA does apply to foreign franchisees. Because Country Inn & Suites and the defendants transacted business within Minnesota at the time of the license agreement, the MFA applied to the license agreement.


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

This case is discussed under the topic heading “Business Opportunity Laws.”

LABOR AND EMPLOYMENT


The Tenth Circuit reversed the lower court’s grant of a motion to dismiss a complaint filed by the Secretary of Labor, which had asserted that Jani-King, a janitorial company providing cleaning services in Oklahoma, violated the Fair Labor Standards Act (FLSA).

Jani-King engages individuals, pairs of related individuals, or small corporate entities to perform janitorial work on its behalf through franchise agreements. Recently, Jani-King began requiring individuals and pairs of related individuals to form corporate entities, which then become the named parties to the franchise agreements.

The Secretary of Labor brought a complaint against Jani-King and sought an injunction requiring the company to keep the requisite FLSA employee records. The Secretary argued that the individuals who form corporate entities and enter franchise agreements as required by Jani-King essentially performed the work of the company and, under the economic realities test, were employees of Jani-King. Jani-King brought a motion to dismiss, which the district court granted, on the basis that the Secretary “ignores corporate forms” and that the FLSA does not plausibly apply to all janitorial cleaners.

The Secretary alleged that Jani-King violated the FLSA because it did not make, keep, and preserve the required records for janitorial cleaners, due to improperly classifying the cleaners as independent contractors, when they were employees. The Tenth Circuit found that, per the six-factor economic realities test, wherein it is well-settled that an individual’s relationship with their employer determines its characterization, a plausible argument existed that certain Jani-King franchisees may fall into the purview of the FLSA. Given the procedural posture, the court found that the Secretary’s complaint contained sufficient factual matters to give Jani-King notice of which franchisees may be implicated by the action.

Frey v. Hotel Coleman, Bus. Franchise Guide (CCH) ¶ 16,278, 903 F.3d 671 (7th Cir. 2018)

The Seventh Circuit addressed a joint employer case involving a franchise management company and the employee of a franchisee. The court held that an employee, Bogustawa Frey, on the payroll of a Holiday Inn franchisee (Hotel Coleman), who was fired after she filed an EEOC charge for sexual harassment and discrimination by the CEO of the company hired to operate the hotel, can sue that company as her employer.

Hotel Coleman owned a Holiday Inn Express franchise and hired a separate entity, Vaughn Hospitality, Inc. (Vaughn Hospitality), to run the daily
operations of the hotel. Per the terms of the hotel management agreement between the two companies, Vaughn Hospitality was responsible for the hiring, supervising, directing, training, compensating, and discharging of employees. Despite the fact that all employees who worked at the hotel, including Frey, were on the Hotel Coleman payroll, Hotel Coleman agreed not to interfere in any way with Vaughn Hospitality’s supervision of the employees.

Following significant sexual harassment at the hands of Vaughn Hospitality’s CEO, Frey brought suit under Title VII and the Illinois Human Rights Act. The district court concluded on a motion for summary judgment that Vaughn Hospitality was not an employer as defined under the relevant statutes. Relying on the economic realities test stated by Knight v. United Farm Bureau Mut. Ins. Co., 950 F.2d 377, 378–79 (7th Cir. 1991), the court noted that Vaughn Hospitality, and not Hotel Coleman, had control over every aspect of Frey’s work environment, provided all necessary training, and expected Frey to work long-term. Given that the economic realities test is a balancing one, the court suggested that, under the test, Vaughn Hospitality could be regarded as Frey’s employer. Thus, the Seventh Circuit remanded the case for further proceedings concurrent with their opinion.

A former Jiffy Lube International, Inc. worker filed a proposed class action antitrust suit against the chain and its parent company Royal Dutch Shell PLC (collectively Jiffy Lube) in federal court on November 29, 2018, alleging that “no-poaching” provisions in Jiffy Lube’s franchise agreements illegally suppress employee wages. In the lawsuit, plaintiff Victor Fuentes (Fuentes) contends the clause prohibits a Jiffy Lube shop from hiring any individual who has worked at another Jiffy Lube within the prior six months. The complaint alleges that this practice essentially suppresses competition among workers resulting in lower pay for all employees. The lawsuit contends Jiffy Lube violated the Sherman Antitrust Act with the “no-poaching” clause, and seeks to bring action against Jiffy Lube on behalf of all current and former Jiffy Lube employees affected.

This case highlights other national franchise chains, such as Jimmy John’s and McDonald’s, who federal courts have reprimanded for using no-poaching clauses in franchise agreements. In this case, the complaint reads that “[w]hile eliminating these anticompetitive clauses will help workers going forward, current and former employees of Jiffy Lube—including [the plaintiff]—are owed antitrust damages for years of wage suppression.” It is not clear how the court will rule, but this will be a case to follow. Fuentes and similarly situated Jiffy Lube workers “seek[] to recover these damages and obtain additional injunctive relief,” as stated in the complaint.
The U.S. District Court for the District of Colorado granted summary judgment on a defendant’s former sales representative’s claim for tortious interference with business relationships by his former employer (a fundraiser products wholesaler) in the context of non-compete, non-solicit, and trade secret claims arising from the sales representative’s post-resignation conduct, but denied cross-motions for summary judgment on the remaining contract and trade secret claims.

The court first determined that Colorado law applied to the claims despite the employment agreement’s choice-of-law provision designating Tennessee law because (1) the defendant was a Colorado resident; (2) the breach allegedly occurred in Colorado; (3) the effects of non-competition would be felt in Colorado; and (4) Tennessee’s reasonableness standard for non-compete clauses was contrary to Colorado’s fundamental public policy of voiding non-compete provisions that do not fall into one of four exceptions. The exception at issue here was whether the contract related to the protection of trade secrets. The court held that a fact issue existed as to whether there was a trade secret at issue; thus enforceability and liability for breach of contract claims could not be determined on summary judgment.

The court also held that a prior Tennessee case by the employer, which found that the employer could not prove lost profits, did not serve to bar the current claims under the doctrine of issue preclusion because the specific customers and circumstances were relevant to proving damages. Thus the prior case did not raise an identical issue. Finally, the court held that the economic loss rule barred the tortious interference claim because the employment agreement imposed the same duty not to solicit the employer’s current or prospective customers as the duty underlying the tort. However, the economic loss rule did not bar the employer’s statutory trade secret claims, despite the fact that the employment agreement provisions were identical to the duties imposed by the Defend Trade Secrets Act and the Colorado Uniform Trade Secrets Act, because the court found that neither of the respective legislatures intended to provide extra-contractual remedies.

NON-COMPETE AGREEMENTS


The U.S. District Court for the Western District of North Carolina held former franchisees in civil contempt of a preliminary injunction prohibiting them from contacting their former customers and for conducting work in violation of a non-compete clause.
In June 2016, franchisor Atlantic Pinstriping terminated the three franchise agreements it had with the franchisees. Shortly after, the franchisor filed suit seeking to enjoin the former franchisees from violating the non-compete and non-solicitation covenants in their franchise agreements. After a hearing, the court entered an order enjoining the former franchisees from owning or operating a competing business and contacting any former customers for a two-year period. The parties then proceeded to arbitrate the remaining claims pursuant to the arbitration agreement in the franchise agreements.

While the arbitration was pending, the franchisor sought relief from the court to obtain discovery from the former franchisees showing their communications with customers and invoices to customers to aid in enforcement of the preliminary injunction. After the franchisees failed to produce all the documents requested, franchisor moved to hold them in contempt.

While the discovery and contempt proceedings were pending, the arbitrator issued an award finding that the termination of the former franchisees was proper, the non-compete and non-solicitation provisions were enforceable, and that the franchisees had violated these provisions, thus entitling franchisor to recover damages.

After the arbitration award was confirmed by the court, the court continued to adjudicate the motion for contempt against the former franchisees. Ultimately, the court found the former franchisees in contempt for violating provisions of the preliminary injunction by continuing to solicit and contact former customers after the entry of the preliminary injunction.

The court awarded the franchisor damages from the former franchisees for work performed for customers solicited in violation of the preliminary injunction. The court also awarded the franchisor almost $100,000 in attorney’s fees incurred for pursuing the motion for contempt. Finally, the court also granted a one-year extension to the initial preliminary injunction, ordering that any further violations would result in a $1,000-a-day fine until cured.


E&G Franchise Systems, Inc., a restaurant franchisor, sought preliminary injunctive relief against its former franchisee, The Janik Group, claiming trade dress infringement stemming from the former franchisee’s operation of an allegedly competing business as defined under the franchise agreement. The U.S. District Court for the Western District of Wisconsin denied E&G’s motion for preliminary injunction.

The franchisor operates and sells franchises under the names “Erbert & Gerberts” and “Erbert and Gerberts Sandwich Shop.” In April 2015, Janik signed a franchise agreement to operate an E&G branded sandwich shop in Plano, Texas. In early 2018, E&G notified Janik on several occasions that it was in default of the franchise agreement for failing to purchase all the...
necessary items from approved supplies, along with other similar defaults. In May 2018, E&G terminated Janik’s franchise agreement without notice or further opportunity to cure. Janik closed the restaurant soon after the termination. Following the termination and closure, Janik opened another sandwich restaurant at the same location with a different build-your-own ordering process and an expanded menu, including salads, wraps, subs, and panini options.

E&G then filed suit to enjoin Janik from operating the new restaurant claiming it violated the non-compete provision in the franchise agreement and constituted trade dress infringement. Upon review of the parties’ briefing, the court denied E&G’s motion for preliminary injunction.

First, the court held that Janik was not infringing on E&G’s trade dress because E&G failed to prove its trade dress was worthy of protection. Specifically, the court found that E&G’s trade dress consisting of the use corrugated metal, the counter space and table layout, and the combination of lighting fixtures, were too generic because the trade dress descriptions lacked specificity as to what the particular elements of the trade dress were or how the combinations made them worthy of protection.

Second, the court also denied E&G injunctive relief enforcing the non-compete agreement. The non-competition provision prohibited Janik from operating a restaurant that derives more than 50% of its sales from “sandwiches.” Janik argued that the term “sandwiches” was defined as cold sub-sandwiches of the type that E&G served, whereas Janik’s new restaurant included hot sandwiches, wraps, and paninis. The court, however, found that the definition of “sandwich” was a fact issue that it could not determine.

However, the court found that E&G failed to demonstrate it would be irreparably harmed by Janik’s operation of the new sandwich shop. In particular, the court rejected E&G’s argument that the language in the franchise agreement stating that irreparable harm occurred upon a violation of the agreement was conclusive. Rather, the court concluded that while this language was persuasive, E&G failed to prove irreparable harm because the next closest E&G franchise was 600 miles away. Moreover, E&G could not show that it was actively seeking new franchisees in the area, especially since three other franchises in the area had also closed and there was no indication of pursuing new franchisees. Accordingly, the court denied E&G’s injunctive relief but retained the case to allow E&G to prove monetary damages.


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


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

The U.S. District Court for the District of Minnesota dismissed a dealer's claims for breach of equipment dealer statutes, and granted the franchisor's motion for summary judgment on its breach of contract claims after the dealer entered into an agreement with one of the franchisor's competitors in violation of the parties' non-compete.

Tri-State Bobcat, Inc. (Tri-State) was an authorized equipment dealer for FINN Corporation (FINN) for five years. The parties typically renewed their contract each year. In early 2016, due to mounting competitive pressure, FINN inserted a non-compete provision in its contract. Tri-State refused to sign FINN's new contract because, unbeknownst to FINN, Tri-State was in serious negotiations to sell equipment for one of FINN's competitors. In August 2016, FINN learned via a press release that Tri-State had become a premier dealer for one of FINN's competitors. FINN later terminated its relationship with Tri-State due to Tri-State's refusal to sign or conduct business under the terms of the non-compete provision.

Tri-State sued FINN for breach of contract and wrongful termination under equipment dealership statutes when the two parties could not reach an agreement on new contract terms. The court dismissed all of Tri-State's claims under the Equipment Statutes and granted FINN's summary judgment motion on Tri-State's breach of contract claim.

First, Tri-State alleged wrongful termination under the Equipment Statutes. Although a 2016 contract was never executed, Tri-State argued that a contract was implied from the conduct of the parties. But the parties' correspondence in 2016 centered on contract negotiations, rather than routine business issues. Further, FINN was clear that it would not continue a relationship with Tri-State without its assent to the non-compete provision. Tri-State's wrongful-termination claims failed.

Second, Tri-State argued that the non-compete would significantly diminish Tri-State's viability and that the Equipment Statutes prohibit manufacturers from substantially changing the competitive circumstances of a dealer agreement without good cause. This argument failed. Sale of FINN equipment was less than five percent of Tri-State's 2015 revenue. Further, Tri-State achieved year-over-year growth in sales and revenue despite FINN's decision to terminate the relationship.

Third, the court rebuffed Tri-State's argument that FINN failed to renew Tri-State's dealership agreement without good cause. The non-compete provision was an essential and reasonable requirement that applied equally to all FINN dealers. FINN's competitive concerns were genuine and documented.

Fourth, FINN moved for summary judgment on Tri-State's breach of contract claim because no implicit or explicit contract existed in 2016. The court agreed, granted FINN's motion for summary judgment, and dismissed Tri-State's complaint with prejudice.
ORAL AGREEMENTS


PMT Machinery Sales, Inc. (PMT) sold products for Yama Seiki USA, Inc. (Yama Seiki), a manufacturer. In late 2015, PMT asked Yama Seiki to grant it an exclusive dealership. Yama Seiki promptly presented conditions of an agreement, which PMT rebuffed. After months of correspondence, PMT became aware that Yama Seiki was treating PMT like an exclusive dealer, with open-ended terms. One year later, Yama Seiki told PMT that it was not an exclusive dealer. PMT then sued Yama Seiki, alleging a violation of Wisconsin's Fair Dealership Law (WFDL) when Yama Seiki made a substantial change to the competitive circumstances of PMT's dealership.

Yama Seiki argued that PMT never had a “dealership” under Wisconsin law, and the court agreed. Inter alia, PMT never had the right to commit Yama Seiki to a sale or use a trade name, trademark, or other commercial symbol of Yama Seiki. “All customer orders were placed with Yama Seiki directly, and Yama Seiki billed the customer directly.” Because PMT never had authority to transfer products itself or commit Yama Seiki to a sale, PMT never had a “right to sell or distribute” as highlighted in the WFDL.

STATUTORY CLAIMS


This case is discussed under the heading “Unfair Competition/Unfair and Deceptive Practices.”


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


In this case, the United States District Court for the Southern District of New York held that a party bringing claims under various state statutes must have some type of connection to the state under which it brings the claims. Here, franchisees brought claims under various state franchise registration and disclosure laws and state trade protection statutes. The court held that the franchisees could not bring statutory claims from states in which they did not have a “concrete connection.”
Specifically, the court held that the franchisees could not bring claims under the California Franchise Investment Law because they were not domiciled in the state of California. The court held the same for a claim brought under the Michigan Franchise Investment Law. The court held that a claim brought under the North Dakota statute on franchise registration did not apply because the franchisees did not allege that the offer to sell or buy occurred in North Dakota or that they were domiciled in North Dakota. The court held that the Rhode Island Franchise Investment Act did not apply because the franchisees were not Rhode Island residents. The court held that the Hawaii Investment Law did not apply because the franchisees were not domiciled in Hawaii. The court held that the Virginia Retail Franchising Act did not apply because there was no nexus or connection with the transaction at issue and Virginia. The court held that the Florida and New Jersey trade protection statutes did not apply because no actions took place in either state, and there was no connection of the parties or transaction to either state.

The court held that the Washington Franchise Investment Act applied because the franchisees were domiciled in Washington. In addition, the court held that because the alleged failure to register occurred in Washington, the Washington statute of limitations must apply. The court held that a two-year statute of limitations was applicable and that, because registration information is publicly available, the failure to register accrues on the date of execution of a franchise agreement. The court explained that the discovery rule does not apply to this type of claim. Given that the claim was brought outside of the statute of limitations, the court held that the claim was time barred.

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

This case is discussed under the topic heading “Non-Compete Agreements.”

TERMINATION AND NONRENEWAL

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

This case is discussed under the topic heading “Damages.”
This case is discussed under the topic heading “Non-Compete Agreements.”

**TRADE INFRINGEMENT**

This case is discussed under the topic heading “Definition of Franchise.”

**TRADE SECRETS**

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

**TRANSFERS**

Franchisor Tim Hortons did not breach the franchise agreements with several of its franchisees when it refused to consent to franchise sales. The franchisees had each entered into ten-year agreements with Tim Hortons and later sought franchisor's approval on the sale of five Tim Hortons restaurants to Ravi Patel, a separate individual, for $4.4 million. The franchisees sought approval to sell the restaurants in accordance with the proposed Asset Purchase Agreements.

Franchisee's agreements with Tim Hortons provide the franchisor with the “sole and absolute discretion” to approve any sale. Tim Hortons denied the franchisee's proposed sale on the basis that the proposed sales price exceeded the depreciated value of the “personalty and inventory.” The court found that this stated reason was squarely within Tim Hortons' right to deny the sale, given that the franchise agreement contains language allowing franchisor to “arbitrarily withhold its consent to any transfer of this Agreement in whole or in part if it determines in its sole and absolute discretion that the sale or transfer price to be paid by any proposed transferee is inappropriate.”

Franchisees additionally claimed that Tim Hortons breached the franchise agreements by failing to consent to the sale of the restaurants. Finding that the language of the contract was unambiguous as to franchisor's right to deny the sale of the restaurants if price was deemed inappropriate, the court regarded franchisees' claim as without merit.
UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES


The U.S. District Court for the District of Colorado granted in part and denied in part a franchisor’s motion to dismiss counterclaims filed by a franchisee.

E&I Holdings, Inc. (E&I) filed a motion to dismiss counterclaims alleging breach of contract, fraud in the inducement, violations of Florida tort law, and violation of the Colorado Consumer Protection Act. E&I was the franchisor of Egg & I restaurants and entered into written franchise agreements with franchisees Pomegranate, Inc. and Coral Springs Egg and I, LLC, in April 2013 and July 2014, respectively. The terms were identical, and both agreements required the franchisees to pay monthly royalties and advertising contributions. E&I sent default notices to the franchisees for failure to pay and terminated the agreements after franchisees refused to cure their payment defaults. Because the franchisees continued to operate at least one restaurant as if it were in good standing, E&I initiated a lawsuit. The franchisees asserted that E&I upsold them using “deceptive false sense of urgency sales tactics,” falsely represented that open territories were scarce, and provided a Franchise Disclosure Document (FDD) with severely understated costs.

E&I merged with a competing breakfast chain in 2015. Soon after, the franchisees believed E&I adopted a policy not to approve any new restaurants for at least a year and intentionally watered down the quality of the Egg & I brand. E&I allegedly knew but failed to disclose that it would be impossible for franchisees to meet the requirement to open twelve stores in only a few years in an expensive area like Palm Beach County, Florida.

The court first considered franchisees’ breach of contract claim, which was premised on E&I’s pretextual termination, watering down the Egg & I brand, and violating the implied covenant of good faith and fair dealing. E&I argued that the franchise agreements had been modified orally or through conduct, but failed to address the implied covenant of good faith and fair dealing claim. Because the court determined that the breach of contract counterclaim was based entirely on the implied covenant, it denied the motion to dismiss due to E&I’s lack of response.

E&I also argued that the fraud in the inducement claim failed the heightened pleading requirements of Federal Rule of Civil Procedure 9(b) and was barred by a non-reliance provision in the contracts under which the franchisees acknowledged they were not relying on any of the alleged misrepresentations. The court rejected the argument under Rule 9(b) and specifically noted that the Rule 9(b) standard is modified when pleading fraudulent omission claims. The franchisees did not respond to the second argument based on the provision in the agreement. While the court did not make any
ruling on the enforceability of the non-reliance provision, it granted the motion because franchisees failed to respond to that allegation.

Third, E&I argued that claims based on the Florida Franchise Act and Florida Unfair and Deceptive Trade Practices Act were barred by the agreements’ choice-of-law provision mandating Colorado law. Colorado had adopted the “most significant relationship” test for multi-state claims, and the court dismissed the claim because the franchisees had not applied the appropriate standard in response to the motion to dismiss.

Finally, the court dismissed the claim under the Colorado Consumer Protection Act because the Colorado Supreme Court had held that the Act could not be used “to remedy a purely private wrong.” The franchisees tried to argue that watering down food and beverages sold to the public did impact actual or potential consumers, but the court once again dismissed the claim since the franchisees relied on yet another incorrect legal standard.


This case is discussed under the topic heading “Definition of Franchise.”

**Sleepy’s LLC v. Select Comfort Wholesale Corp., Bus. Franchise Guide (CCH) ¶ 16,314, 779 F.3d 191 (2d Cir. 2015)**

In the middle of a bench trial, the United States District Court for the Eastern District of New York granted defendant Select Comfort’s motion for judgment under Rule 52(c) of the Federal Rules of Civil Procedure. Sleepy’s, LLC (Sleepy’s) appealed and argued that the district court’s dismissal of its contract, good faith and fair dealing, unfair competition, and slander claims was based on errors of law. The Second Circuit agreed and reversed the trial court’s decision.

Sleepy’s became an authorized retailer of Sleep Number beds manufactured by Select Comfort under a written Dealer Agreement. Sleepy’s sold the “Personal Preference” line of beds, while Select Comfort retained the right to sell its “core” line of beds in company-owned retail stores. These two bed types had different foundations and control features, and the Dealer Agreement required each party not to “adversely affect the character, reputation and good will (collectively the ‘Brand Image’) of the other party.”

Sleepy’s had disappointing sales numbers but soon learned Select Comfort salespeople were disparaging Sleepy’s and the Personal Preference line that it was authorized to sell. To investigate, Sleepy’s hired secret shoppers to visit Select Comfort stores and presented twelve statements by Select Comfort’s salespeople at trial. The secret shoppers testified that the salespeople stated Sleepy’s beds were on inferior wooden foundations, were stored in warehouses where they attracted allergens and dust mites, and came with inferior sales terms that Sleepy’s would deceitfully refuse to honor.

The district court found no evidence of disparagement prior to the expiration of the Dealer Agreement, but the Second Circuit held the trial court
had conflated the terms “expiration” and “termination.” These were distinct terms under the language of the contract. Thus, the Second Circuit vacated the slander claim and ordered the lower court to determine whether the Dealer Agreement had been extended by the parties’ conduct—and whether any disparagement occurred while the agreement was still in force. The Second Circuit vacated the judgment on Sleepy’s unfair competition and good faith and fair dealing claims for the same reasons.

The district court also had concluded that eleven statements were not actionable because the secret shoppers were the first to mention that Sleepy’s stores also sold Select Comfort merchandise and asked questions about Sleepy’s to induce a response. The lower court ruled that this meant Sleepy’s had consented to those statements as a matter of law. As for the final statement, the district court held that a reasonable listener would not have believed the statement asserted facts as opposed to non-actionable sales talk. The Second Circuit disagreed with both findings, in large part because the district court had used an incorrect understanding of New York defamation law, which relies in part on the Restatement (Second) of Torts. The Restatement provides that an honest inquiry or investigation by a person defamed to ascertain the existence, source, content, or meaning of a defamatory publication is not a defense for the defamer. The Second Circuit also found the final statement had a precise meaning capable of being proven true or false and conveyed defamatory facts about Sleepy’s business.

Accordingly, the Second Circuit remanded and ordered the district court to reconsider whether Sleepy’s inquiries via the secret shoppers were motivated by a good faith attempt to learn if Select Comfort had a consistent pattern of slander, or whether it was merely a ruse to bait Select Comfort into a lawsuit. Notably, even if the individual statements were not actionable, the Second Circuit noted that Sleepy’s might still have an actionable claim by showing Select Comfort had a routine practice of slandering Sleepy’s, which would be admissible evidence under Federal Rules of Evidence 406.

VICARIOUS LIABILITY


The Delaware Superior Court held that a real estate broker who worked for RE/MAX Sunvest Realty (Sunvest), a franchisee of the franchisor RE/MAX LLC, was not an indispensable party for claims brought against the franchisee and the franchisor. Defendants had moved to dismiss the complaint filed by plaintiffs alleging that a real estate broker, who was formerly employed by Sunvest in a franchise branch, had embezzled funds that the plaintiffs had given to him for investment in real estate. Defendants argued that the Sunvest broker who allegedly embezzled the funds was an indispensable party.
The court granted the motion in part and denied it in part, ruling that the broker may be an essential fact witness, he was not an indispensable party to the action. The court reasoned that the broker did not have a personal stake in the action nor would his lack of participation impair his ability to protect his interests. Further, the court ruled that plaintiffs had sufficiently pleaded their vicarious liability claims for the RE/MAX franchisor by alleging its apparent authority over the franchisee defendant. Plaintiffs noted that they relied on the franchisor’s name and brand recognition to invest with the broker. The court found that these allegations were sufficient to suggest a plausible vicarious liability claim.
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