Franchise Law Journal

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From the Editor-in-Chief

Daniel J. Oates

Mr. Oates

Winter is settling in, and unlike editorials past (which often focused on the quaint frivolity of winter pastimes), this year is cloaked in the stifling miasma of the pandemic. COVID is once again on the rise, not only in the United States, but across the globe.[1] This plague is not done yet; it is still going to kill and maim a lot more people.[2] But I don't intend to talk about that aspect of the pandemic because, well, it's depressing. And 2020 has been filled with more depressing things than a Super Bowl loss,[3] stuffed in bag of kittens thrown in the river, sandwiched in a copy of Cormac McCarthy's *The Road*. COVID's health toll has also been written about ad nauseum. So, while I in no way mean to diminish the suffering inflicted by the disease, I want to write about something else: hope and opportunity for the future.

But what can there possibly be that inspires hope for the future in this disease-riddled dystopia?[4] Well for starters, 2020 has been a year of new things. We now have an entirely new lexicon of words and phrases that we find ourselves using on a daily basis: Zoom™, bubble, social distance, flatten

1. *See*, *e.g.*, Jennifer Levitz & Erin Ailworth, *Facing Worst COVID-19 Surge, U.S. Tries to Avoid Lockdowns*, Wall St. J. (Nov. 7, 2020).

2. I'm adding this footnote long after having written the editorial. Thanksgivings and Christmas celebrations have been canceled by governmental fiat across the nation, and hospital wards and ICUs are filling up with the sick and dying. To those of you grieving a personal loss as a result of this pandemic, my heartfelt condolences. And to everyone else: we will get through this.

3. Please don't take this as an opportunity to talk to me about the ending of Super Bowl XLIX. I'm still not over it. *See also*, *e.g.*, *sad Atlanta Falcons noises.*

4. He said as he sat wearing his fuzzy pajamas in his comfortable ~~bedroom~~ "home office" with a piece of homemade pumpkin bread and a mug of hot coffee. Ok, I confess, I don't have it all that bad.

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the curve, learning pods, COVID-19, etc.[5] Many of these words and phrases are integral to franchising, have been codified in franchisors' policies and procedures manuals, and directly affect business strategies or operational realities.

We have a tsunami of new legal issues. From royalty deferrals, to employment fights over worker safety in a pandemic, to lease guaranty disputes, to PPP loans, to renewed regulatory scrutiny of Item 19, the world of franchising has been inundated with new questions and concerns.[6] Loan forgiveness, mandated government closures, revised HR protocols on daily temperature tests and questionnaires; all of these changes require legal oversight, comment, and, in many cases, trailblazing. In just one measure of the magnitude of the legal uncertainty of the times, several hundred people attended the Forum's March 2020 COVID-19 webinar.[7] And the flow of new legal issues is not likely to abate any time soon.

In addition to practical legal and operational issues, we are dealing with new twists on old legal concepts. Force majeure, impossibility of performance, impracticability, frustration of purpose—obscure affirmative defenses are having their day in the sun.[8] To wade through these concepts, courts will need to dust off old hornbooks and fragile old case volumes from the early twentieth century, and then figure out how to apply cases involving the failure to timely deliver apples due to a donkey-related cartage mishap to franchisees' inability to pay royalties due to government-mandated business closures. The opportunities for fantastic analogies in court filings have me salivating.

We have new technologies and new ways of interfacing with clients. The proliferation of web-based communication platforms is approaching gold-rush proportions: WebEx, GoogleMeet, Skype, Microsoft Teams, GoToMeeting, Zoom, Convene, Remo; the list goes on. And how we use those platforms is fundamentally changing. Virtual training seminars for

5. I find myself wondering whether these words, which have become so ingrained in our lives, will survive the test of time and become a permanent part of our vocabulary. Some of them will undoubtedly diminish and become fodder for obscure references used only in the *New York Times* crossword puzzle ("toile," "syzygy," etc.). Others may be relegated to context specific words that, while generally known, are not by any stretch of the imagination in the common parlance ("ratatouille," "digeridoo," "maleficent" etc.). Not that they aren't fun words to write or, in certain cases, for Disney to make absurd movies about anti-hero sorceresses or rats dreaming they can be sous chefs.

6. Now this is still franchising. None of this arises to a "the dingo ate my baby" level of national controversy. James Gorman, *After 32 Years, Coroner Confirms Dingo Killed Australian Baby*, N.Y. Times (June 11, 2012). But for franchise lawyers it's a big deal.

7. By comparison, the two most recent non-COVID webinars had several dozen attendees, which is more in line with historical performance. The demand for information about how to deal with the unique challenges of COVID (especially during the initial "Wild West" period in March and April) has been gargantuan.

8. Perhaps 2020 is the fever dream of the drafter of Federal Rule of Civil Procedure 8(c). And if you think that is shameful or sad, just remember that next time you attend the North Carolina State Pickle Festival (https://www.ncpicklefest.org) or the Spivey's Corner Hollerin' Contest (https://en.wikipedia.org/wiki/National_Hollerin%27_Contest). Everyone has to have a passion, right? For some it is wonky civil procedure esoterica.

business-side staff, virtual depositions and court hearings, online conferences,[9] and web-based social networking opportunities are but a few of the new ways that we meet and gather.

New things are good for lawyers. Settled law, routine issues, and formulaic forms-based legal practices lead to intellectual stagnation, lower billings and depressed wages, complacency, and boredom.[10] Conversely, change is invigorating, captivating, and titillating. It is also, if we're being honest with ourselves, good for business. Clients need lawyers (be they in-house or outside counsel) to work through these new issues and provide guidance and assistance on navigating this brave new world. All of these new changes will keep us busy for the foreseeable future.

At the *Journal*, this means a fresh crop of new ideas, concepts, and issues that will need authors to write about them. Much like World War II, Watergate, and 9/11, COVID-19 is an inflection point that will fundamentally alter our world for years, if not decades, to come. At the urging of my devoted colleagues on the *FLJ* editorial board, I will be adding COVID-19 as a new topic to the *Journal*'s cumulative index and currents in anticipation of the wave of cases and legal writing that will reverberate down through the years following this seismic event. And I expect each and every one of you to not only bear witness to these changes, but to actively participate in the drafting of new articles, and the advancement of our understanding and processing of these new issues.

COVID is not going to end anytime soon.[11] "I don't like it. I don't agree with it. But I accept it."[12] And we all need to accept it, because it has presented us with a new opportunity to change the way that we do business. To change the way that we interface and interact with people and institutional clients. And to change our understanding of previously settled law. Those that fail to take that opportunity are doomed to be replaced by those that seize the moment.

9. Special congratulations to Gary Batenhorst and Elizabeth Weldon for pulling off an astoundingly successful virtual Forum on Franchising in October. The dynamic duo planned an entire in-person Forum in Phoenix, Arizona, scrapped it midway through the year, and replanned an entire virtual Forum in half the time. The magnitude of their achievement cannot be overstated.

10. The four horsemen of the imminent job change.

11. Masks or not. BUT WEAR A MASK. Press Release, CDC Calls on Americans to Wear Masks to Prevent COVID-19 Spread (July 14, 2020), https://www.cdc.gov/media/releases/2020/p0714-americans-to-wear-masks.html; *see also* IHME, Measuring What Matters, COVID-19 Model FAQs (2020), http://www.healthdata.org/covid/faqs#Masks ("Our analysis indicates that masks, whether cloth or medical-grade, can reduce infections for mask-wearers by at least one-third."); Andrea Kane & Maggie Cox, *Fauci Says It Might Be Time to Mandate Masks As COVID-19 Surges Across U.S.*, CNN News (Oct. 23, 2020), https://www.cnn.com/2020/10/23/health/fauci-covid-mask-mandate-bn/index.html ("Well, if people are not wearing masks, then maybe we should be mandating it.").

12. Lando Calrissian, Solo: A Star Wars Story (Disney 2018).

Change is hard, but it is also inevitable. Nothing in this universe is static. Even time depends on your frame of reference.[13] But with change comes opportunity and renewed hope for a better tomorrow; a tomorrow that, with so many new issues, looks to be bright and full of possibilities. It is time for us to fully embrace the newness of this post-COVID era so that, when we finally emerge from the wintry depths of this pandemic, we can seize those opportunities and build a better system for our clients, customers, and communities. The *Journal* will be here for you, ready to be the forum for all your new ideas on how to build that new system. I, for one, can't wait to read about it.

13. Special thanks to Albert Einstein for, you know, thinking up that whole relativity thing. And, for me, additional thanks goes to my high school physics teacher Mr. Crandall. Without his patience and biting sarcasm, I never would have understood anything about relativity, much less insist on writing self-indulgently referential comments about it in of all places a legal journal.

Test Letter Agreements in Franchising

*Brian Forgas**

Mr. Forgas

Innovation is driving modern business at a rapid pace. Compared with just a few years ago, the current drive to develop new, different, and better ways of doing business is staggering. When many people think of innovation, they think of technology, but innovation is not limited to technology. Innovation covers every aspect of the business endeavor and is highly valued.[1] It is hard to read any general business or franchising publication without being inundated by articles on the topic.[2] The study of the innovation process has become an independent discipline in academia,[3] and its application in

1. *See* Charles Bonfiglio, *Innovate or Perish*, Franchising USA, Feb. 2019, at 20 (observing that, "[i]nnovation in the franchise space means creating or adopting systems that streamline business operations. Integrating and streamlining processes from point-of sale to marketing, accounting and payroll is the secret sauce of franchising success.").

2. *See*, *e.g.*, Janaki Chadha, *Why Innovation is a Team Sport*, Wall St. J. (Aug. 9, 2018), http://www.wsj.com/articles/why-innovation-is-a-team-sport-1533732288; *The Innovation List: Reviewed and Recommended*, Franchise Bus. Rev., https://franchisebusinessreview.com/page/top-innovative-franchises (last visited May 5, 2019); Dirk Deichmann, Leva Rozentale & Robert Barnhoorn, *Open Innovation Generates Great Ideas, So Why Aren't Companies Adopting Them?*, Harv. Bus. Rev. (Dec. 20, 2017), https://hbr.org/2017/12/open-innovation-generates-great-ideas-so-why-arent-companies-adopting-them; Jacob Grosshandler, *10 Rules for Managing Franchisee Innovation*, Franchising.com (Mar. 10, 2014), https://www.franchising.com/articles/10_rules_for_managing_franchisee_innovation.html; Caroline Howard, *Disruption vs. Innovation: What's the Difference?*, Forbes (Mar. 27, 2013), https://www.forbes.com/sites/carolinehoward/2013/03/27/you-say-innovator-i-say-disruptor-whats-the-difference/#272218de6f43; Randy Myers, *How Franchisees Can Find Room For Innovation*, Entrepreneur.com (Mar. 7, 2013), https://www.entrepreneur.com/article/225992.

3. There are about 134 master's degree programs offered in business innovation fields around the world. *See 134 Masters Programs in Innovation*, Masterstudies.com, http://www.masterstudies.com/Masters-Degree/Innovation/ (last visited Feb. 25, 2020). Universities also have been establishing dedicated institutions for the study of innovation. For example, the University of Pennsylvania, Wharton School of Business, established the Mack Institute for Innovation Management in 2013 to be a "hub of a global learning network for scholars, business leaders, and students . . . relating to innovation and emerging technologies." William & Phyllis Mack Inst. for Innovation Mgmt., https://mackinstitute.wharton.upenn.edu/about/ (last visited Feb. 25, 2020). Similarly, Ohio State University, Fisher College of Business, established a Center for Innovation Strategies in 2010 and is currently building additional facilities to support the growth of the discipline. *See* Ohio State Univ. Fisher Coll. of Bus., https://fisher.osu.edu/centers-partnerships/center-innovation-strategies/about-center (last visited May 5, 2019); Emily

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business a specialty of consulting practices.[4] In a recent benchmarking study by the accounting and consulting firm PwC, about fifty percent of the 1,200 companies that it surveyed stated that innovation had a "great" impact on driving revenue growth and cost management, and fifty-four percent stated that their customers helped to define their innovation strategy.[5]

The franchise sector has long embraced innovation. Historically, new franchise concepts have sprung out of ideas developed to seize upon emerging market opportunities. Today, established franchise systems are compelled to innovate to the same extent as new concepts, often in response to challenges posed by those new concepts.[6] Continuous innovation has become imperative. Staying with the market is necessary to survive,[7] and getting one step ahead of the market is the best way to thrive.[8]

This practical skills article examines why testing is essential for innovation in a franchise system, explains how franchisors document tests with franchisees, and explores the key legal issues that should be addressed when developing a test. This article concludes with a checklist of testing considerations as a reference for practitioners.

Bench, *Ohio State Unveils More Details on West Campus 'Innovation District'*, Columbus Bus. First (Feb. 15, 2019), https://www.bizjournals.com/columbus/news/2019/02/15/ohio-state-unveils-more-details-on-west-campus.html.

4. Business consulting firms that specialize in innovation can include both large companies and small boutiques. Some of these firms combine innovation with other disciplines, which may include a specific focus on the franchise business model. *See, e.g.*, *Directory of Innovation Firms*, InnovationLeader.com, https://www.innovationleader.com/directory/ (last visited Feb. 25, 2020); Michael Schein, *5 Innovative Consultants Who Are Changing the World*, Inc.com (May 26, 2016) (profiling Julie McBride of MSA Worldwide), http://www.inc.com/michael-schein/5-innovative-consultants-that-are-changing-the-world.html.

5. Volker Staack & Branton Cole, *Reinventing Innovation: Five Findings to Guide Strategy Through Execution*, PWC: PwC's Innovation Benchmark Report (2017), https://www.pwc.com/us/en/advisory-services/business-innovation/assets/2017-innovation-benchmark-findings.pdf [hereinafter PWC Report].

6. A well-chronicled example is the effect that Airbnb and other home-sharing platforms have had on the traditional franchised hotel industry. *See, e.g.*, Katie Benner, *Inside the Hotel Industry's Plan to Combat Airbnb*, N.Y. Times (Apr. 16, 2017), https://www.nytimes.com/2017/04/16/technology/inside-the-hotel-industrys-plan-to-combat-airbnb.html; Christine Birkner, *Here's How Airbnb Disrupted the Travel Industry*, Adweek (May 26, 2016), https://www.adweek.com/brand-marketing/heres-how-airbnb-disrupted-travel-industry-171699; Joseph Garcia, *Is Airbnb Really Disrupting the Hotel Industry?*, Bus. World (July 26, 2018), https://www.bworldonline.com/is-airbnb-really-disrupting-the-local-hotel-industry.

7. *See* PWC Report, *supra* note 5, at 2. In the study PwC found that fifty-four percent of respondents said that they struggle to align innovation with their business strategy, and seventy-two percent of respondents believed that they are not out-innovating their competitors. In its assessment, PwC noted that "In an era of digital business and rapid technology change, virtually no company can ignore the imperative to innovate. Failing to do so is an invitation to lose business." *Id.*

8. Based on its survey, PwC found that innovation leaders are growth leaders too—twenty percent of the identified leaders expected their business to grow by fifteen percent or more in the next five years, compared with just thirteen percent of other innovating companies. *See id.* at 4.

I. The Need to Test

In a franchise system, the adoption of new ideas can be tricky. New endeavors typically require additional investments in products, equipment, real estate, building improvements, training, operations, people, and/or promotions.[9] Before pursuing a new endeavor, franchisors and franchisees need to know the potential risks and rewards of an innovation and be able to compare it against the other initiatives that they could pursue.

Consider the following hypothetical. Imagine that a quick-service restaurant franchisee wishes to increase sales by increasing its throughput (customer ordering and service speed). The franchisee has narrowed its options down to three alternatives: (1) a new modern front counter design with touchscreen menu boards for customers to use; (2) electronic self-service ordering kiosks in the dining room; or (3) an expanded double drive-thru lane with multiple ordering points. Assuming none of these things is required, and all have potential to attract customers and increase sales, which should the franchisee choose? Which should the franchisor approve?

For this hypothetical, imagine that the franchisee decided to remodel the front counter with the new digital technology, the franchisor approved it, and the initial results were better than expected. The franchisee launched the update with a grand reopening media event to generate interest. Coincidentally, this reopening occurred at the same time as a new high school opening nearby and a temporary road closure that diverted more traffic past the restaurant than normal. These two things combined to bring in a rush of new customers right away.

But the higher sales volume created unexpected problems. The restaurant ran out of food product faster than it was resupplied, it was not staffed properly for the increased volume, the staff were not trained on the technology and struggled to fix glitches, the kitchen's production capacity was overwhelmed, cooking equipment broke down, there was no back-up equipment, and maintenance calls were slow. These issues resulted in slow service, wrong orders, cold food, angry patrons, and stressed employees. It impacted both the dining room and drive-thru. Customers gave the restaurant poor reviews on social media, and negative news coverage followed. To make matters worse, the franchisee received a letter from the landlord claiming that the renovations violated the lease, and there were complaints alleging that neither the new counter configuration nor the touchscreen devices were

9. Courts have long recognized the substantial investments that may be made by franchised businesses in determining what constitutes a legally protected trade secret. *See* Clark v. Bunker, 453 F.2d 1006 (9th Cir. 1972); Snelling & Snelling, Inc. v. Armel, Inc., 360 F. Supp. 1319 (W.D. La. 1973). In *Clark*, the court noted that where one invests "substantial time, thought, and money in collecting and testing the data and creating and perfecting forms, processes, and techniques that provide the substance and detail" of a commercial program, that program will be protected as a trade secret if it is provided with appropriate secrecy and is not publicly available. 453 F.2d at 1010.

complaint with the Americans with Disabilities Act (ADA). Clearly, this was not the intended result.

But wait, there's more. After sorting through these issues, the franchisor and franchisee sought to analyze the results. They found that they could not discern which part of the traffic increase was due to the improvements and which was due to the other external factors. They also could not determine whether the redesign caused the operational problems. The return on investment (ROI) wasn't clear. Consequently, they could not use these results to help determine whether to expand this test to other restaurants. If businesses cannot determine ROI with confidence, neither can their lenders. This lack of information can effectively render a test useless.

Many operational elements can be affected when a business process changes. In the hypothetical above, the operational problems might have been prevented with a proper end-to-end assessment of the initiative including knowing the local market conditions and pending changes, as well as the in-store staffing needs, training, equipment, inventory, storage, supply timeframes, contingency plans, and legal issues. Were each of these things considered ahead of time? If so, were the assumptions correct? Are solutions available? Who bears the risk of mistakes and the cost of fixing them?

Testing a new innovation is essential to avoid surprises and refine the approach before adopting it throughout a franchise system. This is true regardless of whether the innovation is a new product, service, technology, equipment, process, or procedure. As one commenter explained, "The goal of any system change should be to better the system as a whole. While implementing any change to an established system provides an element of market risk, there are steps that the franchisor can take to minimize that risk before deciding to implement the change system-wide."[10] Testing enables a franchisor to tinker—to try, fail, fix, try again, adjust—and ultimately validate that a new innovation will work *and work within the system*. Testing refines the concept and establishes the business case. It provides the necessary data to support the rationale for additional investment by both franchisees and their lenders. It also helps to identify variables, risks, and dangers that were not apparent at the outset. Data beats opinion every day.

In large franchise systems and more complicated businesses, testing can be a more involved process with multiple stages. In its 2007 Innovation Benchmark Report, PwC profiled Marriott's digital technology testing process as an example:

> One large business that's successfully taken an iterative approach to innovation is Marriott International. George Corbin, the company's senior VP of digital, describes Marriott's innovation cycle as a "prototype-to-pilot" process that is designed to test three risk factors. They will test the innovation as a pilot at a handful of hotels; as the risk factors are vetted, the company will then begin

10. David A. Beyer, Himanshu M. Patel & John Dent, *Changes in System Standards—What Is the Extent of the Franchisor's Latitude?*, ABA 35th Annual Forum on Franchising, W14 (Oct. 3–5, 2012).

> to scale up to several hundred hotels, and ultimately may deploy worldwide. As part of this process, the team's first test customer adoption of the new service—do customers really use it, and if not, why not? Next, they need to prove that the new underlying technology not only works, but that it can scale; after all, Marriott will need to roll out the innovation to thousands of hotels around the world, and many promising technologies can struggle when activated at scale. Finally, the company tests the concept for its "operationalization" at the hotels. That is, can the people and protocols on property deliver the service consistently, cost-effectively, and with high accuracy (98–99%) once deployed globally? "If the concept passes those three tests, then, ladies and gentlemen, we have a winner. We move into the full funding and deployment mode." Typically, the testing takes a matter of months.[11]

Proper testing and research can be necessary for a franchisor to meet its legal obligations and prevent challenges to system changes. In certain circumstances, a franchisor's failure to conduct adequate research or testing could give rise to a claim that the franchisor has breached its duty of good faith and fair dealing.[12] Courts have embraced the principle that, even when franchisors have the discretion to make changes to the franchise system unilaterally, they must exercise that discretion "reasonably and with proper motive, and may not do so arbitrarily, capriciously, or in a manner inconsistent with the reasonable expectations of the parties."[13]

Apart from any legal obligations, testing also is important for maintaining good franchise relations.[14] Testing done in cooperation with franchisees enlists the experiences of those franchisees to help guide the effort. Equally important, it can enhance the franchisor's credibility within the franchise system.[15] This credibility can be an effective tool for persuading franchisees to be early adopters of new ideas and to share in the costs of them.[16] It can also be an effective bulwark against the "unwelcome mandate" problem that can arise when franchisees are not consulted on system changes. Moreover, it can create brand ambassadors. There is a tremendous difference between a franchisor telling franchisees, "you should try this" and franchisees telling each other, "you should try this!"

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11. *See* PWC Report, *supra* note 5, at 11–12.

12. *See* Beilowitz v. Gen. Motors Corp., 233 F. Supp. 2d 631, 644 (D.N.J. 2002) (franchisor failed to conduct research before implementing a system change); Amos v. Union Oil Co. of Calif., 663 F. Supp. 1027, 1030 (D. Or. 1987) (franchisor held liable because it failed to conduct and consider research).

13. Burger King v. Agad, 941 F. Supp. 1217, 1221 (N.D. Ga. 1996).

14. *See* Beyer et al., *supra* note 10, at 10 ("Communication with the franchisees is critical to ensure harmony in the system, prevent needless litigation, and maximize the market potential for the change. By listening to its franchisees, the franchisor can determine whether the change will meet wide-spread approval, or require the franchisor to incentivize the franchisees to implement the change.").

15. *Id.*

16. *Id.*

II. The Need for a Legal Framework

Franchise agreements normally prohibit a franchisee from selling any product or service that is not approved by the franchisor. Likewise, they require franchisees to use approved equipment, follow prescribed procedures, maintain minimum service levels, and advertise within specific guidelines as set forth in the franchisor's operations manual, standards, policies, and procedures (collectively, the manual).[17] New innovations often fall outside of these requirements, carry additional costs, and involve new risks. Prudence teaches, therefore, that when testing at a franchised location, the parties should document their agreement on their rights and responsibilities, especially (1) the franchisor's consent to vary from the manual within defined parameters; (2) the allocation of costs; and (3) the allocation of risks.

A. *The Temporal Component of Risk*

1. Long-Term Tests

It can take time to test an idea properly. For example, large retail and hospitality establishments often use an energy management system (EMS) to manage heating and cooling, lighting, elevators, life safety, and other electrical systems for efficiency. To properly test a new EMS, the system should be installed and operated in multiple climate zones for at least a year to gather performance data across each annual season (one cycle). Ideally, the test would extend for multiple years to establish performance averages over longer-term climate trends.[18] But over this extended period of time, any number of unexpected events could occur.

A well-known example involved the Target Corporation. In 2013, Target suffered a massive data breach in which hackers stole about forty million customers' names and credit and debit card numbers, along with seventy million phone numbers, addresses, and other personal information. [19] The

17. *See* James Denison, *Why It's Tough to Have Hard-and-Fast Rules About Operations Manuals*, 30 Franchise L. J. 239 (2011); Scott McLester, Susan Morton & Karen Satterlee, *Operations Manual—Essential to Success*, 24 Franchise L.J. 31 (2004).

18. *See* U.S. Dep't of Energy, Better Buildings Initiative Case Studies, https://betterbuildingssolutioncenter.energy.gov/iso-50001/resources/case-studies#. One such case study profiled the Hilton Columbus Downtown, a 532-room hotel in Columbus, Ohio. Through a combination of solutions that included an EMS, this hotel reported a thirty-two percent energy reduction and $387,000 in annual energy cost savings versus the benchmark (based on ASHRAE standards). This hotel utilizes Hilton's program known as LightStay to calculate and analyze energy, water, waste, and carbon output. *See, e.g.*, *Building-Wide Sustainability Efforts*, https://www4.eere.energy.gov/challenge/sites/default/files/uploaded-files/Hilton_Columbus_Downtown_LEED_Overview.pdf; *Hilton Worldwide: LightStay*, *Environmental + Energy Leader*, https://www.environmentalleader.com/products/hilton-worldwide-lightstay. Hilton requires all of its franchised and managed properties across all of its seventeen hotel brands to comply with LightStay requirements through its manual. As a result, Hilton was the first global hospitality company to achieve portfolio-wide certification for environmental management. *See, e.g.*, *ISO 50001 Energy Management Systems*, ISO.org (July 2018), http://www.iso.org/files/live/sites/isoorg/files/store/en/PUB100400.pdf.

19. *See* Kevin McCoy, *Target to Pay $18.5M for 2013 Data Breach That Affected 41 Million Consumers*, USA Today (May 23, 2017), https://www.usatoday.com/story/money/2017/05/23

hackers gained access to Target's computer network through its EMS. Specifically, Target was utilizing an EMS software program on its internal network that enabled its heating, ventilation, and air conditioning (HVAC) vendors to remotely monitor energy consumption and temperatures at certain stores.[20] Investigators determined that the hackers apparently infected the computer system of an HVAC vendor with malware (in an email) that was designed to steal the vendor's login credentials.[21] The hackers then used those credentials to access Target's network and "leapfrog" from the HVAC system over into Target's payment card system.[22] Target is not a franchise system, and its EMS was not in testing when this event took place, but this example illustrates the risk well. If this kind of hack occurred within a franchise system that was in the midst of a test, and had there been no clear allocation of risks and responsibilities between the parties at the outset, the disaster would be even worse.

Like Target, many other companies have suffered data breaches and cyberattacks, including many franchisors and franchisees in systems such as Marriott, Dairy Queen, Supervalu, Jimmy John's, Wyndham, Aaron's, and the UPS Store.[23] The consequences of these breaches can be very serious and costly.[24] Accordingly, addressing the risk of a data breach is imperative in any test of new computer technology that uses customer data.[25]

/target-pay-185m-2013-data-breach-affected-consumers/102063932/; Teri Radichel, *Case Study: Critical Controls that Could Have Prevented Target Breach*, SANS Inst. Info. Sec. Reading Rm. (Aug. 15, 2014); Jaikumar Vijayan, *Target Attack Shows Danger of Remotely Accessible HVAC Systems*, Computerworld (Feb. 7, 2014), https://www.computerworld.com/article/2487452/target-attack-shows-danger-of-remotely-accessible-hvac-systems.html.

20. Vijayan, *supra* note 19.

21. *Id.*

22. *Id.*

23. *See Dairy Queen Says Data Breached at Stores*, USA Today (Oct. 9, 2014), https://amp.usatoday.com/story/money/business/2014/10/09/dairy-queen-says-data-breached-at-stores/16993077/; Nicole Perlroth, *Supervalu Discloses a Data Breach*, N.Y. Times (Aug. 15, 2014); Press Release, Fed. Trade Comm'n, Aaron's Rent-To-Own Chain Settles FTC Charges That It Enabled Computer Spying by Franchisees, (Oct. 22, 2013), https://www.ftc.gov/news-events/press-releases/2013/10/aarons-rent-own-chain-settles-ftc-charges-it-enabled-computer; *Jimmy Johns Reveals Breach of Credit, Debit Data*, Chi. Trib. (Sept. 24, 2014), https://www.chicagotribune.com/business/chi-jimmy-johns-data-breach-20140924-story.html; Press Release, Marriott Int'l, Marriott Provides Update on Starwood Database Security Incident (Jan. 4, 2019), https://news.marriott.com/2019/01/marriott-provides-update-on-starwood-database-security-incident; Paresh Dave, *UPS Stores Hit by Breach of Credit Card, Customer Data*, L.A. Times (Aug. 20, 2014); David B. Ramsey, CYBER CENTER: *Cyber-Security Considerations for Franchisors: Protecting the Brand While Avoiding Vicarious Liability*, ABA Bus. L. Sec. (July 20, 2016), https://www.americanbar.org/groups/business_law/publications/blt/2016/07/cyber_center; Jonathan Stempel, *Wyndham Settles FTC Data Breach Charges*, Reuters (Dec. 9, 2015), https://www.reuters.com/article/us-wyndham-ftc-cybersecurity-idUSKBN0TS24220151209.

24. *See* Ponemon Inst., LLC, *2018 Cost of a Data Breach Study: Global Overview* (July 2018) (concluding that the average total cost of a data breach on a per capita basis—or per record lost—was $148; the average cost of a data breach was $3.86 million overall; but the average cost of a mega-breach of one million records was $40 million, and the average cost of a mega-breach of fifty million records was $350 million.).

25. *See* Ramsey, *supra* note 23 (citing FTC v. Wyndham Worldwide Corp., No. 2:13-CV-01887-ES-JAD (D.N.J. 2014) (FTC sought to hold the franchisor liable for allegedly failing to maintain the security of the computer system it required franchisees to use to store

2. Short-Term Tests

The time required for thorough testing can conflict with the need for speed. Speed-to-market can be critical for a business to be nimble, respond to competitors, capture market share, and establish brand identity in an emerging area.[26] In the race to market, business leaders may be willing to forgo even the most basic cautions in favor of "handshake" deals and "go-ahead" emails. They may also make system decisions on incomplete or inadequate data. Therefore, short-term tests can also carry risks that are different risks than those for long-term tests. Accordingly, it can be wise to have a legal framework of standard terms in place and/or a template or form test agreement at the ready, which can be used quickly.

B. *Documenting the Legal Framework*

The first consideration is always how to document the terms and conditions of a test. A franchisor can use two main methods either independently or together. They are (1) to set forth the terms and conditions that apply to all approved tests in the manual; and/or (2) to set forth the terms and conditions of each individual test in a separate agreement with each participating franchisee (test letters).

1. The Manual

Depending on the nature of the business and the franchisor's individual circumstances, it may be wise to set forth the basic terms and conditions of tests within the manual. These terms and conditions could be presented as a separate chapter or section in the manual under the category of "permitted exceptions." The manual should first set forth the requirement of having the franchisor's consent to conduct any test, and list any prerequisites to obtaining that consent. It should then lay out the principal terms that apply to every test that occurs in the system *unless agreed otherwise*. If the franchisor utilizes policies that are incorporated under the franchise agreement and/or manual, the method is the same.

The benefits of this approach are fourfold. First, it creates a legal baseline that can be modified case by case through individual test letters with franchisees. Second, it enables the individual test letters to be shorter and more concise, because they need to cross-reference only the manual and set forth non-standard terms. Third, franchisees may be less likely to negotiate individual terms, due to their familiarity with the manual and a sense of overall fairness (i.e., the test terms are uniform across the system). Fourth, if an individual test letter is defective in any manner (due to issues around enforceability, vagueness, ambiguity, or otherwise), the terms and conditions in the manual can provide a safety net on which to fall back.

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guests' personal information), and *In re* Aarons, Inc., 2014 WL 1100702 (F.T.C. Mar. 10, 2014), (raising the proposition that a franchisor could be liable for consumer privacy violations by franchisees if the franchisor "knowingly assisted" the franchisees in committing the violations)).

26. Rebecca O. Bagley, *Speed to Market: An Entrepreneur's View*, Forbes (May 1, 2013) (observing that "[a lack of commercialization resources] is a growing problem in a rapidly changing global market place, where speed to market may dictate success or failure. Companies that take too long to commercialize their products may fail to capitalize on a narrow window of opportunity before competitors swoop in and pass them by.").

The primary drawback of this approach is that only a very limited set of terms and conditions may be appropriate for a manual—those which would apply to every test and are thus "global" in nature. Terms and conditions that are specific to each particular test would still need to be contained in an individual test letter with each participating franchisee.

2. Test Letters

Individual test agreements are commonly referred to as "test letters" because they are often written in the form of letter agreements. This letter format is helpful because letters tend to be more reader-friendly and less intimidating than formal contracts. Businesspeople are also more likely to read a letter than long, dense contracts assumed to be full of boilerplate and legalese. And short, reader-friendly test letters tend to be executed more quickly.

The letter format comes with an important caution. Businesspeople may be more inclined to modify and/or sign a test letter without seeking the assistance of counsel. This circumstance is especially true for those who do not have in-house counsel at hand. Modifications written by a businessperson without legal assistance often can introduce ambiguity, vagueness, and internal inconsistencies in the document. The parties may have had a meeting of the minds on a change (or thought they did), but their writing leaves it unclear. In some cases, this lack of clarity is not a problem because the test will proceed in line with the parties' expectations despite the imperfect documentation. But if a problem arises, the test letter is important; and if the problem is serious, the test letter could be critical.

An attorney should always review a test letter before execution and should counsel clients that the letter is binding. If a franchisor uses standard-form test letters, the franchisor should implement a process to ensure that businesspeople do not modify the form and sign it without having counsel review the changes. While this suggestion seems basic, in reality, the desire to move quickly by the business team often results in this step being missed. This reality is as true in large sophisticated systems as it is in small, unsophisticated start-ups.

A test letter should set forth all material terms and conditions of the test that are not otherwise specified in the manual and incorporated into the test letter. Authorized representatives of the franchisor and franchisee should sign the test letter. Ensuring that authorized representatives sign the test letter again seems basic. However, franchisors may be inclined to let field personnel sign the document, and franchisees may let their store managers or staff sign because of the perception that the letter is just a formality. But signing authority matters, especially if the test letter operates as an amendment to the franchise agreement.

3. Franchise Agreement Amendment

Franchisor counsel should consider whether a test letter is or should be an amendment to the franchise agreement and plan accordingly. If a test letter is an amendment, then it must comply with all the formalities of an amendment.[27]

27. *See* text *infra* note 29, for an example.

a. *Is It an Amendment?*

Conceptually, if the franchise agreement requires the franchisee to comply with the manual, and neither the franchise agreement nor the manual contemplates tests (or other permitted deviations from the standards with the franchisor's consent), then a test letter arguably operates as an amendment to the franchise agreement whether or not it is expressly identified as such, because it creates a new exception and modifies the existing legal framework with new terms and conditions. However, if the franchise agreement and/or manual expressly contemplates tests (or other deviations from the standards with the franchisor's consent), and the test falls within those parameters, then conceptually the test is merely business conduct occurring within the existing legal framework and does not amend or modify it.[28]

b. *Should It Be an Amendment?*

Whether a test letter should be an amendment to the franchise agreement depends on the nature of the business, the nature of the test at issue, and the needs and goals of the parties. In some circumstances it might be preferable to avoid amending the franchise agreement and establish the terms of the test in a different manner.

For example, if a U.S. franchisor wishes to formally amend a franchise agreement for a location in Brazil, the amendment might need to be registered with the Brazilian Institute of Industrial Property (INPI) so that it (1) is enforceable against third parties; (2) permits the remittance of payments to a foreign franchisor (if not already permitted); or (3) qualifies the franchisee's payments for tax deductions.[29] For the document to be registered with the INPI, it must be originally written in or translated into Portuguese; the parties' signatures must be notarized, their initials included on every page; two witnesses must sign; and the foreign franchisor's signature must also be legalized at a Brazilian consulate or embassy.[30] If the representative of the party is an attorney, a copy of a power of attorney that has been notarized and legalized is also required.[31] The time and cost of these steps could be burdensome. In such a case, the franchisor would want to consider whether to structure a test letter as an amendment and, if so, whether it

28. *Black's Law Dictionary* defines "amendment" as "To change or modify for the better. To alter by modification, deletion, or addition." Black's Law Dictionary 52 (6th ed. 1991).

29. Luiz Henrique O. do Amaral & Eduardo Turkienicz, *Brazil*, Int'l Franchise Sales L. 68–86 (Andrew Loweinger & Micahel Lindsey eds., 2015). In 2019, Brazil amended its franchise law and added requirements regarding the language and governing law of franchise agreements and the venue for disputes, among other things. These new requirements became effective in March 2020. *See* Brazil Federal Law No. 13,966/2019 (revoking and replacing Brazil Federal Law No. 8,955/1994).

30. *Id.* The Brazilian Franchise Association also published a summary of the INPI's requirements in 2011. *See* Luiz Henrique do Amaral, Cândida Ribeiro Caffé & Camila Costa de Castro Silva, *Guidelines for the Recordal of Franchise Agreements in Brazil*, Brazilian Franchise Ass'n (Jan. 2011), https://www.franchise.org/international/brazil (click on "GUIDELINES FOR THE RECORDAL OF FRANCHISE AGREEMENTS" hyperlink).

31. *Id.*

needs to be registered with INPI. Factors that bear on this analysis could include the importance of the test, the nature of the test, payments to the franchisor, applicable taxes, whether intellectual property licensing risks are involved, and whether suppliers are involved in the test, among other things.

In any case, whatever form of instrument is used to document the test, counsel should ensure that the critical provisions from the franchise agreement are carried over and made applicable to the test. These critical provisions would include all fundamental compliance with law, indemnity, breach, default, governing law, and dispute resolution provisions (which may be modified for the test if necessary). Other common terms and conditions are outlined below.

C. *Key Elements of the Framework*

The following section summarizes key elements that franchisors should consider for every test conducted at a franchised location, but it is not an exhaustive list. Additional elements may apply, depending on the particular circumstances of each test. However, the list sets forth the principal issues that can be useful in the drafting of a test letter as well as any brand standards manual or policy provisions.

1. The Scope

a. *Location*

A test letter should clearly state which franchised locations will conduct the test. To prevent the need for a single franchisee organization to sign more than one test letter for multiple locations, and to enable the addition of other locations over time, it can be helpful to attach a list of locations as an exhibit that the parties can modify over time.

b. *Duration*

i. Term

A test letter should clearly establish the beginning and end dates of the test and the mechanism for extensions, if any (at the option of either party or both, by notice or additional signed agreement, etc.). The term and any extensions should be expressly aligned to the term of the franchise agreement and disclaim any implied extension to the term of the franchise agreement itself.

ii. Termination

A test letter should clearly spell out the notice requirements for terminating the test. When determining those requirements, the parties should consider the period needed to wind down the test and any legal notice requirements that may apply. In winding down the test, the franchisor and franchisee have a shared interest in concluding the test and resuming normal operations in a manner that reduces any business disruption. Therefore, each of the steps and time required to physically stop the test and resume normal operations

should be accommodated. The steps of winding down could include, for example, the removal of physical improvements, the sale or return of inventory and equipment, cessation of marketing efforts, the migration of information held within technology platforms, and the termination or assignment of test-related agreements. Regarding legal notice requirements, normally the termination of a test is not a termination of the franchise itself so any good cause and notice obligations that would apply to the termination of the franchise would not separately apply to the test.[32] However, if the test utilizes a separate supply or distribution agreement[33] and that agreement comes within the scope of Article 2 of the Uniform Commercial Code (UCC),[34] which most states have codified,[35] then the UCC may impose a "reasonable notice" requirement as to the termination of the agreement upon which the test relies.[36] In addition, other legal requirements like permitting and licensing, discussed in more detail later, and/or the franchisor's own policies and practices, may affect the termination of a test by virtue of requirements that concern the products, services, and other elements that are the subject of the test. Therefore, counsel should be careful to consider whether any legal requirements may affect the notice requirements and time period for terminating and winding-down the test.

32. Currently eighteen states impose "good cause" requirements and/or prior notice and procedural requirements for terminating or not renewing a franchise under their franchise relationship statutes, including Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Washington, and Wisconsin. *See* Ark. Code Ann. § 4-72-201 *et seq*.; Cal. Bus. & Prof. Code § 20000, *et seq*.; Conn. Gen. Stat. § 42-133e, *et seq*., Del. Code Ann. tit. 6 § 2551 *et seq*.; Haw. Rev. Stat. § 482E-1 *et seq*.; 815 Ill. Comp. Stat. 705/1 *et seq*.; Ind. Code § 23-2-2.7-1 *et seq*.; Iowa Code § 523H.1 *et seq*.; Mich. Comp. Laws § 445.1501 *et seq*.; Minn. Stat. § 80C.01 *et seq*.; Miss. Code Ann. § 75-24-51 *et seq*.; Mo. Rev. Stat. § 407.400 *et seq*.; Neb. Rev. Stat. § 87-401 *et seq*.; N.J. Stat. Ann. § 56.10-1 *et seq*.; R.I. Gen. Laws § 6-50-1 *et seq*.; Va. Code Ann. § 13.1-557 *et seq*.; Wash. Rev. Code § 19.100.180 *et seq*.; Wis. Stat. § 135.01 *et seq*.

33. Many traditional distribution agreements are not franchises because they either do not meet the statutory definitions of "franchise" under federal and state laws, or they fall within defined exceptions or exclusions, including, for example, the *bona fide wholesale price exclusion* under the FTC's Franchise Rule. *See* 16 C.F.R. § 436.1 (h); Fed. Trade Comm'n, Franchise Rule Compliance Guide (May 2008), https://www.ftc.gov/system/files/documents/plain-language/bus70-franchise-rule-compliance-guide.pdf. For a fuller discussion of the differences between distribution agreements and franchises, see Paul R. Fransway, *Traversing the Minefield: Recent Developments Related to Accidental Franchises*, 37 Franchise L.J. 217 (2017); Suzie Trigg & Jamee M. Cotton, *Changing How Products Get from the Manufacturer to the Customer: Common Questions and Risks*, 37 Franchise L.J. 77 (2017).

34. *See* UCC §§ 2-102, 2-103 (scope and definitions); *see also* Henry D. Gabriel, ABCs of The UCC Article 2: Sales (3d ed. 2013).

35. A state-by-state list of jurisdictional enactments of the UCC has been prepared by the Uniform Law Commission. *UCC Article I, General Provisions*, Uniform Law Comm'n, https://www.uniformlaws.org/committees/community-home?CommunityKey=53650937-4723-4bc4-9a81-fa609b431933; *see also* Trigg & Cotton, *supra* note 33, at 96.

36. *See* UCC § 2-309(3). For a discussion of the UCC's effects on supply agreements, see Joyce G. Mazero & Leonard MacPhee, *Setting the State for a "Best in Class" Supply Chain*, 36 Franchise L.J. 219 (2016); *see also* Trigg & Cotton, *supra* note 33, at 85 (explaining that "reasonable notice" for termination under the UCC is determined by state law and that various courts have found reasonable notice to be anywhere from thirty days to nine months depending on the circumstances).

iii. Early Termination

The early termination of a test should be addressed according to the factual scenario that gives rise to the termination. Common factual scenarios are below.

Franchisee Default and Termination. A test letter should terminate automatically and without additional notice if the underlying franchise agreement expires or terminates. In some cases, it may also be appropriate for the test to terminate upon an event of default by the franchisee. The rationale for this view is that it stems from the franchisee's failure to maintain a prerequisite to participation—that the franchisee has failed to remain in good standing (see Prerequisites ahead). However, in many cases the franchisor may prefer that the test continue during the cure period of any default, particularly if the test is going well and the franchisee's default is unrelated to the test itself. Accordingly, many franchisors retain the option to terminate in the event of default, rather than imposing an automatic trigger.

At the Franchisor's Discretion. Separate from any default-related issue, a test letter should provide the franchisor with a right to terminate the test early in its sole discretion. This right is generally considered reasonable because it is necessary to enable the franchisor to protect customers and the brand if an exigent situation should arise that requires an immediate response (such as a life-safety issue or brand-damaging media coverage in relation to a test). If a franchisee might suffer a loss in such a circumstance, and the situation was not the franchisee's fault or within his or her control, the question of reimbursement may arise. In other words, the question becomes whether the parties should share the risk of a rapid termination when neither party was at fault (Reimbursement for Early Termination is discussed later in the article).

Termination for Convenience. A test letter may set forth when the franchisee or franchisor can terminate for convenience, including if either is unhappy with the results of the test. If the test is one in which the franchisor is trying to accumulate a certain data set, the franchisor may want to restrict the franchisee's ability to terminate before that data set is complete (see Information ahead). But this limitation can cause friction if the franchisee is losing money in the test and wants to stop the loss. It can cause additional friction if different franchisees are treated differently when such situations arise. Accordingly, it is best to anticipate these kinds of circumstances in advance and determine how they will be handled, as much as possible, to set the expectations of the participants and implement a consistent approach.

Termination Upon Sale or Transfer. A test letter should address whether the test will continue after the franchised business is sold or transferred during the testing period. Often the parties will want the test to continue after the transfer is complete. However, in some cases, the franchisor may wish to temporarily suspend the test while the business transitions to new ownership. To accommodate this circumstance, test letters may provide that the test will terminate automatically upon any transfer of the franchise unless

the transferee assumes all rights and obligations under the test letter with the franchisor's consent. That enables the parties to determine the best approach in each instance and document it accordingly. Also, due to the timing of the transfer, the franchisor may require the transferee to assume all of the transferor's indemnification obligations related to the test (regardless of when a liability or claim may have arisen or accrued). Accordingly, from the franchisee's perspectives, any potential liabilities associated with the test should be addressed in the purchase and sale agreement or other transfer documents, and an assignment and assumption of the test letter should be among the items on each party's checklist for closing.

Reimbursement for Early Termination. Whether either party should compensate the other party for their costs upon an early termination, which costs should be reimbursed (if any), and in which circumstances reimbursement would or would not apply depend on the nature of the business, the standard practice in the industry, and the investment levels of each party. The simplest approach and perhaps the most common in certain sectors is a framework in which each party bears all risk of its own investments in the test, disclaims any representation or warranty regarding the outcome or results of the test, and is not liable for any loss, damages, compensation or reimbursement to the other party for an early termination of the test for any reason (except for any indemnity obligations and any loss or damages arising from a termination of the test due to a default and termination of the underlying franchise agreement).

c. *Principal Obligations*

A test letter should set forth the principal obligations of the parties in the conduct of the test, which are normally general in nature and precede the more detailed terms and conditions that are unique to the test. Normally, the general obligations of franchisees are to cooperate with the franchisor in conducting the test and to follow all operational procedures established by the franchisor before, during, and after the test, including during any wind-down period. This broadly includes complying with all financial terms of the test, collecting and reporting test information to the franchisor, following the marketing and advertising requirements, adhering to the equipment requirements, and complying with all other terms and conditions of the test, which are further discussed below. To the extent that a supplier is involved in the test, the obligation to cooperate and follow procedures may extend to the supplier as well. Test letters also should prohibit franchisees from making any modifications to the testing procedures, products, equipment, and other critical elements of the test without the franchisor's prior consent. The reason for these requirements is to provide a set of controlled conditions that can be monitored and measured in a systemic fashion to produce the most reliable—and repeatable—test results. Franchisors are not typically bound in a similar manner, but rather retain the ability to modify the testing parameters at any time in their discretion. The reason for this dichotomy is simple.

In exercising control over the test, franchisors need to have the flexibility to make changes to help improve results and drive the most value out of the endeavor for the system, which is in everyone's best interest. Moreover, franchisors need not relinquish aspects of control in order for franchisees to have the protections that they need in a test. This fact does not mean that a franchisor should make changes without the advice and counsel of their franchisees. But, as to legal control, test letters tend to be one-sided for good reasons.

d. *Allocation of Risk*

A test letter should set forth the allocation of risks between the parties. In the ordinary case, tests are voluntary, and each party will bear their own risks of participation except as expressly provided otherwise. This foundational element is usually captured within the framework of disclaimers and indemnity clauses. For disclaimers, it is important for the test letter to contain an express acknowledgment by the franchisee that (1) the franchisee's participation in the test is voluntary; (2) the test involves a risk of loss; (2) the franchisee independently evaluated the risks when making its decision to voluntarily participate in the test; (3) the franchisor makes no representation or warranty, express or implied, that the franchisee's participation in the test will confer any benefit to the franchisee or its business; (4) as to any equipment, inventory, supplies, and other physical items as may be applicable, the franchisor is not a merchant or vendor, and disclaims any and all warranties, express or implied, including any warranty of condition or fitness for any particular purpose or use, merchantability, and any statutory warranty.[37] With respect to indemnity, a test letter may adopt the protections already within the franchise agreement and expound upon them if needed. Likewise, a test letter may adopt the dispute resolution clauses in the franchise agreement and expound upon them if needed. In light of these considerations, in many cases a cross reference to the relevant clauses in the franchise agreement is sufficient and helps to keep the test letter short.

2. Prerequisites

The franchisor should determine what qualifications are necessary for franchisees to qualify for participation in a test at the outset, and whether they should continue to apply throughout the duration of the test.

a. *Good Standing*

A common prerequisite is the requirement that the franchisee be in "good standing." This condition generally means that (1) the franchisee is not in default of the franchise agreement; (2) the franchisee is not delinquent with any

37. If the test of a new product falls outside the scope of the franchise system's normal products, specific product liability issues may arise that need to be addressed in the test letter. *See* discussion *infra* Part II(C)(7) (Unique Considerations Based on Test Type).

payments due to the franchisor; and (3) the franchisee's facilities are in compliance with the franchisor's minimum standards and requirements. Beyond the principle that a non-compliant franchisee should not be rewarded with benefits like participating in tests, the reasons for a "good standing" requirement are very practical. For example, a "good standing" requirement helps to ensure that the franchisee has sufficient funds to meet its normal financial obligations and invest in the test and that the test results will be predicated on the correct baseline (such as in a test of new equipment, having the right equipment present and working correctly *before* any modifications are made for the test is important). In some franchise systems, franchisors utilize specific criteria to determine whether franchisees are in "good standing" in such a manner as to be considered eligible for renewals, additional franchises, royalty discounts, and/or other benefits within the system. In that case, the franchisor should consider whether the eligibility criteria might also be appropriate for determining good standing for purposes of the test.

Caution is needed, however, where the nature of a test is based on geography and/or the test requires multiple outlets to participate together. In these kinds of tests, prerequisites such as a "good standing" requirement could undermine the results by removing necessary outlets from the sample set. In particular, this could be a significant issue for promotional tests that are targeted on specific media markets (DMAs) or based on cost sharing within marketing cooperatives in the franchise system. Therefore, prerequisites should be carefully considered.

b. *Sufficient Franchise Term*

As noted above, the franchisee should have a sufficient remaining term under its franchise agreement to conduct the test properly. If a franchise agreement will expire (by its terms and without renewal) during the testing period, this issue needs to be addressed by the parties to establish clear expectations and develop whatever contingency plans are appropriate under the circumstances.

c. *Permits, Licenses, and Consents*

A franchisee may need to obtain additional permits or licenses from local authorities in order to conduct the test. In some cases, a variance from local zoning ordinances may be required. In each test where a physical modification will be made to the property (like a front counter change in a store) or a device will be added that people interact with (like an electronic kiosk or vending machine), the modification or device will need to comply with the ADA. In addition, a franchisee and/or franchisor may also need to obtain consents under property leases and other real estate restrictions (such as "permitted use" restrictions), which are common in shopping centers and strip malls. These restrictions could appear in any real estate instrument such as recorded covenants, conditions and restrictions (CC&Rs), declarations, reciprocal easement agreements, and/or common area maintenance (CAM) agreements.

For illustrative purposes, here are some types of permits and licenses that need to be considered by category. For external modifications, one would need to consider, among other things, property leases and head leases, building permits, zoning, ADA compliance, and CC&R requirements, CAM issues, signage, lighting and height restrictions, venting and emissions, drive-thru configuration, sound levels, curb cuts, and minimum parking spaces. For internal modifications, topics to consider include property leases and head leases, building permits, certificate of occupancy, ADA compliance, CC&R requirements. For equipment, property leases and head leases, ADA compliance, CC&R requirements, and workplace safety requirements are some of the categories that must be considered. Similarly, for services and products, property leases and head leases, ADA compliance, CC&R requirements, business licenses, and liquor licenses all must be evaluated. Finally, for business license restrictions, there must be an evaluation of scope of operations, including onsite versus offsite service, restaurant versus catering, and/or twenty-four-hour operations versus limited operating hours. Beyond these kinds of issues, there may be other legal requirements that apply to a test depending on the nature of the test (see Unique Considerations Based on Test Type ahead). An exhaustive list is beyond the scope of this article. Thorough due diligence is needed to understand what is required, and the timeline and cost of each requirement, in order to plan the test properly. If a test that is meant to start in two weeks requires a permit that takes six weeks to obtain, that timing will cause a problem. If the parties begin the test without knowing a permit was required in the first place, that will cause a bigger problem. These things can be avoided with proper legal review.

It is important that a test letter does not necessarily need to detail every regulatory requirement. To the contrary, very simple statements of obligations may be sufficient, such as the following: "Franchisee will comply with all applicable laws, regulations, and ordinances in connection with the conduct of this test. Franchisee will obtain and maintain all permits, licenses and consents that are required to conduct this test at its own cost and expense, and provide copies of such permits and consents to Franchisor upon request." However, in a test letter, it may be wise to call out specific requirements that have particular importance.

3. Financial Terms

Any financial terms that will apply to the test that alter the regular financial arrangements of the parties under the franchise agreement, and any new or different financial obligations for the test, should be specified in the test letter. Some of the most important financial terms relate to who will pay for the costs of testing and typically concern (1) the initial investment; (2) ongoing operational costs; (3) royalties and fees that apply to the test; and (4) insurance. These issues, as well as additional issues that pertain to financial reporting and pricing controls, are examined in this section.

a. *Initial Investment & Ongoing Costs*

The initial investments in a test typically include the costs of acquiring and installing equipment, training staff, initial marketing, and other start-up expenses. The ongoing costs in a test typically include wages and salaries, supplies, inventory, utilities, ongoing training and marketing, equipment lease payments, insurance, and other continuous or periodic expenses. Many test letters state that the franchisee will "bear all costs" related to the test. And, in many cases, this simple statement may be adequate. But counsel cannot be certain whether it is adequate without first reviewing each of the operational elements and a list of all associated costs. If the client does not have such a list, then it is important to create one. The list should cover the full lifecycle of the test as well as any contingencies. Often, businesspeople who are excited about a new endeavor tend to focus on the positive outcomes that they expect and do not think about the things that could go wrong. The exercise of preparing a full list of costs and contingencies forces the client and counsel to think through all the implications together. That exercise is invaluable for issue spotting.

It is almost never appropriate for a franchisor to agree to "bear all costs" because, in most cases, there are myriad potential minor expenses that occur in the day-to-day operation of the business that might be incidental to the test (such as ancillary supplies) and/or cannot be accurately segregated from other day-to-day operational costs of the business (such as utilities). Moreover, the concept of "all costs" is so broad that it could have unintended consequences on the allocation of liabilities, indemnities, and other issues absent specific exceptions to the contrary. It is normally the best practice for test letters to provide that the franchisee will bear all costs, other than those specific items that will be provided, paid for, or reimbursed by the franchisor or suppliers. Although this is a practical approach, it can raise a particular risk for the franchisee: the risk of the "ugly surprise" discussed below.

i. Cost Caps

Despite everyone's best efforts to plan for contingencies, an unforeseen event could occur that requires substantial additional expenditure for the test to continue. This is the proverbial "ugly surprise." The risk of an ugly surprise is often proportional to the overall size and scope of the test itself. For example, if a test requires a $40,000 piece of equipment that breaks down and must be replaced, and in that particular circumstance it is not covered by warranty or insurance, then the replacement expense would fall on the franchisee under a "bear all costs" arrangement. But it could be completely impractical for the franchisee to bear this cost without frustrating the very purpose of the test by destroying the franchisee's ROI. Accordingly, it may be wise for the franchisee to include a cap on its total out-of-pocket expenses in the test letter. Such a cap could be expressed as a whole dollar figure, a percentage, or by a list of cost categories. In this manner a cap would protect the franchisee while giving the franchisor the option to either fund the

replacement (or share in the cost of replacement) or terminate the test. In a situation where it might not make economic sense for the franchisee to pay for a replacement, it might make economic sense for the franchisor to do so to protect the integrity of the test for the system as a whole. The reverse is true for franchisors. In the (rare) situation where the franchisor agrees to bear all costs, then the franchisor may likewise need to cap its own expenses as a safety net. Where a cap is utilized by either party, counsel should consider whether the cap should give rise to a termination right. In many cases a cap on franchisee expenses does not give rise to a termination right *unless* the franchisor elects not to bear the additional expense to continue the test, as in the example here.

ii. Franchisor Contributions

As noted earlier, it is usually best for a test letter to state that the franchisee bears all costs except for enumerated items. Accordingly, the franchisor's contributions to a franchisee for a test should be clearly identified and expressly limited to what has been identified. A franchisor may choose to contribute a specific dollar amount to the franchisee (with or without specifying for what the money is to be used), contribute equipment, provide training, operational support, and/or other services in support of the test. In all cases, the franchisor's contributions should be clearly set forth in the test letter, which may be accomplished either within the body or as an exhibit to the document.

iii. Supplier Contributions

In some tests, a supplier may wish to facilitate and participate in the test in a similar fashion by covering costs, providing equipment, training, operational support, and/or other services to the franchisee, the franchisor, or both. The supplier may also wish to participate in marketing efforts or pursue its own marketing. For example, a beverage supplier might wish to test its newest self-service dispenser in a restaurant franchise system. In that case, a supplier agreement is normally warranted (see below), and the test letter should make it clear that neither the franchisee nor franchisor is responsible for those items that will be provided by the supplier. The test letter should also state what occurs if the supplier does not fulfill its obligations. Ordinarily either party can terminate the test at that point, or the franchisor can seek a replacement supplier.

b. *Royalties and Fees*

A fundamental question in testing a new product or service is whether the franchisee must pay royalties and fees to the franchisor for sales made under the test. In some cases, a franchisor may choose to waive royalties and fees in consideration of the investment that the franchisee is making in the test. Indeed, such a waiver can provide a good incentive for franchisees to participate. This kind of waiver should have a time limit, which may or may

not need to be coterminous with the test itself. At the very least, if the test is successful and the new product or service becomes a standard offering in the system, then the normal royalties and fees should apply from that point forward. In a test letter, the end of any fee waivers must be clear to avoid disputes.

c. *Insurance*

The insurance aspect of a test has two components: franchisor coverage and franchisee coverage. Before any test begins, the franchisor should be certain whether the standard insurance coverage that it carries, and that its franchisees carry, is sufficient to buffer the risks of the test. The risks may be different for each party in each different situation, but the principal questions are common in all cases: Is the subject matter of the test included within the "covered losses" of the policy? Are the general liability and workers compensation coverage limits sufficient? Are employee practices liability, business interruption, or other special insurance coverages needed? Is a policy rider needed? If the parties must purchase additional coverage, can it be arranged as group coverage for the test? If so, who bears that cost?

Perhaps one of the best examples that illustrates the importance of insurance review is the classic delivery test. There, a restaurant franchisor is considering testing a food delivery service in which the franchisee's employees conduct deliveries (rather than a third-party delivery service) using either the franchisees' vehicles that bear the franchisor's name and logo, or the employees' own vehicles in some circumstances with or without any identifying signage. In this scenario, a whole host of new potential liabilities could arise from motor vehicle operations and off-premises catering. This concept is certainly not new as food delivery has been common for many years.[38] But, when it is being considered by a business that has never previously used it, one can easily see how this test should necessitate robust conversations with insurance representatives early in the planning stages. The parties should always consider insurance issues, regardless of the nature of the test and regardless of whether it is a 'minor' test (i.e., relatively insignificant in the overall operation of the business). For example, if a business wishes to test a new commercial trash compactor or baling machine, the legal review may reveal that it is subject to specific Occupational Safety and Health Administration (OSHA) workplace safety rules,[39] which may have insurance implications as well as operational ones. If insurance premiums will rise, new premiums are needed, and/or deductibles will change because of a test, who

38. *See* Ian Harvey, *Food Delivery: The Epic History of Humanity's Greatest Convenience*, Vintage News (Jan. 8, 2019), https://www.thevintagenews.com/2019/01/08/food-delivery; *see also The 5 Biggest Food Delivery Risks*, Wasserstrom Blog (Oct. 12, 2018), https://www.wasserstrom.com/blog/2018/10/12/food-delivery-risks.

39. *See, e.g.*, U.S. Dep't of Labor, Fact Sheet #57: Hazardous Occupations Order No. 12 Rules for Employing Youth and the Loading, Operating, and Unloading of Power-Driven Scrap Paper Balers and Paper Box Compactors under the Fair Labor Standards Act (FLSA) (July 2010), https://www.dol.gov/sites/dolgov/files/WHD/legacy/files/whdfs57.pdf.

should bear those expenses? And were these things contemplated when the parties agreed that one of them would "bear all costs"?

4. Test Results and Information

a. *Ownership of Data*

Test letters normally require the franchisee to collect and report to the franchisor all operational and financial information related to the test at such times and in such form as the franchisor may require. In some cases, this data may go above and beyond the franchisee's regular duties to provide information, but it is normally not controversial because it is necessary for the franchisor to analyze the test results properly. However, an issue that is sometimes overlooked in test letters is who *owns* the data. This point can be extremely important. Businesspeople may tend to focus on the financial data generated from a test and not consider the other information involved. This approach can create blind spots. For example, customer data is becoming increasing valuable in the digital age.[40] If a test of a new marketing app generates new customer lists, and neither the franchise agreement, the manual, nor the test letter address the topic (or do not apply to the test in a particular instance), a dispute could easily arise over ownership and use of this data in the future. Indeed, if the franchisor normally owns customer lists under the franchise agreement, a poorly written test letter could actually create an unintended loophole for the test. And if the customer list created by the test is commingled with customer lists derived outside of the test, the situation could become very complicated to resolve. Accordingly, it is important that ALL DATA from a test be recorded separately, or be recorded in a way that is easily identifiable as test data, and that the ownership of the test data be clear under the franchise agreement, the manual, and/or the test letter. In the author's experience, it may be wise to specify this point in the test letter, even if it is redundant of the franchise agreement or manual, when these kinds of elements are significant to the test.

b. *Ownership of Intellectual Property and Derivative Works*

A related issue can arise over the ownership of intellectual property. As a basic principle, intellectual property laws vest legal ownership of intellectual property (copyrights, trademarks, patents, trade secrets, and trade dress) in those persons who create, first file, or first use the intellectual property in commerce, as applicable, absent an agreement to the contrary, including work-for-hire arrangements.[41] Some of these rights can attach automatically

40. *See* Andrei Hagiu & Julian Wright, *When Data Creates Competitive Advantage*, Harv. Bus. Rev., Jan.–Feb. 2020; Adi Ignatius, *The Real Deal on Data*, Harv. Bus. Rev., Jan.–Feb. 2020.

41. *See* 15 U.S.C. § 1127; 17 U.S.C. § 102(a); 35 U.S.C. § 1; *see also* Mark J. Burzych, *System Standards and Franchisee Innovation: Striking a Balance*, 38 Franchise L.J. 253 (2018) (reviewing how franchisees may claim ownership rights in innovations in certain circumstances and the importance of explicit contractual provisions in franchise agreements to prevent ownership disputes).

and provide multiple persons with legal rights in their collective works.[42] In a franchise system, franchisee contributions can be some of the most valuable contributions in the system, and smart franchisors encourage them.[43] Therefore, to provide a legal framework for a franchisor to receive these contributions without risking a dispute over who owns them, it is nearly universal and considered best practice for the franchisor to include clear provisions in each franchise agreement that assigns to the franchisor, and vests in the franchisor, any and all rights in any invention, discovery, creation, development, improvement, adaptation, and derivative work (collectively Works) that arise out of or in connection with the franchisor's intellectual property, the franchise agreement, the manual, and/or the franchised business.[44] By its very nature, testing inherently involves the creation of these kinds of Works, to which the franchisees may contribute their own ideas and inspiration in a significant way. Accordingly, it is essential that counsel ensure that any such Works are covered by the existing intellectual property provisions of the franchise agreement or are clearly set forth in the test letter. Depending on the nature of the test (for example, in the testing and development of software), it may be wise to include this kind of provision in the test letter even if it is redundant to the franchise agreement. In a similar manner, to the extent that a supplier is participating in or contributing to the test, the franchisor should ensure that the same kinds of protections exist in the relevant supplier agreements.

c. *Financial Reporting*

In the test of a new product or service, franchisors should consider how to account for and report sales, regardless of whether royalties and fees will apply. In some cases, the product or service might fall outside the scope of the business's usual computerized inventory controls, point-of-sale (POS) systems, and/or reporting systems. Can these systems be reprogrammed to add it? If not, should the parties consider using alternate systems to account for the sales? These questions are equally important to the franchisee and franchisor. For example, if the franchisor's standard POS system did not apply the correct state and local taxes rates on the test product, the parties

42. Burzych, *supra* note 41.

43. For example, the McDonald's restaurant system has benefitted significantly from the contributions of its franchisees. In 1965, the Filet-O-Fish was developed by Lou Groen, a franchisee in Cincinnati. In 1968, the Big Mac was developed Jim Delligatti, a franchisee in Pittsburgh. In 1975, the Egg McMuffin was developed by Herb Peterson, a franchisee in Santa Barbara. *See The McDonald's Story*, https://corporate.mcdonalds.com/corpmcd/about-us/history.html. In a more recent example, in 2004, Stuart Frankel, a Subway franchisee, developed the "$5 Footlong" promotion that became a very valuable and important system-wide promotion very quickly. *See Five Dollar Footlongs: The History of Subway's Game-Changing Promotion*, Franchise Help, https://www.franchisehelp.com/franchisee-resource-center/subway-five-dollar-footlongs-history-promotion.

44. *See generally* Corby Anderson & Rebekah Prince, *Operating Manual, Advertising, Trademarks, and Other Intellectual Property*, Ann. Franchise Agreement (Nina Green et al. eds., 2018); Burzych, *supra* note 41.

may not discover the error until long after the test is over. When it is discovered, the franchisee may be liable for the tax deficiencies plus penalties and interest to the taxing authority. As between the franchisor and franchisee, is the franchisor ultimately responsible for this loss? Should it be? Who was responsible for programming the POS system for the test? It is easy to see how a dispute could arise in such a circumstance. In every test, the arrangements for financial accounting and reporting should be organized so as to avoid introducing any increased risks in the business.

d. *Confidentiality*

A test letter should be clear about whether the test information, and which test information, is confidential. Both the franchisor and franchisee share an interest in keeping valuable new trade secrets from the eyes of competitors.[45] In addition, the franchisor may want to keep test data from other franchisees until it has the opportunity to evaluate and analyze the results. If the very early results from a new test are not positive, that could color opinions against the new initiative before it has had an opportunity to get a foothold and become successful. Therefore, it may be wise for a franchisor to restrict information-sharing by franchisees to just those participating in the test. If the franchisor is running a single-blind study, it may need to require that participating franchisees not share information with each other. In every case, the franchisor should take care to explain the need and rationale for intrasystem confidentiality to the participants to avoid any misunderstandings about intent. After the test is concluded, the franchisor should not have any legal obligation to share test information within the test letter itself. Whether it chooses to do so, and what types of information it may share, will depend upon the circumstances at that time. But at this stage it is important for counsel to keep in mind that the duty of good faith and fair dealing (as well as common sense franchisee relations) may make it necessary for the franchisor to share certain information, and enough information to demonstrate that the franchisor undertook proper due diligence during a test to support the ultimate decision that it makes based on the test.[46]

5. Supplier Considerations

All of the issues outlined above take on an additional component when a supplier will be supporting and participating in the test.

a. *Who Is the Supplier?*

In the context of a test, "suppliers" can include more than just the manufacturers and distributors of equipment, supplies, and services. Suppliers can

45. *See* Natalma M. McKnew & Emily I. Bridges, *I've Got a Secret . . . and I'm Willing to Use It! Franchisors, Franchisees, and Trade Secrets*, 36 Franchise L.J. 561 (2017); Mark S. VanderBroek & Christian B. Turner, *Protecting and Enforcing Franchise Trade Secrets*, 25 Franchise L.J. 191 (2006).

46. *See generally supra* note 12 and accompanying text.

include any third party that is involved or has an interest in the test. For example, if a franchisor wishes to test solar energy panels or electric vehicle charging stations at its franchised locations, the energy equipment suppliers will normally help to identify financial incentives that can offset the cost of installation. Such incentives could include government agency grant funding and utility energy efficiency rebates. In this scenario, the suppliers and the agencies/utilities may all be involved in the test in some manner, either directly or indirectly. Under their funding programs the government agency and/or utility could have the right to receive information, impose reporting obligations on the franchisee and supplier, and publicly disclose information about the test which supersede any private agreements to the contrary. If a franchisor anticipates that an energy initiative may provide a real competitive advantage in the marketplace, would the franchisor want that information to be publicly available through a government agency? The franchisor's desire to keep the information from its competitors may outweigh the "free advertising" value that the agency promotion could provide.[47]

b. *Supplier Agreements*

When a supplier is involved, or will have an interest in the test, the franchisor should use a supplier agreement to document the respective rights and obligations of the parties *that are particular to the test*. When the supplier is already a regular supplier in the system, the parties may not need a new supply agreement; perhaps only a brief addendum to an existing agreement will suffice to accommodate the test. An in-depth review of supplier agreements is beyond the scope of this article.[48] In brief, supplier agreements that are prepared for a test normally should exist separately from franchisee test letters, but should always be consistent with them and may be exhibits to the test letters if appropriate. During the planning phase, a question will naturally arise as to whether the supplier agreement should be structured as either of the following: (1) one three-party agreement for each location signed by the supplier, franchisor, and franchisee, or (2) one agreement signed by the supplier and the franchisor, and a series of separate agreements signed between the supplier and each of the franchisees. In many cases the latter approach is the most efficient when there will be several franchisees in a test because it requires less administrative work by the franchisor. In addition, having separate agreements is helpful to clearly distinguish the separation of the parties and the different rights and responsibilities that they have towards each other, including how the test is ended. Franchisors must also consider the termination of a supply arrangement in the context of a test that might

47. For example, many businesses are proud to promote when their products become Energy Start certified by the U.S. Environmental Protection Agency (EPA). A list of Energy Star certified products, federal income tax credits, and other financial incentives for energy efficiency can be found on the EPA's website, https://www.energystar.gov.

48. For a review of the key issues in supply chain management and supplier agreements (including RPFs, RFIs and RFQs), see Mazero & MacPhee, *supra* note 36.

be very short or could end early. This is especially true where the parties might end up with unused inventory. As noted earlier, the termination of a supplier or distribution agreement that falls under Article 2 of the UCC may be subject to "reasonable notice" requirements.[49] Finally, regardless of the arrangement of the documents, if the franchisor will receive a rebate or other benefit from the supplier under the test, both legal principles and good franchise-relations practices may dictate that franchisees be informed of this fact at the outset to remove any doubts about the franchisor's intentions.[50]

6. Marketing Issues

Under most franchise agreements, the franchisor must approve all marketing and advertising by the franchisee using the trademarks. Under that fundamental requirement, franchisors may develop different types of procedures for operating national, regional, and local advertising funds and programs, and allowing franchisees to perform certain types of advertising activities independently and/or in cooperative arrangements within specified parameters.[51] If the subject of the test is a new marketing or advertising approach, it may fall well outside of the franchise system's normal procedures and require more specific terms in the test letter that are particular to the test. A few examples of this situation include new customer loyalty programs, online marketing and mobile apps, and text-message marketing initiatives.[52] If the test requires hiring an advertising agency for support, then the test agreement should contain the relevant terms for the engagement and supervision of the agency, and the agency agreement would exist separately alongside any other supplier agreements for the test. The parties can organize any number of different arrangements to best suit their needs. In all cases, franchisors should carefully consider the marketing elements that are intended to work with the existing system and those that operate separate from it. While this task is primarily a business operations matter, some common legal issues do arise.

First, test advertising requires the franchisor to engage in decision-making that is more in-depth than its normal review and consent procedures because of advertising's impact on the test results. In particular, the franchisor may wish to stage promotions at different levels of investment in order to gather data on different ROI models. In addition, the advertising of certain topics may

49. *See supra* notes 32–36 and accompanying text.

50. *See supra* note 14 and accompanying text.

51. *See generally* Anderson & Prince, *supra* note 44 (citing Roger D. Blair & Francine Lafontaine, *Understanding the Economics of Franchising and the Laws that Regulate It*, 26 Franchise L.J. 55, 57 (2006)); *see also* Lauren Smith Madden, *Not Your Mama's Advertising Fund: Best Practices in the Use of Franchise System Advertising Funds*, 38 Franchise L.J. 379 (2019).

52. *See, e.g.*, Jennifer L. Crowder, Shazmah Hakim, David Moorhead & Melissa Landau Steinman, *Loyalty Land Mines*, 8th Ann. Hotel & Lodging Legal Summit, Geo. Univ. L. Ctr. (Oct. 25, 2019); Maisa Jean Frank & Julia Colarusso, *Vicarious Liability May Apply: TCPA-Compliant Text Message Advertising in Franchise Systems*, 35 Franchise L.J. 421 (2016); Daniel A. Graham, *Mobile Apps Within a Franchise System: The Vicarious Liability Risk*, 34 Franchise L.J. 213 (2014).

be subject to additional legal requirements. For example, in the solar-panel hypothetical discussed earlier, any environmental marketing claims would be subject to the Federal Trade Commission's (FTC's) Green Guides[53] as well as traditional advertising legal principles. To address these kinds of issues, the test letter may contain a relatively simple clause such as:

> Franchisee will not market, promote or make any media statements about the [test/equipment] or the environmental benefits associated with the [test/equipment] except in compliance with all applicable laws and as approved in advance by Franchisor. Franchisee will not endorse the [supplier] or permit the [supplier] to market or promote [supplier's] products or services using franchisor's name or trademarks or in reference to this [test] in any manner. The [supplier] must receive consent for any such activity directly from franchisor.

Parallel requirements would normally appear in supplier agreements.

Second, as an extension of the principles above, and for the same reasons, the franchisor should consent to any announcements of new ventures and any other media statements related to the test.

Third, a franchisor may wish to test a new product or service at different consumer price levels for effectiveness. The supplier may have the same desire. Doing so can provide very valuable information to assess ROI in a test environment. If the test involves any type of pricing controls by the franchisor and/or the supplier, or any price agreements between the franchisor, franchisees, and/or suppliers, the franchisor should vet the arrangement for compliance with all applicable antitrust laws. Antitrust analysis is complex and beyond the scope of this article. Indeed, antitrust concerns are pervasive and a common source of discussion in the franchise sector.[54] When considering antitrust issues related to testing programs in the franchise context, counsel should carefully assess the various different types of arrangements that franchisors can utilize, and their legal implications, to help identify parameters that will achieve the business goals without creating unnecessary antitrust risks (or other competition law risks in international jurisdictions). Key distinctions become apparent when comparing specified pricing arrangements to minimum and maximum resale price maintenance arrangements, and when assessing the difference between an agreement to *charge* customers a certain price point versus an agreement to *advertise* a certain price point in which the franchisee remains entirely free to charge any price he or she wishes.

53. The FTC first issued truth-in-advertising "Green Guides" in 1992 to instruct businesses on (a) general principles that apply to environmental marketing claims; (b) how consumers are likely to interpret particular claims and how marketers can substantiate these claims; and (c) how marketers can qualify their claims to avoid deceiving consumers. *See* FTC, Green Guides, https://www.ftc.gov/news-events/media-resources/truth-advertising/green-guides.

54. It is notable that this publication, the American Bar Association's *Franchise Law Journal*, has published approximately fifty-four different articles on antitrust law topics in franchising. *See Franchise Law Journal Cumulative Index* (Sept. 2019), https://www.americanbar.org/content/dam/aba/events/franchising/2019/cum_index_38_4.pdf.

7. Unique Considerations Based on Test Type

In addition to the principal terms and conditions in a test letter outlined earlier, additional terms may be specific to the type of test the parties intend on conducting. It is not possible to create an exhaustive list of these considerations, but some of the more common ones follow.

a. *Test of Product or Service*

In the test of a new product or service, special operational procedures might need to be put in place and training conducted at the unit level in order for the franchisee to produce the product or provide the service. Implementation of the procedures at the unit level is often called the "deployment" phase. In connection with deployment, the franchisor should assess whether its normal quality assurance and inspection procedures are adequate or if special procedures will be needed for the test. Test results could be negatively impacted by quality problems quickly, so it is necessary to have proper checks in place to protect both the integrity of the test and the franchisor's brand reputation overall.[55] It is not normally necessary to detail special quality assurance procedures in the test letter. An umbrella clause is usually adequate in the test letter if the franchisor specifies the procedures under a separate document and communicates them clearly to the franchisee. Relatedly, the franchisor should consider whether any special terms are necessary to ensure compliance with laws that pertain specifically to the product or service being offered (beyond the required permits and licenses described earlier). This may include, for example, food safety requirements,[56] health code requirements,[57] packaging and product labeling requirements,[58] product liability issues,[59] toy safety regulations, online data gathering and consumer privacy protections,[60] and any other issues that pertain specifically to the new product or service offering. Although these topics are beyond the scope of this article, franchisors should always consider them in a product or service test along with the fundamental principles of vicarious liability.[61]

55. *See* Burzych, *supra* note 41; Edward Wood Dunham, Joseph Schumacher & G. Adam Swhweickert III, *Retaining and Improving Brand Equity by Enforcing System Standards*, 24 Franchise L.J. 10 (2004).

56. *See* Stephanie L. Russ, *Does This Law Make My Butt Look Big? A Survey of Health-Related and Food Labeling Laws Food Service Franchise Systems Should Know*, 33 Franchise L.J. 217 (2013); Stephanie L. Russ, *Does This Law Make My Butt Look Big? Part II: No, but Food Does: An Overview of the FDA's Menu Labeling Requirements*, 35 Franchise L.J. 61 (2015); Mei Zhang, *International Franchising: Food Safety and Vicarious Liability*, 35 Franchise L.J. 93 (2015).

57. *See supra* note 56.

58. *Id.*

59. *See* Trigg & Cotton, *supra* note 33.

60. *See* Jason Adler, Megan S. Demicco & John Neiditz, *Critical Privacy and Data Security Risk Management Issues for the Franchisor*, 35 Franchise L.J. 79 (2015); Charles B. Cannon, *What Franchisors Need to Know About Privacy Rights*, 22 Franchise L.J. 176 (2003); Lee J. Plave & John W. Edson, *First Steps in Data Privacy Cases: Article III Standing*, 37 Franchise L.J. 485 (2018).

61. *See* David Laufer & David Gurnick, *Minimizing Vicarious Liability of Franchisors for Acts of Their Franchisees*, 6 Franchise L.J. 3 (1987); Heather C. Perkins, Sarah J. Yatchak & Gordon M. Hadfield, *Franchisor Liability for the Acts of the Franchisee*, 29 Franchise L.J. 174 (2010).

b. Test of Equipment

In a test of new equipment, the test letter should specify who owns the equipment (who holds legal title), who is in possession of the equipment, who is responsible for the maintenance and repair of the equipment, and who is responsible to remove the equipment and restore the premises to its original condition after the test concludes. For ownership of the equipment, any number of different arrangements could apply. The franchisor could provide the equipment on loan or by lease to the franchisee. The franchisee could purchase the equipment outright, with financing from a lender, or under an installment agreement with a supplier. The franchisee could also lease the equipment from a supplier with an option to purchase the equipment later (which may be most the cost-effective approach in a test). In any scenario, the franchisor should understand the rights, duties, and security interests of the parties involved and should be clear about what could occur in the event of a casualty loss, default, bankruptcy, termination, or other unexpected event.

III. Conclusion

Innovation is driving modern business at an ever-rapid pace and the need for franchise testing is growing in kind. Test letters between franchisors and franchisees have traditionally been the most common and easiest way to set out the parameters of a test and the legal framework upon which the parties rely. Test letters need not be long or complicated documents. In the author's experience, a test letter is often limited to just two or three pages and is written in a business-friendly way. But test letters must be thoughtful. Tests can involve any number of traps for the unwary. Accordingly, test letters should reflect a thorough and prudent assessment of the issues involved to help keep an exciting business opportunity from turning into a regretful episode. Following this article is a checklist of key test letter considerations for counsel.

Test Letter Agreements
Checklist of Considerations

(1) Documentation
- (a) Franchise agreement
- (b) Manual
- (c) Letter agreement vs. contract format
- (d) Franchise agreement amendment or not

(2) Key Terms and Elements
- (a) Location
- (b) Duration
  - (i) Term and expiration
  - (ii) Early termination
    - (1) Franchise default and termination
    - (2) Franchisor's discretion
    - (3) Termination for convenience
    - (4) Termination on sale or transfer
    - (5) Reimbursement of costs
- (c) Prerequisites
  - (i) Good standing
  - (ii) Sufficient franchise term and real estate tenure
  - (iii) Permits, licenses, consents
- (d) Operational Terms
  - (i) Control and conduct of the test
  - (ii) Winding down and restoring the premises
- (e) Financial Terms
  - (i) Initial investment and ongoing costs
    - (1) Franchisor contributions
    - (2) Supplier contributions
    - (3) Cost caps
  - (ii) Royalties and fees
  - (iii) Insurance
- (f) Information
  - (i) Operational and financial reporting
  - (ii) Ownership of data
  - (iii) Ownership of intellectual property and derivative works
  - (iv) Confidentiality

(g) Indemnity, Governing Law, Dispute Resolution
   (i) Same as franchise agreement?

(3) **Supplier Considerations**
   (a) Supply requirements
   (b) Supplier participation—how are the terms affected?
   (c) Supplier agreements

(4) **Pricing and Marketing**
   (a) Antitrust guardrails
   (b) Control of advertising
   (c) Control of press releases and media statements

(5) **Unique Issues Based on Type of Test**
   (a) Product Test
   (b) Service Test
   (c) Equipment Test

What Is "Unfair" Conduct in a Franchise Case Under California's Unfair Competition Law?

*Kevin A. Adams**

Mr. Adams

California's Unfair Competition Law (UCL)[1] is intended to foster "fair business competition" by curtailing "'anti-competitive business practices' as well as injuries to consumers."[2] At first glance, franchise practitioners may question the general applicability of the UCL to franchise disputes that involve *neither* antitrust *nor* consumer claims. However, California courts have found the UCL's scope to be intentionally broad with sweeping coverage.[3] In this vein, courts have found the UCL to apply to any "business act that is either fraudulent, unlawful, or unfair"—including intellectual property disputes, employment claims, and franchise cases, among others.[4] This broad interpretation and application of the UCL has made it one of the most frequently litigated statutes in California.

On its face, the UCL defines *unfair competition* to "include any unlawful, unfair or fraudulent business act or practice."[5] Each of these terms, *unlawful*, *unfair*, and *fraudulent*, represents a separate and distinct theory of liability and are each "independently actionable" under the UCL. [6]

1. Cal. Bus. & Prof. Code § 17200 *et seq*.
2. Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co., 973 P.2d 527, 560 (Cal. 1999) (quoting Barquis v. Merchs. Collection Ass'n, 496 P.2d 817, 829 (Cal. 1972)). The UCL is commonly referred to in California as the "UCL" or "Section 17200."
3. *Cel-Tech*, 973 P.2d at 561.
4. Levine v. Blue Shield of Cal., 117 Cal. Rptr. 3d 262, 277 (Ct. App. 2010).
5. Cal. Bus. & Prof. Code § 17200.
6. *Cel-Tech*, 973 P.2d at 540; *see also* Lozano v. AT&T Wireless Servs., 504 F.3d 718, 731 (9th Cir. 2007) (citing S. Bay Chevrolet v. Gen. Motors Acceptance Corp., 85 Cal. Rptr. 2d 301, 316–17 (Ct. App. 1999)); State Farm Fire & Cas. Co. v. Superior Court, 53 Cal. Rptr. 2d 229, 234 (Ct. App. 1996); People ex rel. Mosk v. Nat'l Research Co. of Cal., 20 Cal. Rptr. 516, 521(Ct. App. 1962) (stating "it would be impossible to draft in advance detailed plans and specifications of all acts and conduct to be prohibited [citations], since unfair or fraudulent business practices may run the gamut of human ingenuity and chicanery.").

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Case law defining the types of business acts and practices that are "unlawful" or "fraudulent" under the UCL is well-developed and relatively straightforward. An "unlawful" business practice "borrows violations of other laws and treats them as unlawful practices," independently actionable under the UCL.[7] Stated differently, "[v]irtually any state, federal, or local law can serve as the predicate" to a UCL "unlawful" claim.[8] On the other hand, a "fraudulent" business practice is one that is likely to deceive members of the public and is *actually relied upon* by the plaintiff to his or her detriment.[9] These legal standards are consistently applied to evaluate business conduct that is allegedly "unlawful" or "fraudulent." However, evaluating conduct under the UCL's "unfair" prong is significantly more convoluted.

There are at least *four* tests that have been unevenly applied by the courts to evaluate conduct under the UCL's "unfair" prong. The California Supreme Court, in the seminal case of *Cel-Tech Communications, Inc. v. Los Angeles Cellular Telephone*, identified the proper test that the courts must use when evaluating claims of "unfairness" between *competitors*.[10] Still, the *Cel-Tech* court left open the question of which test controlled in cases involving consumers and other non-competitor relationships. The law in this area remains unsettled.[11]

Because the typical franchisor-franchisee dispute does not involve competitors or consumers, courts have analyzed UCL "unfairness" claims under a myriad of tests. This has led to mixed, and sometimes baffling, results, and has even caused some judges to openly question whether the UCL applies to disputes between franchisors and franchisees.

This article will provide franchise practitioners with some history and guidance on this complicated, and heavily litigated, area of California law. The article addresses whether the UCL "unfairness" prong has been (and can be) applied in franchise disputes, the controlling "unfairness" tests in both competitor and consumer actions, and the courts reconciliation and application of these tests in the typical franchise dispute, which involves neither competitors nor consumers. The article concludes with suggested approaches that franchise practitioners can pursue when litigating a claim under the "unfairness" prong of the UCL.

7. *State Farm*, 53 Cal. Rptr. 2d at 234.

8. Friedman v. AARP, Inc., 855 F.3d 1047, 1052 (9th Cir. 2017). The unlawful prong of the UCL can be especially useful to a plaintiff when the predicate law does not provide for a private right of action.

9. *See* Planned Parenthood Fed'n of Am., Inc. v. Ctr. for Med. Progress, 2016 WL 2643680 (N.D. Cal. May 5, 2016); *In re* Tobacco II Cases, 207 P.3d 20, 39 (Cal. 2009).

10. Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co., 973 P.2d 527, 545 (Cal. 1999).

11. *In re* Qualcomm Litig., 2017 WL 5985598, at *6 (S.D. Cal. Nov. 8, 2017).

I. Can a Franchisee Pursue a UCL "Unfairnes" Claim Against the Franchisor?

As mentioned previously, the stated intent of the UCL is to protect both *consumers* and *competitors* by promoting fair competition in commercial markets for goods and services.[12] Still, courts routinely apply the UCL to cases that do not involve consumers or competitors so long as the alleged conduct involves "a business act or practice that is fraudulent, unlawful, or unfair."[13] This begs the threshold question: does a franchisee have standing to bring a UCL claim when the dispute is devoid of both competitor and consumer elements?

This issue was considered by the district court in *Prudential Insurance Company of America v. Herman*.[14] In that matter, defendant Herman, a franchisee, filed a counterclaim against its franchisor, Prudential Real Estate Affiliates, Inc., for violation of the UCL. The UCL claim was predicated upon the franchisor's alleged failure to provide the support and growth opportunities required by the parties' franchise agreement.[15] The franchisor moved to dismiss the UCL claim, arguing that "contract breaches do not rise to the level of 'unfair' within the meaning of the statute."[16] The trial court agreed.[17] As part of its ruling, the court, in a footnote, questioned whether a UCL claim was viable because the franchise dispute presented "neither a competitor nor a consumer suit, but rather a case involving franchisees complaining that their franchisor breached certain contractual obligations under their franchise agreement."[18] The court ultimately sidestepped the standing issue by dismissing the UCL claim on the merits following a full analysis of multiple UCL tests.[19]

Although the author could find no reported case holding that the UCL was inapplicable to non-consumer, non-competitor franchise disputes, several courts have found in other contexts that the dismissal of a UCL claim may be appropriate "when the plaintiff is neither a competitor nor a

12. *See*, *e.g.*, Kasky v. Nike, Inc., 45 P.3d 243, 249 (Cal. 2002), *as modified*, May 22, 2002, (stating "the UCL's purpose is to protect both consumers and competitors by promoting fair competition in commercial markets for goods and services. . . .").

13. *See*, *e.g.*, *In re* Pomona Valley Med. Grp., 476 F.3d 666, 675 (9th Cir. 2007) ("As the California courts have explained, the unfair competition statute is not limited to 'conduct that is unfair to competitors.'"); Drum v. San Fernando Valley Bar Ass'n, 106 Cal. Rptr. 3d 46 (Ct. App. 2010) (not questioning the plaintiff's standing to pursue a non-consumer, non-competitor UCL claim against state bar association); People ex rel. Renne v. Servantes, 103 Cal. Rptr. 2d 870 (Ct. App. 2001) (stating that the UCL is "intentionally broad to give the court maximum discretion to control whatever new schemes may be contrived, even though they are not yet forbidden by law.").

14. Prudential Ins. Co. of Am. v. Herman, 2009 WL 10674431 (C.D. Cal. Aug. 31, 2009).

15. *Id.* at *1.

16. *Id.* at *2.

17. *Id.* at *4.

18. *Id.* at *2 n.3.

19. *Id.* at *2.

consumer."[20] For instance, in *Linear Technology Corp. v. Applied Materials, Inc.*, the California Sixth District Court of Appeal upheld the trial court's dismissal of the UCL claim by a corporate plaintiff seeking indemnification in a patent dispute that did not involve consumer or competitor issues.[21] In its decision, the appellate court noted that "the alleged victims are neither competitors nor powerless, unwary consumers, but [plaintiff] and other corporate customers in Silicon Valley, 'each of which presumably has the resources to seek damages or other relief . . . should it choose to do so.'"[22]

Similarly, in the wage-and-hour class action case *Casas v. Victoria's Secret Stores, LLC*, the district court noted "that it remains extremely skeptical of plaintiffs' UCL unfairness theory" because plaintiffs are neither competitors nor consumers.[23] Still, the court allowed the UCL claim to survive a motion to dismiss, acknowledging that it will "consider whether Plaintiffs have satisfied UCL standing at a later time."[24]

Conversely, most courts have no trouble applying the UCL to non-consumer, non-competitor disputes.[25] For example, in *BladeRoom Group Limited v. Facebook, Inc.*, the district court found that "the UCL's comprehensive purpose" extends beyond disputes involving consumers and competitors.[26] "Instead, the UCL more broadly requires the plaintiff demonstrate a loss of money or property as a result of unfair competition."[27] *Power Quality & Electrical Systems, Inc. v. BP West Coast Products LLC* addressed this question in a franchise context after the franchisor moved at the onset of the case to dismiss the franchisee's UCL claim, arguing that the parties were not competitors and the franchisee was not a consumer within the meaning of the UCL.[28] The district court summarily rejected the franchisor's argument as "unavailing," finding that the term *unfair competition* "embrac[es] anything that can properly be called a business practice."[29] "Where an 'unlawful'

20. Dillon v. NBCUniversal Media LLC, 2013 WL 3581938, at *7 (C.D. Cal. June 18, 2013) (citing Linear Tech. Corp. v. Applied Materials, Inc., 61 Cal. Rptr. 3d 221, 237 (Ct. App. 2007) (upholding trial court's dismissal of UCL claim when "the alleged victims are neither competitors nor powerless, unwary consumers.")); Rosenbluth Int'l, Inc. v. Superior Court, 124 Cal. Rptr. 2d 844, 847 (Ct. App. 2002), *as modified* Sept. 11, 2002 (holding that the UCL does not apply to consumer claims of sophisticated corporations, each of which had the resources to seek damages or other relief should it choose to do so) (distinguished by *In re* Yahoo! Litig., 251 F.R.D. 459, 475 (C.D. Cal. 2008)).

21. *Linear Tech. Corp.*, 61 Cal. Rptr. 3d at 237.

22. *Id.* (citing *Rosenbluth*, 24 Cal. Rptr. 2d at 844); *see also* S. Bay Chevrolet v. Gen. Motors Acceptance Corp., 85 Cal. Rptr. 2d 301, 305 (Ct. App. 1999) (holding that the UCL "is directed toward protecting the general public, not automotive dealerships aware of GMAC's use of [lending] method").

23. Casas v. Victoria's Secret Stores, LLC, 2015 WL 13446989 (C.D. Cal. Apr. 9, 2015).

24. *Id.* at *4 n.7.

25. *See, e.g.*, *In re* Pomona Valley Med. Grp., 476 F.3d 665, 675 (9th Cir. 2007); Drum v. San Fernando Valley Bar Ass'n, 106 Cal. Rptr. 3d 46 (Ct. App. 2010).

26. BladeRoom Grp. Ltd. v. Facebook, Inc., 219 F. Supp. 3d 984, 995–96 (N.D. Cal. 2017).

27. *Id.* at 996.

28. Power Quality & Elec. Sys., Inc. v. BP W. Coast Prods. LLC, 2016 WL 6524408, at *7 (N.D. Cal. Nov. 3, 2016).

29. *Id.* (citing *In re Pomona*, 476 F.3d at 675).

business practice is charged, actual injury to the consuming public or even to business competitors is not a required element of proof of a violation of [the UCL]."[30]

In short, although dismissal for lack of UCL standing in a franchisor/franchisee dispute may hold appeal with certain judges, it is not likely to dispose of the UCL "unfairness" claim in most circumstances. Thus, a deeper analysis is necessary.

II. What Is an "Unfair" Business Act or Practice Under the UCL?

The UCL does not define which business practices are "unfair," and unlike the "fraud" and "unlawful" theories of liability, courts have struggled to come up with a workable test to identify "unfair" conduct reliably.[31] As explained later, in the aftermath of *Cel-Tech*, courts now use as many as four tests to evaluate allegedly "unfair" business acts and practices.

A. *"Unfair" After* Cel-Tech

The California Supreme Court decided *Cel-Tech* in 1999. "Before *Cel-Tech*, courts held that 'unfair' conduct occurs when that practice 'offends an established public policy or when the practice is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers.'"[32] However, the *Cel-Tech* court described the existing tests as "too amorphous and provide too little guidance to courts and businesses."[33] According to the California Supreme Court, California businesses need to know, "to a reasonable certainty, what conduct California law prohibits and what it permits."[34]

To that end, the court announced "a more precise test for determining what is unfair under the unfair competition law."[35] Under the new test, unfair business acts or practices are limited to that conduct which "*threatens an incipient violation of an antitrust law, or violates the policy or spirit of one of those laws because its effects are comparable to or the same as a violation of the law, or otherwise significantly threatens or harms competition*."[36]

In formulating this test, the *Cel-Tech* court relied upon Section 5 of the Federal Trade Commission Act and federal antitrust laws.[37] Appreciating that

30. *Id.* (citing People *ex rel.* Van de Kamp v. Cappuccio, Inc., 251 Cal. Rptr. 657, 663 (Ct. App. 1988)).

31. Gregory v. Albertson's, Inc., 128 Cal. Rptr. 2d 389, 393 (Ct. App. 2002).

32. Davis v. HSBC Bank Nev., N.A., 691 F.3d 1152, 1169 (9th Cir. 2012) (citing S. Bay Chevrolet v. Gen. Motors Acceptance Corp., 85 Cal. Rptr. 2d 301, 316 (Ct. App. 1999)); *see also* Hodsdon v. Mars, Inc., 891 F.3d 857, 866 (9th Cir. 2018).

33. Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co., 973 P.2d 527, 564 (Cal. 1999).

34. *Id.* ("[A]n undefined standard of what is 'unfair' fails to give businesses adequate guidelines as to what conduct may be challenged and thus enjoined and may sanction arbitrary or unpredictable decisions about what is fair or unfair. In some cases, it may even lead to the enjoining of pro competitive conduct and thereby undermine consumer protection, the primary purpose of the antitrust laws.").

35. *Id.*

36. *Id.* at 565 (emphasis added).

37. *Id.* at 564 (citing 15 U.S.C. § 45(a)).

the purpose of these federal laws is "to foster and encourage competition," the court concluded that UCL claims of "unfair" conduct among competitors must either be "*tethered*" to a "legislatively declared policy" protecting competition, or based on "proof of some actual or threatened impact on competition."[38] The test articulated in *Cel-Tech* continues to be good law and controls UCL claims of "unfairness" between competitors.

B. *Express Limitation in* Cel-Tech

The universal application of *Cel-Tech* to both competitor and consumer UCL actions would provide consistency to the law and a certain level of predictability for California businesses (consistent with the rationale identified in *Cel-Tech*).[39] However, and unfortunately, the *Cel-Tech* court included the following caveat: "Nothing we say relates to actions by *consumers*. . . ."[40] This express limitation has caused much debate and confusion over the past twenty years.

The California appellate court's opinion in *Bardin v. DaimlerChrysler Corp*. perhaps best captures the confusion created by the limitation in *Cel-Tech*. In *Bardin*, the plaintiff brought a proposed class action against an automobile manufacturer claiming that the manufacturer's use of tubular steel, rather than the more expensive cast iron, in exhaust manifolds of certain vehicles violated the UCL.[41] The manufacturer demurred to the plaintiff's UCL claim on the basis that the use of tubular steel over cast iron was not "unfair" within the definition of the UCL.[42] Both the trial court and court of appeal agreed.[43] While analyzing the "unfairness" prong of the UCL, the *Bardin* court posed the question: "Did the Supreme Court limit its holding in *Cel-Tech* to UCL actions brought by competitors simply because the circumstance of a consumer UCL action was not before it, or because the definition of 'unfair' should be different depending on whether the action is brought by a consumer or a competitor?"[44] The *Bardin* court also "urge[d]

38. *Id.* at 565 ("These principles convince us that, to guide courts and the business community adequately and to promote consumer protection, we must require that any finding of unfairness to competitors under [the UCL] be tethered to some legislatively declared policy or proof of some actual or threatened impact on competition."); *see also* Power Integrations, Inc. v. De Lara, 2020 WL 1467406, at *23 (S.D. Cal. Mar. 26, 2020) (dismissing the UCL claim after finding that the plaintiff failed to allege that that the defendants "violated a public policy tied to an established constitutional, statutory, or regulatory provision").

39. *Cel-Tech*, 973 P.2d at 564, 566 n.12 (although criticizing consumer cases applying the former balancing test, the court nonetheless expressly limiting its holding to anticompetitive practices cases, stating that "[n]othing we say relates to actions by consumers").

40. *Id.*

41. Bardin v. DaimlerChrysler Corp., 39 Cal. Rptr. 3d 634, 636 (Ct. App. 2006).

42. *Id.*

43. *Id.* at 638, 649.

44. *Id.* at 647. Other related questions posed by the *Bardin* court included:

> Was the Supreme Court expressing the view that regulation of competitive conduct is contained in existing legislation, but there is no analogous law pertaining to consumers? Should a broader definition of "unfair" apply in consumer actions because consumers require more protection than competitors even though such a distinction between consumers and competitors is not reflected in the language of

the Legislature and the [California] Supreme Court to clarify the scope of the definition of 'unfair' under the UCL."[45] Unfortunately, they have provided no such clarity.

To date, neither the California Supreme Court nor the state legislature has identified a single test for use in evaluating unfair business acts and practices in consumer actions.[46] This lack of guidance has paved the way for a significant split of authority on which test to apply to *non-competitor* claims under the UCL.[47]

C. *Interpreting "Unfair" in Consumer Actions*

Despite *Cel-Tech*'s express limitation of its test to actions by competitors, many courts have still applied the *Cel-Tech* test in both competitor *and* consumer cases.[48] For instance, in *Herman*, the district court articulated "at least two reasons to prefer the *Cel-Tech* test" when evaluating a consumer action.[49] "First, the *Cel-Tech* court was construing the statutory language of 'unfair' as that term is used in [the UCL]. Because there is only one term 'unfair' used in the statute, the same word 'unfair' should mean the same thing for all purposes as a matter of statutory construction."[50] Second, "simple logic dictates that the *Cel-Tech* court's criticisms of the old test, as supplying a standard

> the statute? Is the *Cel-Tech* definition of "unfair" too narrow to sufficiently protect consumers? Is the definition of "unfair" applied in *Smith* too amorphous in the consumer context, and does it provide "too little guidance to courts and businesses?"

Id.

45. *Id.*

46. Aleksick v. 7-Eleven, Inc., 140 Cal. Rptr. 3d 796, 806–08 (Ct. App. 2012).

47. *See* Herron v. Best Buy Co. Inc., 924 F. Supp. 2d 1161, 1177–78 (E.D. Cal. 2013) ("Under the UCL's 'unfair' prong, the test for liability in consumer suits is 'in flux.'") (citing Lozano v. AT&T Wireless Servs., Inc., 504 F.3d 718, 735 (9th Cir. 2007)); Chang Bee Yang v. Sun Trust Mortg., Inc., 2011 WL 3875520, at *8 (E.D. Cal. Aug. 31, 2011) (applying multiple tests); Mlejnecky v. Olympus Imaging Am. Inc., 2011 WL 1497096, at *7 (E.D. Cal. Apr. 19, 2011) (adopting the balancing test); Jackson v. Ocwen Loan Servicing, LLC, 2011 WL 587587, at *4 (E.D. Cal. Feb. 9, 2011) (applying the tethering test); Yanting Zhang v. Superior Court, 304 P.3d 163, 174 n.9 (Cal. 2013) (describing the standard for determining what business acts or practices are "unfair" in consumer actions under the UCL as "unsettled"); Smith v. State Farm Mut. Auto. Ins. Co., 113 Cal. Rptr. 2d 399, 416 n.23 (Ct. App. 2001) (acknowledging that "we are not to read *Cel-Tech* as suggesting that such a restrictive definition of 'unfair' should be applied in the case of an alleged consumer injury").

48. *See In re* Firearm Cases, 24 Cal. Rptr. 3d 659 (Ct. App. 2005); Progressive W. Ins. Co. v. Superior Court, 37 Cal. Rptr. 3d 434 (Ct. App. 2005); Bernardo v. Planned Parenthood Fed'n of Am., 9 Cal. Rptr. 3d 197 (Ct. App. 2004); Gregory v. Albertson's, Inc., 128 Cal. Rptr. 2d 389, 395 (Ct. App. 2002) ("Moreover, where a claim of an unfair act or practice is predicated on public policy, we read *Cel-Tech* to require that the public policy which is a predicate to the action must be 'tethered' to specific constitutional, statutory or regulatory provisions."); Walker v. Countrywide Home Loans, Inc., 121 Cal. Rptr. 2d 79, 87 (Ct. App. 2002); Schnall v. Hertz Corp., 93 Cal. Rptr. 2d 439 (Ct. App. 2000).

49. Prudential Ins. Co. of Am. v. Herman, 2009 WL 10674431, at *3–4 (C.D. Cal. Aug. 31, 2009).

50. *Id.*

that is 'too amorphous and provide[s] too little guidance to courts and businesses,' would also extend to other cases, including consumer cases."[51]

Notwithstanding these arguments in favor of a single test for "unfair" conduct, the majority of courts read *Cel-Tech* to be inapplicable, and, to some degree unworkable, in consumer actions. The most prominent criticisms of the universal application of *Cel-Tech* to consumer UCL actions came from the California Second District Court of Appeal in *Camacho v. Automotive Club of Southern California*.[52] There, an uninsured motorist filed a purported class action against a collection agency and insurer alleging that the collection practices of the defendants were "unfair" under the UCL.[53] The trial court, on its own motion, granted judgment on the pleadings in favor of defendants.[54] The ruling was affirmed by the appellate court, but not without criticizing the application of *Cel-Tech* to consumer actions. Specifically, the appellate court articulated two distinct reasons why the *Cel-Tech* definition of "unfair" should *not* apply in consumer actions:

> First, "tethering" a finding of unfairness to "specific constitutional, statutory or regulatory provisions" does not comport with the broad scope of [the UCL]. "Tethering" the concept of unfairness to existing positive law undercuts the principle that a practice is prohibited as "unfair" or "deceptive," even if it is not "unlawful" or vice versa. . . . Second, anticompetitive conduct is best defined in terms of the policy and spirit of antitrust laws; the same cannot be said of a business practice that is "unfair" or "deceptive" in the terms of [the UCL]. That is, cases involving anticompetitive conduct move in a far smaller, and more clearly defined, universe than unfair or deceptive business practices. It is therefore possible to "tether" anticompetitive conduct to the antitrust laws, while the universe of laws and/or regulations that bear on unfair practices is so varied that it is not possible to achieve a consensus which of these laws and regulations might apply to define an unfair practice.[55]

As of this writing, there is no definitive test to determine whether a business practice is "unfair" in consumer actions.[56] *Cel-Tech* aside, three consumer tests have been unevenly applied by the courts.[57]

51. *Id.* (quoting Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co., 973 P.2d 527, 564 (Cal. 1999)).

52. Camacho v. Auto. Club of S. Calif., 48 Cal. Rptr. 3d 770, 776–77 (Ct. App. 2006) ("Definitions that are too amorphous in the context of anticompetitive practices are not converted into satisfactorily precise tests in consumer cases. This squares with the fact that, in disapproving appellate court opinions defining 'unfair' in 'amorphous' terms, the Supreme Court did not hold that the old definitions were appropriate in consumer cases.").

53. *Id.* at 771.

54. *Id.*

55. *Id.*

56. Drum v. San Fernando Valley Bar Ass'n, 106 Cal. Rptr. 3d 46, 53 (Ct. App. 2010) (citing Davis v. Ford Motor Credit Co. LLC, 101 Cal. Rptr. 3d 697, 706–10 (Ct. App. 2009) (tracing post-*Cel-Tech* split in authority among California courts of appeal in consumer cases)); Bardin v. DaimlerChrysler Corp., 39 Cal. Rptr. 3d 634, 641 (Ct. App. 2006) (noting split of authority).

57. For simplicity, all three tests are summarized in *West v. JPMorgan Chase Bank, N.A.*, 154 Cal. Rptr. 3d 285, 305 (Ct. App. 2013).

1. The Balancing Test

Originally expressed by the *People v. Casa Blanca Convalescent Homes, Inc.*,[58] and followed by *State Farm Fire and Casualty Co. v. Superior Court*,[59] a business practice is "unfair" under the balancing test when (1) the alleged conduct "offends an established public policy or when the practice is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers," and (2) the utility of the alleged conduct is not outweighed by the gravity of harm to the alleged victim.[60]

2. The Tethering Test

This second consumer test was articulated by the First District Court of Appeal in *Gregory v. Albertson's*, *Inc.*,[61] and is viewed as an extension of the *Cel-Tech* test to consumer cases.[62] Under the tethering test, an "unfair" business practice is present when the public policy allegedly violated is tethered to a specific constitutional, statutory, or regulatory provision.[63] As a rationale for its test, the *Gregory* court explained:

> [*Cel-Tech*] may signal a narrower interpretation of the prohibition of unfair acts or practices in all unfair competition actions and provides reason for caution in relying on the broad language in earlier decisions that the court found to be "too amorphous." Moreover, where a claim of an unfair act or practice is predicated on public policy, we read *Cel-Tech* to require that the public policy which is a predicate to the action must be "tethered" to specific constitutional, statutory or regulatory provisions.[64]

3. The Section 5 (or Federal Trade Commission) Test

The test applied in a third line of cases was first expressed by the *Camacho* court and draws on the definition of "unfair" in section 5 of the Federal Trade Commission Act.[65] Under the Section 5 test, an act or practice is "unfair" if (1) the consumer injury is substantial, (2) the injury is not outweighed by

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58. People v. Casa Blanca Convalescent Homes, Inc., 206 Cal. Rptr. 164, 177 (Ct. App. 1984) (disapproved of by *Cel-Tech*, 973 P.2d at 543 (noting that the test advanced in *Casa Blanca* as "too amorphous and provide too little guidance to courts and businesses" in competitor actions)).

59. State Farm Fire & Cas. Co. v. Superior Court, 53 Cal. Rptr. 2d 229, 235 (Ct. App. 1996) (disapproved of by *Cel-Tech*, 973 P.2d at 543 (noting that the test advanced in *State Farm Fire* as "too amorphous and provide too little guidance to courts and businesses" in competitor actions)).

60. *See also Drum*, 106 Cal. Rptr. 3d at 53 (citing *Bardin*, 39 Cal. Rptr. 3d at 636); Ticconi v. Blue Shield of Cal. Life & Health Ins. Co., 72 Cal. Rptr. 3d 888, 895–96 (Ct. App. 2008); Progressive W. Ins. Co. v. Superior Court, 37 Cal. Rptr. 3d 434, 453 (Ct. App. 2005) (concluding "that the balancing test should continue to apply in consumer cases" post-*Cel-Tech*); Smith v. State Farm Mut. Auto., Ins. Co., 113 Cal. Rptr. 2d 399, 415 (Ct. App. 2001).

61. Gregory v. Albertson's, Inc., 128 Cal. Rptr. 2d 389, 392 (Ct. App. 2002).

62. *See*, *e.g.*, Lozano v. AT & T Wireless Servs., Inc., 504 F.3d 718, 736 (9th Cir. 2007) (explaining that the *Gregory* court extended the *Cel-Tech* definition to consumer cases).

63. *Gregory*, 128 Cal. Rptr. at 392; *see also In re* Anthem, Inc. Data Breach Litig., 162 F. Supp. 3d 953 (N.D. Cal. 2015); Drum v. San Fernando Valley Bar Ass'n, 106 Cal. Rptr. 3d 46, 53 (Ct. App. 2010); Scripps Clinic v. Superior Court, 134 Cal. Rptr. 2d 101, 116 (Ct. App. 2003).

64. *Gregory*, 128 Cal. Rptr. 2d at 395.

65. 15 U.S.C. § 45(n).

any countervailing benefits to consumers or competition, and (3) the injury could not reasonably have been avoided by the consumers themselves.[66]

In federal court, there is at least a little more clarity. The Ninth Circuit has directed the federal district courts within its jurisdiction to use either the balancing test or tethering test to define unfair conduct in consumer actions.[67] In *Lozano v. AT&T Wireless Services, Inc.*, the Ninth Circuit acknowledged that the UCL's unfairness prong, as it applies to consumer suits, "is currently in flux."[68] Attempting to make sense of California case law following *Cel-Tech*, the *Lozano* court declined to apply the Section 5 test—"in the absence of a clear holding from the California Supreme Court"—because Section 5 "clearly revolves around anti-competitive conduct, rather than anti-consumer conduct."[69]

Yet, these multiple tests along with the continued, intermittent use of the *Cel-Tech* test in consumer actions have significantly complicated the application of the "unfair" prong in non-competitor UCL actions.

III. Which Test of Unfairness Applies in Franchise Cases?

The elephant in the room, assuming the UCL applies to non-consumer, non-competitor franchise cases, is which test should be used to evaluate alleged violations of the "unfair" prong? Unfortunately, the answer is not clear. In predictable fashion, franchisee counsel generally advocate for the amorphous balancing test, while franchisor counsel push for the more definitive and restrictive *Cel-Tech* or tethering tests. These competing positions aside, both federal and state courts have been all over the map in their analysis of the "unfair" prong in franchise cases, leading to mixed and often illogical results.

For example, in *Ahussain v. GNC Franchising*, the plaintiff franchisees filed a class action lawsuit against GNC Franchising for, among other things, violation of the UCL for allegedly engaging in unlawful business practices designed to earn a profit at the expense of the franchisees' stores.[70] The court certified the class on the UCL claim as to the following five alleged GNC business practices: (1) requiring its franchises to carry poor selling products that could not be returned to GNC after expiration; (2) requiring franchised

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66. Camacho v. Auto. Club of S. Cal., 48 Cal. Rptr. 3d 770, 776 (Ct. App. 2006); *see also* Aleksick v. 7-Eleven, Inc., 140 Cal. Rptr. 3d 796, n.5 (Ct. App. 2012); Davis v. Ford Motor Credit Co. LLC, 101 Cal. Rptr. 3d 697, 709–10 (Ct. App. 2009); Daugherty v. Am. Honda Motor Co., Inc., 51 Cal. Rptr. 3d 118, 130 (Ct. App. 2006).

67. Lozano v. AT&T Wireless Servs., 504 F.3d 718, 736 (9th Cir. 2007); *see also* Davis v. HSBC Bank Nev., N.A., 691 F.3d 1152, 1170 (9th Cir. 2012) (recognizing that California appellate courts are divided on the definition of "unfair" and whether the *Cel-Tech* standard should apply to UCL actions brought by consumers); Power Quality & Elec. Sys., Inc. v. BP W. Coast Prods. LLC, 2016 WL 6524408, at *8 (N.D. Cal. Nov. 3, 2016).

68. *Lozano*, 504 F.3d at 736.

69. *Id.*

70. Ahussain v. GNC Franchising, LLC, 2009 WL 10672353, at *1–2 (C.D. Cal. Mar. 18, 2009).

stores to purchase new or experimental products, effectively forcing franchisees to provide free market research; (3) using the "Gold Card" program to glean information on franchised store customers and then soliciting business from such customers; (4) underselling its franchise stores by selling products through the GNC website at prices below or close to the wholesale price, thereby forcing franchises to sell the same products at a loss; and (5) manipulating prices at which franchised stores can purchase products from third-party suppliers, so as to maintain GNC's favored position as a product wholesaler.[71] GNC moved for summary judgment and lobbied the court for the application of the *Cel-Tech* test, arguing that the frachisees should be considered competitors of stores owned by GNC for purposes of the UCL analysis in light of their claim that "[t]he greatest threat to the profitability and survival of franchised stores comes not from third-party competition, but from [the franchisor] itself."[72] The franchisees pushed for the less stringent balancing test.[73]

In deciding which test to apply, the district court took a unique approach by placing the burden on the franchisor to show that the parties were competitors in order for the *Cel-Tech* test to apply.[74] When the franchisor failed to cite to any authority showing "that a franchisor and its franchisees should be deemed competitors for purposes of the UCL," the court concluded (without any real analysis) that the consumer tests controlled and that GNC's alleged practices must be "unfair" under either the tethering test or balancing test for the UCL claim to survive summary judgment.[75] Ultimately, the court found that the franchisees failed to satisfy either consumer test. Applying the balancing test, the court found that the franchisees failed to show that "the alleged harm of [GNC's] practices outweigh their utility" and that the UCL did not grant the court the right to generally review the franchise agreements for "fairness."[76] Applying the tethering test, the court found that the franchisees failed to "put forth any constitutional, statutory or regulatory provisions that suggest that the business practices at issue are unfair."[77] Because the franchisees could not show that GNC's alleged practices were "unfair" under either consumer test, the court granted summary judgment in favor of GNC.[78]

The *Ahussain* court's imposition of a burden on GNC to show that the relationship was that of competitors before applying *Cel-Tech*—and corresponding treatment of the consumer tests as the *default* tests—is

71. *Id.* at *2.
72. *Id.* at *3.
73. *Id.*
74. *Id.*
75. *Id.* at *3–4 (citing to Lozano v. AT&T Wireless Servs., Inc., 504 F.3d 718, 736 (9th Cir. 2007)).
76. *Id.* at *3–4 (citing Samura v. Kaiser Found. Health Plan, Inc., 22 Cal. Rtpr. 2d 20 (Ct. App. 1993)).
77. *Id.* at *4.
78. *Id.* at *6.

unprecedented. Inversely, why wasn't *Cel-Tech* the default test absent the showing of a consumer relationship? Perhaps, the court's preference for the consumer tests is best explained by its ultimate ruling in favor of the franchisor, finding that not even the consumer tests could be satisfied by the facts of the case. Still, the analysis leaves much to be desired.

Five months after *Ahussain* was decided, a different judge sitting in the same district faced with a franchisor-franchisee dispute noted that "the Court is not at all convinced that this case can be easily classified as a consumer suit as opposed to a competitor suit."[79] In *Prudential Insurance Co. of America v. Herman*, the franchisees claimed that Prudential violated the "unfair" prong of the UCL by (1) "fail[ing] and refus[ing] to provide the requisite training, support, or assistance to the [franchisees]" required by the franchise agreements, (2) "fail[ing] to equitably allocate to the [franchisees] business referrals," (3) "never present[ing] a single growth opportunity to the [franchisees]," and (4) "unreasonably refus[ing] to allow them to acquire an existing franchise or open a new franchise in these areas."[80] According to the franchisees, these alleged actions of Prudential were done in an effort to "drive [the franchisees] out of business" and to "generate business for Prudential by depriving [the franchisees] of their ability to engage in reasonable competition."[81] Prudential moved to dismiss the UCL claim, analyzing it under the *Cel-Tech* test. The franchisees argued that the balancing test controlled.[82]

Citing to the Ninth Circuit's decision in *Lozano*, the court recognized that it could "equally" apply either the tethering test or the balancing test when analyzing claims of "unfairness" under the UCL.[83] However, upon further examination, the court found "at least two reasons to prefer [the tethering test] over the old balancing test."[84] First, the *Cel-Tech* court's definition of the term *unfair* "should mean the same thing for all purposes as a matter of statutory construction."[85] Second, "simple logic dictates that the *Cel-Tech* court's criticisms of the old test, as supplying a standard that is 'too amorphous and provide[s] too little guidance to courts and businesses,' would also extend to other cases, including consumer cases."[86] In light of these considerations, the *Herman* court found that "the better view is that the same test for 'unfairness' applies in all cases," and that test is the tethering test.[87] Applying the tethering test, the court dismissed the franchisees' UCL claim with prejudice,

79. Prudential Ins. Co. of Am. v. Herman, 2009 WL 10674431, at *3 (C.D. Cal. Aug. 31, 2009).

80. *Id.* at *1.

81. *Id.* at *2, n.2.

82. *Id.* at *3.

83. *Id.* (citing Lozano v. AT&T Wireless Servs., Inc., 504 F.3d 718, 736 (9th Cir. 2007)).

84. *Herman*, 2009 WL 10674431, at *3.

85. *Id.*

86. *Id.* (citing Cel-Tech Commc'ns, Inc. v. L.A. Cellular Tel. Co., 973 P.2d 527, 543 (Cal. 1999)).

87. *Id.* at *3.

finding that claim was improperly predicated upon contract breaches, and was not "tethered to any legislatively declared policy of the UCL."[88]

In the footnotes of its opinion, the court took its analysis a step further by suggesting that even if the *Cel-Tech* test—as extended by the tethering test—did not have universal application to both consumer and competitor cases, it still would apply it to the instant dispute because the franchisees' "substantive allegation posits a competitive relationship."[89] The court explained that "[t]he most natural reading of [the franchisees'] allegation is that Prudential acted unfairly by treating the [franchisees] like competitors, rather than mere consumers under the franchise agreement."[90] The court's comments suggest that, even if it did not have the flexibility to apply the *Cel-Tech* test to consumer disputes through the tethering test, it still would have applied *Cel-Tech* to the case as the underlying substantive allegations of the complaint support a competitor relationship.

Although *Herman* is not alone in its proposed methodology of reviewing the substance of the underlying allegations to determine the appropriate test of unfairness,[91] other courts, like that in *Ahussain*, have found that the type of allegations asserted in a complaint are not conclusive of the parties' relationship and merely "descriptive of the allegations that have given rise to the instant lawsuit."[92] Needless to say, the *Herman* and *Ahussain* opinions, originating from the same district, exemplify the difficulties confronting franchise practitioners when attempting to navigate the UCL.

The uncertainty surrounding the analysis of UCL claims in franchise cases continued with the California Second District Court of Appeal's opinion in *R.N.R. Oils, Inc. v. BP West Coast Products LLC*.[93] In that case, sixteen franchisees of BP West Coast Products LLC filed suit against the franchisor and its affiliate, Atlantic Richfield Company (ARCO), alleging that the defendants violated the UCL by engaging in various unfair business practices, including (1) implementing an automated gasoline delivery system in a manner that forced the franchisees to accept unnecessary fuel deliveries when fuel prices were decreasing and to experience fuel shortages when fuel prices were increasing and that caused the franchisees to bear the cost of fuel price changes while scheduled fuel deliveries were pending; (2) keeping vendor rebates and promotional allowances that belonged to the franchisees; and (3) delaying payment of refunds and reimbursements owed to

88. *Id.*

89. *Id.* at *2 n.2.

90. *Id.*

91. *See, e.g.*, *In re* Qualcomm Litig., 2017 WL 5985598, at *7 (S.D. Cal. Nov. 8, 2017) (describing Qualcomm and Apple as "far closer to a competitor relationship than a consumer relationship" as both "are sophisticated corporations with an ongoing business relationship"); Dillon v. NBCUniversal Media LLC, 2013 WL 3581938, at *8 (C.D. Cal. June 18, 2013) (examining the plaintiffs' allegations and concluding that the parties were competitors within the meaning of the UCL).

92. Ahussain v. GNC Franchising, LLC, 2009 WL 10672353, at *3 (C.D. Cal. Mar. 18, 2009).

93. R.N.R. Oils, Inc. v. BP W. Coast Prods. LLC, 2011 WL 37962 (Ct. App. Jan. 6, 2011).

the franchisees for erroneous gasoline charges.[94] The defendants' motion for summary adjudication of the UCL claim was granted by the trial court, and the franchisees appealed.[95] In a lengthy but unpublished opinion, the appellate court acknowledged, upfront, the difficulty identifying the appropriate test of "unfairness" because "[p]laintiffs are franchisees, not competitors of [the franchisor], and are distributors rather than consumers of the products sold by defendants."[96] The court then examined the current state of the law under the UCL before conceding that it was "unclear" which test of "unfairness" applies to the parties' franchise dispute.[97] Unable to justify the use of a single test, the court applied both the balancing test and *Cel-Tech* test (referred to as the "tethering test for competitor claims") before concluding that, "[r]egardless of the test applied," the franchisees failed to show an unfair business practice proscribed by the UCL.[98] Affirming the trial court's summary adjudication ruling, the appellate court found that the UCL claim failed under the *Cel-Tech* test because there was no constitutional, statutory, or regulatory basis for the franchisees' claimed relief, and the franchisees offered no proof that the franchisor's alleged conduct significantly threatened competition.[99] The court also found that the claim also failed under the balancing test because the franchisees presented "no evidence of any injury to the public" or that the purported injury outweighed the utility of the conduct.[100]

The U.S. District Court for the Northern District of California also expressed confusion over which "unfairness" test to apply to the UCL claim of a putative franchisee class in *Juarez v. Jani-King of California, Inc.* [101] In that case, franchisees of Jani-King sought to certify a class to advance numerous claims, including violation of the UCL's "unfairness" prong through Jani-King's alleged practice of (1) charging franchise fees that are "excessive and unfair," (2) including a non-compete clause in its franchise agreements, and (3) including a refund policy in the franchise agreement that allegedly rewards Jani-King for failing to satisfy its contractual obligations.[102] Although the court opened its analysis of the "unfairness" prong of the UCL claim by questioning which test to apply—that is, the balancing test, the *Cel-Tech* test, or the Section 5 test—the court ultimately failed to apply any of the three tests, instead, finding that the franchisees had failed to show common evidence of injury necessary to certify a class.[103]

94. *Id.* at *2.
95. *Id.* at *4.
96. *Id.* at *6.
97. *Id.*
98. *Id.* at *12.
99. *Id.* at *7, *9.
100. *Id.* at *7, *9.
101. Juarez v. Jani-King of Calif., Inc., 273 F.R.D. 571 (N.D. Cal. 2011).
102. *Id.* at 585.
103. *Id.*

Other courts have summarily applied only consumer tests to franchisor-franchisee disputes. For instance, in *Power Quality & Electrical Systems, Inc. v. BP West Coast Products, LLC*, the U.S. District Court for the Northern District of California rejected the franchisee's UCL claim after limiting its analysis to the tethering and balancing tests.[104]

In *Nagrampa v. MailCoups Inc.*, the U.S. District Court for the Northern District of California limited its analysis of the UCL claim to just the tethering test.[105] There, the franchisee claimed that the franchisor violated the "unfairness" prong of the UCL by seeking to enforce an arbitration agreement that was unconscionable and a violation of California law.[106] The franchisor moved to dismiss the UCL claim, arguing that the franchisee failed "to state a cognizable claim for violation of the [UCL]."[107] The court denied the franchisor's motion, finding that that the franchisee's UCL claim was tethered to a specific statutory provision under California law codifying unconscionability in California.[108]

Likewise, the U.S. District Court for the Central District of California limited its "unfairness" prong analysis to only the tethering test in the franchise dispute of *Flip Flop Shops Franchise Co., LLC v. Neb.*[109] In that case, franchisees sued their franchisor and its affiliates for alleged violations of the California Franchise Investment Law, violations of the Sherman Act, and fraudulent misrepresentations.[110] The franchisees loosely based their derivative UCL claim upon these other alleged violations of the law.[111] The franchisor moved to dismiss the UCL claim for failing to state a claim. The court agreed, finding, among other things, that to the extent the franchisees' UCL claim "is based on the unfairness prong, [the franchisees] have failed to allege sufficient facts to demonstrate that the [franchisor's] conduct either offends an established public policy or is immoral, unethical, oppressive, unscrupulous or substantially injurious to consumers."[112] No other test of "unfairness" was referenced in the opinion.

Finally, in the joint employment class action lawsuit *Aleksick v. 7-Eleven, Inc.*, the court summarily found that a UCL claim brought by employees of 7-Eleven franchisees against the franchisor triggered only the tethering test.[113] In that case, the employees of the franchisee brought a class action

104. Power Quality & Elec. Sys., Inc. v. BP W. Coast Prods. LLC, 2016 WL 6524408, at *1, *8 (N.D. Cal. Nov. 3, 2016) (holding that the franchisee's "unfairness" claim against the franchisor arising out of the purchase of two franchises to operate gasoline stations failed to articulate how the alleged wrongdoing was conduct tethered to any legislative policy).

105. Nagrampa v. MailCoups Inc., 2007 WL 2221028, at *2 (N.D. Cal. July 30, 2007).

106. *Id.*

107. *Id.*

108. *Id.* (discussing Cal. Civil Code § 1670.5).

109. Flip Flop Shops Franchise Co. v. Neb, 2017 WL 2903183, at *9 (C.D. Cal. Mar. 14, 2017) (applying the balancing test only).

110. *Id.*

111. *Id.*

112. *Id.*

113. Aleksick v. 7-Eleven, Inc., 140 Cal. Rptr. 3d 796, 807–08 (Ct. App. 2012).

against the franchisor for allegedly violating the UCL in the provision of payroll services to franchisees.[114] The trial court granted summary judgment of the UCL claim in favor of the franchisor, and the employees appealed.[115] On appeal, the California Fourth District Court of Appeal announced that it follows the *Gregory* line of cases and applies the tethering test to analyze allegations of "unfair" conduct under the UCL.[116] Applying the tethering test to the facts of the case, the court then rejected the employees' argument that the alleged misconduct by the franchisor was "'directly tethered to a legislatively declared policy,' the public policy in favor of full payment to employees for all hours worked."[117] The court explained that the underlying policy relied upon by the employees was the California Labor Code, but those statutes are inapplicable to the franchisor in this context as the franchisor "was not the class members' employer."[118] In affirming the trial court's ruling on summary judgment, the appellate court did not consider or reference any other test of "unfairness" under the UCL.

This inconsistent application of the "unfairness" tests in franchise disputes is seemingly impossible to reconcile. Unfortunately, *stare decisis* in California does not help to mitigate the confusion. The California Court of Appeal is comprised of six judicial districts spread across nine courthouses. Unlike many other jurisdictions, all published California appellate decisions are equally binding on all California trial courts, regardless of the judicial district in which the trial court sits.[119] Because the appellate courts have indiscriminately applied each of the UCL unfairness tests in non-competitor cases, California trial courts are essentially at liberty to select the precedent that they prefer to follow. Until the California Supreme Court or the California State Legislature clarifies which consumer test should be used in evaluating "unfair" conduct in UCL actions, all of the tests of "unfairness" remain *in play* for all appellate and trial courts in California.

114. *Id.* at 799–800.

115. *Id.* at 798.

116. *Id.* at 807 (citing to Gregory v. Alberton's, Inc., 128 Cal. Rptr. 2d 389 (2002)).

117. *Id.* at 808.

118. *Id.*

119. *See*, *e.g.*, Auto Equity Sales, Inc. v. Superior Court, 369 P.2d 937 (Cal. 1962). Conversely, federal district courts and many state trial courts are bound only by the appellate decisions from the particular circuit in which the trial courts sits (as well as those decisions of the U.S. Supreme Court or the applicable state supreme court). *See*, *e.g.*, *In re* Barakat, 173 B.R. 672, 677 (Bankr. C.D. Cal. 1994), *subsequently aff'd*, 99 F.3d 1520 (9th Cir. 1996) ("When no Supreme Court decision has been issued, the decisions of the court of appeals for a particular circuit are binding on all lower courts within that circuit. [. . .] Even if the circuits are split and the lower court disagrees with its own circuit, the lower court still must follow its court of appeals.") (Internal citations omitted.); 29 Holding Corp. v. Diaz, 775 N.Y.S.2d 807, 813 (N.Y. Sup. Ct. 2004) (recognizing that the appellate decisions of one judicial department are not binding in the lower courts of other judicial departments); *but see* Pardo v. State, 596 So. 2d 665, 666 (Fla. 1992) (Florida Supreme Court made clear that "in the absence of interdistrict conflict, district court decisions bind all Florida trial courts.").

IV. Conclusion

Despite the muddied application of the UCL to franchise disputes, there is a *non-trivial* lesson that cannot be overlooked: the courts have almost unanimously ruled in favor of franchisors finding that the alleged conduct did not constitute "unfair" business practices under any test.[120] Yet, outlier rulings like those in *Nagrampa* (denying the franchisor's motion to dismiss the franchisee's "unfairness" claim under the tethering test) exist, meaning that dismissal of a UCL "unfairness" claim is far from automatic.[121]

Faced with UCL claims in franchise disputes, franchisor counsel should continue to advocate for the application of the *Cel-Tech* test and related tethering test in both federal and state courts. Depending on the facts of the case and the court, the franchisor may also benefit from concurrently raising and disposing of the UCL claim under the balancing test as well. This option would allow the franchisor to frame the argument from the onset and mitigate any potential that the court disagrees with the franchisor's choice of test, thereby undermining the franchisor's entire opening position. Conversely, franchisee counsel is best served by characterizing the case, from the initial pleadings, as a consumer dispute and pushing for the application of the balancing test. These competing approaches to franchise disputes under the UCL will likely continue to be the norm until either the California Supreme Court or the California State Legislature steps in to clean up this area of California law.

120. *See* Flip Flop Shops Franchise Co. v. Neb, 2017 WL 2903183 (C.D. Cal. Mar. 14, 2017); Power Quality & Elec. Sys., Inc. v. BP W. Coast Prods. LLC, 2016 WL 6524408 (N.D. Cal. Nov. 3, 2016); R.N.R. Oils, Inc. v. BP W. Coast Prods. LLC, 2011 WL 37962 (Ct. App. Jan. 6, 2011); Ahussain v. GNC Franchising, LLC, 2009 WL 10672353, at *3 (C.D. Cal. Mar. 18, 2009); Prudential Ins. Co. of Am. v. Herman, 2009 WL 10674431, at *3 (C.D. Cal. Aug. 31, 2009).

121. Nagrampa v. MailCoups Inc., 2007 WL 2221028, at *2 (N.D. Cal. July 30, 2007).

Setting the Stage for a Best-in-Class Supply Chain: Part 2

*Joyce G. Mazero & Leonard MacPhee**

I. Introduction[1]

Ms. Mazero

Mr. MacPhee

The authors previously wrote an article addressing important aspects of successful supply chains, including due diligence on suppliers, key terms of supply contracts, and implementing corporate compliance programs: *Setting the Stage for a "Best in Class" Supply Chain.*[2] This article is a sequel to that prior writing. In this article, the authors address recent developments in technology, specifically the advent and potential material impact of blockchain technology and smart contracts to supply chains, as well as some key terms of supply contracts pertaining to choice of law, venue, and dispute resolution.

Timely and safe delivery of high-quality products and services in the most cost efficient and sustainable way possible is foundational for a successful franchise system. This is best achieved through strategic and competitive use of a franchise system's supply chain. A disperse, broken, or compromised supply chain can have deadly consequences on a franchise system, including increased costs, failure to timely deliver products to outlets necessary to meet consumer demand, or providing adulterated

1. The authors want to acknowledge the significant contributions of former Polsinelli Summer Associates Alex Mazero, Esq., currently government relations with the International Franchise Association, and Jessica Peel, Esq., attorney at Polsinelli in Kansas City, Missouri, as well as Emily Doan, Esq., attorney at Polsinelli in Denver, Colorado.

2. Joyce G. Mazero & Leonard H. MacPhee, *Setting the Stage for a "Best in Class" Supply Chain*, 36 Franchise L.J. 219 (2016).

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products for consumer consumption.[3] Quick reaction and correction of problems resulting from contaminated or adulterated products—at the source—is critical. The cost savings to a system based upon efficiency, sustainability, and economies of scale can be the difference in financial success.

This article addresses the key benefits of using a blockchain technology strategy for franchising and supply chain purposes, as well as certain business and legal challenges inherent in such a strategy. This article also addresses the advantages of utilizing a private blockchain and coupling it with hybrid smart contracts to address those challenges, including maintaining confidentiality of trade secrets and increasing the certainty of enforcement of key terms.

II. Smart Contracts and the Blockchain

A. *Blockchain Technology*

The blockchain is a decentralized immutable ledger possessing certain attributes that make it attractive for doing business in a digital world.[4] A blockchain ledger is distributed and shared across a digital network.[5] It can be available to anyone in a public blockchain or only to those permitted in a private, permission-based blockchain (often encrypted).[6] It is a means of recording and verifying transactions in a tamper and revision-proof way. There is only one ledger and, thus, only a single source of reliable information. In the world of blockchain, there are no trusted third parties or intermediaries such as a bank or a broker. Instead, the network participants themselves police the system and verify transactions through a process called consensus.[7] Because the transactions recorded cannot be changed or deleted, the blockchain is also immutable.

The mechanics of the consensus process vary depending on the application. In a cryptocurrency transaction, the system is public and the requirements for verification are onerous. In private networks, the verification process is less demanding, but arguably more secure. In each case, the blockchain rewards truth and transparency. Hijacking the blockchain is not easy because the participants would have to conspire to provide false information, and decentralization prevents corruption of the entire record.

Because an unlimited network of users distributes and shares the ledger, there is even greater visibility and auditability. In short, the ledger is a shared system of record among participants on a business network; each member of the network has access rights and consensus is required from all network

3. *Id.*

4. *See generally Internal Report 8202: Blockchain Technology Overview*, Nat'l Inst. of Standards and Tech. (Oct. 2018), https://doi.org/10.6028/NIST.IR.8202 [hereinafter NIST].

5. *Id.* at iv.

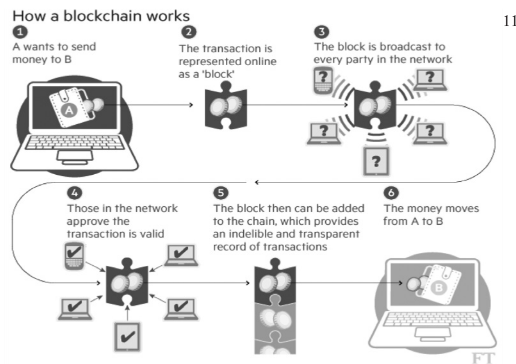
6. *Id.* at v, 11.

7. Jared R. Butcher & Claire M. Blakey, *Cybersecurity Tech Basics: Blockchain Technology Cyber Risks and Issues: Overview*, Practical Law, https://us.practicallaw.thomsonreuters.com/w-023-8731 (last visited July 30, 2020); *see also* NIST, *supra* note 4, at 18–26.

members; and all validated transactions are permanently recorded. It eliminates the need to reconcile disparate ledgers; through permission it protects confidential information; and it is secure because no one, not even a system administrator, can delete a transaction.[8]

Over time there is a snowball effect made possible by the scalability of these digital networks. Once a series of transactions is committed to a block, the creation of new blocks depends on the accuracy of the previous blocks. That process is repeated *ad infinitum*. After agreement, the block of transactions is given a timestamp secured through cryptography and subsequently linked to the previous completed block in the chain so that a party can see the provenance of an asset, such as the origin location, its history of where it has been, and who at any given point had ownership over it.[9]

Use of permissioned networks can address concerns over publicity of confidential information. Permissioned networks restrict who may participate in transactions. Permissioned networks can also limit the extent of participation and access to information by those allowed to participate. Parties to a permissioned network must be invited and subsequently validated before they can be involved and contribute.[10] By implementing a permissioned blockchain for some or all of its supply chain, a franchisor can achieve substantial improvement in efficiencies in tracking transactions and goods from the origin to a warehouse, and then to units in an automated and transparent way visible to only those who need to know, thereby protecting its trade secrets and other confidential and proprietary information.



[11]

8. *Blockchain and Distributed Ledger Technology (DLT): Overview*, Practical Law, https://us.practicallaw.thomsonreuters.com/w-023-8731 (last visited July 30, 2020) [hereinafter Blockchain Overview].

9. *See* Birgit Clark, *Blockchain and IP Law: A Match Made in Crypto Heaven?*, WIPO Mag., Feb. 2018, http://www.wipo.int/wipo_magazine/en/2018/01/article_0005.html ("A ledger showing who owns what offers brand owners a potential reference point for their rights and for the extent those rights are used within the market.").

10. Blockchain Overview, *supra* note 8.

11. Jane Wild, Martin Arnold & Philip Stafford, *Technology: Banks Seek the Key to Blockchain*, Fin. Times, Nov. 1, 2015, fig. 3, https://www.ft.com/content/eb1f8256-7b4b-11e5-a1fe-567b37f80b64.

This immediate access of information via blockchain technology dramatically improves the ability of the franchisor and its manufacturers, suppliers, and distributors to identify, assess, and remedy a defect or other failure and improves the ability to make product-specific recalls or take other corrective measures. For example, information—such as product origination details, batch numbers, factory and processing data, expiration dates, storage temperatures, and shipping details—is digitally connected to the food products, entered into the blockchain, and accessible to all participants as the transactions proceed.[12] In addition to food safety issues, the data provides a record that can help manufacturers and retailers improve management of inventory, including with respect to the products' shelf-life within a distribution center, during transport over ocean and land, and in stores and restaurants.

Blockchain supports cryptocurrency transactions such as Bitcoin, and Bitcoin utilizes blockchain as its shared ledger to track the movement of any asset and record any transaction.[13] Although Bitcoin is the first and arguably most well-known application of blockchain, blockchain technology "has rapidly and broadly permeated many industries worldwide," including smart contracts (discussed later), supply chain solutions, public records, financial services and payment systems, and other applications that "require sharing verified data among multiple geographically distributed parties."[14] For example, in the supply chain context, Walmart, Carrefour, Nestle, and Dole have utilized blockchain technology to drastically reduce food tracking times through the IBM Food Trust blockchain platform.[15] With the use of blockchain, it now takes only seconds to locate the tracking information when it took days of searching through paperwork before.[16]

Recognized as the "leading enterprise blockchain provider,"[17] IBM's cloud-based, IBM Blockchain Platform is helping companies across various industries such as banking, finance, insurance, consumer goods, government,

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12. For example, IBM Food Trust, which is built on blockchain, digitizes such transactions and data across the supply chain. *See IBM Food Trust*, IBM, https://www.ibm.com/blockchain/solutions/food-trust (last visited July 30, 2020) ("The complete history and current location of any individual food item, as well as accompanying information such as certifications, test data and temperature data, are readily available in seconds once uploaded onto the blockchain.").

13. Hanna Halaburda & Christoph Mueller-Bloch, *Will We Realize Blockchain's Promise of Decentralization?*, Harv. Bus. Rev. (Sept. 4, 2019), https://hbr.org/2019/09/will-we-realize-blockchains-promise-of-decentralization.

14. Blockchain Overview, *supra* note 8.

15. Biser Dimitrov, *How Walmart and Others Are Riding a Blockchain Wave to Supply Chain Paradise*, Forbes (Dec. 5, 2019, 8:47 AM), https://www.forbes.com/sites/biserdimitrov/2019/12/05/how-walmart-and-others-are-riding-a-blockchain-wave-to-supply-chain-paradise/#7f4156447791.

16. *See, e.g.*, Reshma Kamath, *Food Traceability on Blockchain: Walmart's Pork and Mango Pilots with IBM*, J. Brit. Blockchain Ass'n 1 (June 2018). For example, a 2017 study found that Walmart's and IBM's blockchain collaboration reduced time for tracking mango origins from seven days to 2.2 seconds. *Id.*

17. Roger Aitken, *IBM Forges Global Joint Venture with Maersk Applying Blockchain to 'Digitize' Global Trade*, Forbes (Jan. 16, 2018), https://www.forbes.com/sites/rogeraitken/2018/01/16/ibm-forges-global-joint-venture-with-maersk-applying-blockchain-to-digitize-global-trade/#6d47c5f7547e.

healthcare, automotive, travel and transportation, and media and entertainment to enhance their visibility and add value to their businesses.[18] In addition, the IBM Blockchain Platform allows users to build a complete blockchain platform as well as develop and operate the blockchain, all while counting on the highest level of blockchain security available, IBM Z, to protect against insider attacks and malware.[19]

Companies have employed IBM's blockchain technology in various ways to enhance supply chain solutions. For example, Chateaux Software and Vertrax are using IBM Blockchain Platform as the basis for the Vertrax Blockchain, which provides real-time data to visualize and respond to supply chain disruptions in the oil and gas industry.[20] In October 2019, Raw Seafoods and IBM announced a collaboration regarding the IBM Food Trust, built on the IBM Blockchain Platform, to "enhance seafood traceability."[21] The technology allows distributors, suppliers, retailers, and customers to obtain detailed information on the origin, harvesting, and transportation of seafood in the supply chain—literally "from farm to table."[22]

Furthermore, IBM and Maersk, a Danish global leader in container logistics, created a joint venture called TradeLens, which uses blockchain technology to "offer a jointly developed 'global trade digitization' platform built on open standards and designed for use by the entire global shipping ecosystem."[23] In May 2019, IBM and Maersk signed up two of the largest shipping companies in the world—Mediterranean Shipping Company (MSC) and CMA-CGM—to join TradeLens.[24] MSC and CMA-CGM operate a blockchain node on the distributed ledger and validate transactions for the network.[25] With TradeLens, a permissioned party for a shipment (e.g., shippers, freight forwarders, ocean carriers, ports, terminals, authorities, and more) can add, view, and update critical information about the shipment status and activity.[26] This information network simplifies the shipping process and

18. *IBM Blockchain Solutions*, IBM, https://www.ibm.com/blockchain/solutions (last visited July 27, 2020).

19. *Id.* For additional information on IBM's blockchain services, *see id.*

20. *See Research Leading Blockchain Use Cases*, IBM, https://www.ibm.com/blockchain/use-cases (last visited Aug. 11, 2020).

21. Press Release, IBM, Raw Seafoods Collaborate to Use Blockchain to Help Improve Seafood Traceability and Sustainability While Addressing Fraud (Oct. 17, 2019), https://newsroom.ibm.com/2019-10-17-IBM-Raw-Seafoods-Collaborate-to-Use-Blockchain-to-Help-Improve-Seafood-Traceability-and-Sustainability-While-Addressing-Fraud.

22. *Id.* ("[T]he initiative will start by digitizing the supply chain for scallops sourced from the Atlantic Sea Scallop Fishery.").

23. Aitken, *supra* note 17.

24. Ian Allison, *IBM, Maersk Finally Sign Up 2 Big Carriers for Shipping Blockchain*, CoinDesk (May 28, 2019), https://www.coindesk.com/ibm-maersk-finally-sign-up-2-big-carriers-for-shipping-blockchain; *see also* Dimitrov, *supra* note 15 ("In 2019 the network grew to 150 members spanning over 80 terminals and ports, and 17 customs offices.").

25. Allison, *supra* note 24.

26. *See Research Leading Blockchain Use Cases*, IBM, https://www.ibm.com/blockchain/use-cases (last visited Aug. 11, 2020); *see also Shipwaves Joins Maersk-IBM Developed Tradelens Platform in a Bid to Accelerate the Digitization of Ocean Logistics*, TradeLens (July 21, 2020), https://www.tradelens.com/press-releases/shipwaves-joins-maersk-ibm-developed-tradelens

keeps all stakeholders informed when changes are made, demand increases, or unexpected events occur.[27]

As the earlier examples demonstrate, blockchain's utility in a supply chain is far more impactful than its currency and bookkeeping uses. Application of the blockchain to franchise systems and the global supply chain may soon become the prime example of how blockchain technology can revolutionize product delivery systems and solve myriad problems that plague the international franchise development process.[28] As IBM's Manav Gupta has explained:

> Supply chains are prime examples of blockchain's potential for transformation that spans industries. Initial blockchain efforts could have quick impact by transforming even a small portion of the supply chain, such as the information used during importing. If import terminals received data from bills of lading earlier in the process, terminals could plan and execute more efficiently and without privacy concerns. Blockchain technology could make appropriate data visible in near real-time (for example, the departure time and weight of containers) without sharing information about the owners or value of the cargo. Costly delays and losses due to missing paperwork could be avoided.[29]

Gupta's foregoing remarks, made in 2017, provide a framework for how blockchain is used in supply chain networks to alleviate "pain points."[30] For example, blockchain improves quality control for goods subject to environmental changes (e.g., temperature, pressure), tampering, and counterfeiting, as discussed in earlier examples.[31] In general, blockchain benefits parties in the supply chain by "lowering costs associated with documentation and bureaucracy."[32] As discussed in the following section, supply chains may also utilize smart contracts to automate aspects of supply chain transactions and payments.[33]

B. *Smart Contracts*

Smart contracts are computer program agreements with the ability to self-enforce and self-execute the terms of each agreement.[34] The primary

-platform-in-a-bid-to-accelerate-the-digitization-of-ocean-logistics ("Having directly connected with over 160 entities ranging from ocean carriers, ports, shippers, inland providers, and more, the granularity of data [that TradeLens offers] includes over 120 supply chain events including transportation plans, estimated and actual events.").

27. *See Research Leading Blockchain Use Cases*, *supra* note 26.

28. *See*, *e.g.*, Adam Sulkowski, *Blockchain, Business Supply Chains, Sustainability, and Law: The Future of Governance, Legal Frameworks, and Lawyers?*, 43 Del. J. Corp. L. 303 (2019); *see also* Joyce Mazero, Dan McAvoy & Richard Smith, *What Is Blockchain and Why Is It Critical to the Future of Your Domestic and International Business?*, Int'l Franchise Ass'n 52nd Annual Legal Symposium 1, 32–35 (May 2019).

29. Manav Gupta, Blockchain for Dummies 29 (2017).

30. Jeffrey D. Neuburger, Wai L. Choy & Jonathan P. Mollod, *Blockchain and Supply Chain Management*, Practical Law, https://us.practicallaw.thomsonreuters.com/w-017-3806 (last visited Aug. 2, 2020).

31. *Id.*

32. *Id.*

33. *Id.*

34. Mazero, McAvoy & Smith, *supra* note 28, at 7.

purpose of a smart contract is to allow multiple parties to a given transaction to do business with one another. By leveraging this technology, the contract becomes easier to structure and deploy because of the smart contract's self-executing and automatic features.[35]

Specifically, the terms of the contract are written directly into lines of code through a series of "if-then" functions.[36] "If" a certain condition is met, "then" the smart contract proceeds to the next coded step in the transaction, with the process repeating until all of the necessary if-then conditions are met.[37] However, the smart contract cannot proceed to the next step until a node confirms and validates that the current transaction satisfies the pending condition.[38] A node is an individual device on a blockchain network that carries out a variety of tasks, including maintaining a copy of the blockchain and validating transactions.[39] When determining whether a transaction is valid, the node always independently comes to its own conclusion, irrespective of what the other nodes conclude.[40]

Uniquely, smart contacts define the rules and penalties around the agreement and enable the parties to observe one another's performance of the contract. Smart contracts can verify if and when a contract has been performed and further guarantee that only those particular details necessary for completion are revealed to the relevant parties. They also save valuable time and resources by being self-enforcing and, therefore, make policing the contract less burdensome. Most importantly, smart contracts eliminate the need for a trusted intermediary or central authority.[41]

Companies across various industries are using smart contracts in various capacities. Other companies are experimenting with the applicability of smart contracts in various contexts. For example:

- When a customer buys flight delay insurance from multinational insurance company AXA on its "fizzy" platform,[42] AXA records the transaction on the Ethereum[43] platform. This transaction is connected to global air traffic databases, so if the flight is delayed for more than the specified amount of time, compensation is triggered automatically.

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35. *Id.* ("Smart contracts are autonomous and automatic, eliminating human interference and reducing the potential for human error and increasing a party's access to valuable and timely information.").
36. Jeffrey D. Neuburger, Wai L. Choy & Kevin P. Milewski, *Smart Contracts: Best Practices*, Practical Law, https://us.practicallaw.thomsonreuters.com/w-022-2968 (last visited July 30, 2020).
37. *Id.*
38. *Id.*
39. Blockchain Overview, *supra* note 8.
40. *Id.*
41. Neuburger, Choy & Milewski, *supra* note 36.
42. *AXA Goes Blockchain with Fizzy*, AXA (Sept. 17, 2017), https://group.axa.com/en/newsroom/news/axa-goes-blockchain-with-fizzy.
43. Ethereum is a public blockchain platform for smart contracts. *See Learn About Ethereum*, Ethereum, http://www.ethereum.org/en/learn (last visited Aug. 11, 2020).

- Populous World uses smart contracts to automate invoice terms and prevent unpaid invoices.[44]
- Slock.it uses smart contracts to automate payments and grant or restrict access to rented or shared spaces or objects, including rented bikes and electric vehicle charging stations.[45]
- Propy was one of the first companies to use smart contracts to buy and sell real estate when a customer purchased an apartment in the Ukraine for $60,000. Both buyer and seller participated in the smart contract, which ensured a fair and legal cross-border transaction.[46]
- An Ethereum project called Provenance conducted a six-month pilot that used blockchain technology and smart contracts to successfully track "responsibly-caught fish and key social claims down the chain to export."[47] Projects such as Provenance demonstrate blockchain's success in enhancing visibility in the global supply chain.
- In a collaboration between Change Healthcare and TIBCO, the companies created Project Dovetail to enable users "to make healthcare-related payments and remittances as well as issue claims and perform other operations much faster and more efficient than before."[48]
- Symbol created a hybrid blockchain to prevent wine fraud (e.g., tampering, theft, or counterfeiting) and to create more transparency between parties in the supply chain, which incorporates smart contracts with if-then conditions to assist with verification and confirmation of the wine shipment as it travels to its final destination.[49]
- Recently the World Bank investigated whether it could employ smart contracts to issue index-linked insurance and short-term unsecured loans within poorer nations, but it ultimately determined that smart contracts would have limited and redundant roles in improving financial

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44. Bryan Weinberg, *Smart Contracts to Automate Workflows*, OpenLedger (Aug. 22, 2019), https://openledger.info/insights/smart-contracts-applications.

45. *See id.*; *see also 5 Companies Already Brilliantly Using Smart Contracts*, Medium (Mar. 8, 2018), https://medium.com/polyswarm/5-companies-already-brilliantly-using-smart-contracts-ac49f3d5c431.

46. *Companies Already Brilliantly Using Smart Contracts*, Medium (Mar. 8, 2018), https://medium.com/polyswarm/5-companies-already-brilliantly-using-smart-contracts-ac49f3d5c431.

47. *From Shore To Plate: Tracking Tuna on the Blockchain*, Provenance (July 15, 2016), https://www.provenance.org/tracking-tuna-on-the-blockchain.

48. Weinberg, *supra* note 44.

49. Charles Brett, *Symbol and Wine Fraud Prevention by Blockchain*, Enter. Times (July 10, 2020), https://www.enterprisetimes.co.uk/2020/07/10/symbol-and-wine-fraud-prevention-by-blockchain/ ("What Symbol offers growers is the ability to set up disposable smart contracts which rely on the verification and confirmation of the authenticity and quality of the wine transported—before payments go out to logistics partners.").

services in poorer nations.[50] Previously the World Bank used smart contracts to issue bonds using the Ethereum platform.[51]

Whether domestic or international, the traditional supply chain management system's operations are based on utilizing reams of paper. This system is complex, and requires a third party to update information in the system. This circumstance, in turn, leads to a party's inability to see and, in some cases, not even have access to the most recent transactions that have occurred in their supply chain.

For example, after a company sends a purchase order to the supplier, the company often has no means of tracking the order's status until the shipment is received at the warehouse. It is therefore difficult to manage supply and demand, with little to no information.[52] Similarly, there is no data to inform the company about third-party performance, to troubleshoot issues, or to determine what went wrong because the information is distributed across various supply chain partners and locations.[53] In some cases, data that would be useful to the company does not even exist.[54]

In contrast, smart contracts are managed with a decentralized public distributed ledger and therefore are transparent to allow parties to see every detail of their transactions in an instant. Smart contracts integrate payment with blockchain technology because they arrange payments automatically at the same time as deliveries occur, ultimately making the transaction and payment more efficient and transparent. As a result, it is possible to self-monitor terms of agreements, certify transactions and facilitate or evidence certain transfers of payments, and automate performance of contracts. Franchisors and their franchisees and suppliers will benefit significantly through a more transparent and reliable supply chain because finding, negotiating, and enforcing supply contracts across countries can fail to meet even the most humble of expectations, resulting in the demise of a franchise relationship and the franchised business.[55]

Getting products from one point to another across markets involves complex global logistics. Manufacturers, freight forwarders, shippers, brokers,

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50. Sebastian Sinclair, *World Bank Investigates Smart Contracts as Financial Tools, With Mixed Results*, CoinDesk (July 13, 2020), https://www.coindesk.com/world-bank-investigates-smart-contracts-as-financial-tools-with-mixed-results.

51. *Id.*

52. *See, e.g.*, *Technology Trend "The Impact Of Blockchain on Supply Chain Management*," NTT Data (Sept. 18, 2019), https://www.nttdata.com/th/en/foresight/2019/september/technology-trend-the-impact-of-blockchain-on-supply-chain-management ("[D]emand is unpredictable for the most of the time, and . . . it is difficult to convey the information to the upstream of the supply chain. As a result, companies are forced to plan with limited information that in turn causes overstock or shortage. As a technological element to tackle this challenge, [b]lockchain has gained attention.").

53. *Id.*

54. *Id.* This is especially relevant in the food supply chain, where visibility of new data can help companies monitor and control food spoilage and the spread of foodborne illnesses. *See* Jan Keil, *Blockchain in Supply Chain Management: Key Use Cases and Benefits*, Infopulse (Aug. 8, 2019), https://www.infopulse.com/blog/blockchain-in-supply-chain-management-key-use-cases-and-benefits.

55. Mazero & MacPhee, *supra* note 2, at 219–21.

and agents require numerous parties, actions, and compliance with legal and regulatory requirements to get products from one point to another across markets. Blockchain technology permits these steps including payment, licensing, inspection, and delivery obligations contained in smart contracts to be tracked and updated automatically, indelibly recording the path of shipping containers as they move from product origin to the delivery destination. This creates increased transparency for the shipment process, which improves efficiencies and results in improved costs across the supply chain.

One of the primary documents used in the shipping process is the "bill of lading."[56] The bill of lading refers to the documents that specify the party responsible for a particular obligation in the shipping process at any given point from the time the goods leave the place of origin to the delivery destination.[57] It lays the foundation for the terms for transport and delivery of the goods.[58]

Incorporating blockchain technology into the shipping process will make available a record of the bill of lading and the shipment's transport and transfer history available.[59] For example, when a shipping company signs for a particular shipment of goods it is accepting that shipment for future transport to its next destination. With blockchain technology, that signature will be recorded and that record available to anyone in the network anywhere in the world with an appropriate timestamp. The recipient of the shipment or an invested party will effectively see the information about which company was responsible for transporting the goods at the moment and exactly where they last signed for it.[60]

If a problem arises with the company responsible for the shipment during transit, the sender and recipient must troubleshoot the problem. Shipping agreements are often complex because they may be bundled together or even subcontracted in such a way that the company responsible for the shipment lacks knowledge of anything about the entity who paid for the shipment or where the target destination lies. Thus, in a traditional supply chain, tracking

56. *Bills of Lading*, Practical Law, https://us.practicallaw.thomsonreuters.com/2-534-2846 (last visited July 31, 2020). Bills of lading are "documents of title used in the transportation of goods." *Id.*

57. *See generally id.*

58. *Id.*

59. *Alibaba Joins Blockchain Bill of Lading Project*, Port Tech. (June 19, 2020), https://www.porttechnology.org/news/alibaba-joins-blockchain-bill-of-lading-project.

60. *Id*. For example, the International Port Community Systems Association (IPCSA) has established a Blockchain Bill of Lading initiative. This initiative matches the bill of lading to various events in the shipment of cargo to give "much-needed information and flexibility" to parties in the supply chain such as shippers, importers, banks and agents. In June of 2020, Alibaba, the prominent "Chinese e-commerce and technology group" joined IPCSA's initiative, and several pilots for the Blockchain Bill of Lading initiative have been completed in 2020. *See id.* Recently, a maritime industry representative noted that the COVID-19 pandemic could quicken the adoption of electronic Bills of Lading to "clear the increasing backlog of goods in ports around the world." *See* Max Schwerdtfeger, *PTI Webinar: COVID-19 Could Accelerate Adoption of Electronic Bill of Lading*, Port Tech. (May 28, 2020), https://www.porttechnology.org/news/pti-webinar-covid-19-could-accelerate-adoption-of-electronic-bill-of-lading.

a shipment and assessing a problem is very difficult and time consuming. Because of the transparency protocol that blockchain inherently implements, all parties have the ability to see each and every completed block in the whole chain, enabling them to successfully identify issues, where they occurred, and how to find the appropriate solution—saving valuable time and resources while the shipment is still in transit.

The first benefit of blockchain technology is its potential to aid in certification. Currently, a company must place implicit trust in the shipping company to deliver goods safely. The blockchain automates certification of the delivery itself, protects the shipment from tampering, and certifies the authenticity of a given shipment's contents. This process means that a company can have full certainty whether and how a shipment will arrive once it placed its order.

The second advantage of blockchain technology is advanced security and reduction of fraud across the supply chain. When fraud occurs in a company, the repercussions can be significant, including loss of money, reputational harm to the franchisor's brand, and risk to intellectual property (IP). Fraud in conventional supply chains may go undetected for a long time and is often hard to uncover, resulting in a loss of valuable time and resources. Conversely, in a blockchain, transaction data is continually reconciled, shared across a peer-to-peer network, and decentralized,[61] authorization and management of the transaction data is distributed across the network. This results in an absence of a honey pot (i.e., a centralized location of most or all data) for an individual to instigate a fraudulent scheme.[62] Decentralization also increases the transparency and visibility of the transactions completed between members throughout the supply chain. This transparency gives the parties the ability to see the transfer of assets and the history of those transfers, making fraudulent transactions easier to identify. To successfully tamper with the transaction records, an individual or colluding group would essentially have to control the majority of the system.[63]

Authenticity of a company's products is subject to challenge in a traditional supply chain because the chain typically has multiple parties and is lengthy, complex, and ultimately lacking in transparency. Implementing blockchain technology creates an immutable transparent transaction history, which in effect will make it difficult to counterfeit a product.[64]

A third benefit of blockchain technology involves currency exchange and credit. Currency conversion and exchange is undeniably an important part

61. Neuburger, Choy & Mollod, *supra* note 30. ("The fact that blockchain's peer-to-peer nature does not require a centralized database and the true copy of the database is continuously replicated and reconciled across all the nodes makes it less susceptible to hackers.").

62. *Id.* ("[U]nless a back door is built in or a single entity controls more than the percentage of the nodes or controls the specific nodes necessary to dictate changes to it (called a consensus attack), blockchain transactions are likely to be immutable and the software can likely detect and prevent attempts to wrongfully access or modify network data.").

63. Blockchain Overview, *supra* note 8.

64. *Id.*

of international trade. Financial institutions across markets use blockchain technology to maintain foreign currency accounts, which facilitate transparent and efficient reconciliation of currency exchange accounts. Financial institutions can also use blockchain technology to decrease delays in obtaining credit for financing the purchase and sale of products on a blockchain, thereby making access to capital easier for manufacturers, distributors, and suppliers.

Blockchain technology with smart contracts also facilitates access to products and funds by expediting the processes for obtaining of approvals, authorizations, and licenses (e.g., customs, trucking, ocean, and other transportation concerns) for the shipping of products across international borders. It creates this expediting by allowing all parties to sign approvals and by tracking the status of the inspection, approval, authorization, and licensing processes, and then triggering action(s) upon the occurrence of material events, such as when payment is received or products are delivered.

Despite the myriad advantages and benefits to employing blockchain solutions in the supply chain, some disadvantages may exist. Although the characteristic of decentralization in blockchain technology is an often-cited benefit, the heightened security of a decentralized blockchain may present access issues in the supply chain context.[65] Because there is no central administrator, it is possible for a user to lose access permanently in a permissioned system if the user's private key is lost or stolen.[66] Similarly, blockchain's immutability characteristics foreclose the ability to fix errors on the blockchain with a workaround, even if crime, fraud, or simple error caused the mistakes.[67]

In addition, regardless of how the blockchain technology is set up, a company seeking to join or implement a blockchain solution will have to ensure buy-in from its employees and third parties so that all supply chain partners are participating in the technology, even if the partners are doing so passively.[68] There is a high cost to developing and building a blockchain as well as ongoing expenses and resources to train individuals to competently implement and oversee the technology.[69] Moreover, until blockchain is more widely adopted in supply chains, there are limits to the interoperability of a specific blockchain technology with other applications and with other companies' blockchain solutions, particularly if the blockchain technology is permissioned.[70]

65. *See* Mazero, McAvoy & Smith, *supra* note 28, at 6.

66. *Id.*

67. *Id.*

68. Francisco Guillen, *The Supply Chain and Blockchain. I: Pros and Cons*, BlockTac (Nov. 8, 2019), https://www.blocktac.com/en/newness/the-supply-chain-and-blockchain-i-pros-and-cons/. ("[I]t requires willingness and collaboration of all participants [to] reach agreements to build a new common system that provide[s] value for all of them.").

69. *Id.* Companies may consider joining a blockchain consortium to build a blockchain.

70. *Id.* ("Current applications in [b]lockchain are developed on independent platforms and in private networks, which makes them incompatible with other applications. . . . The benefits of its implementation will be achieved only when a critical mass of participants is reached.").

The primary features of blockchain technology—immutability, decentralization, and validation, for example—present both advantages and disadvantages, especially where blockchain technology expands from its initial cryptocurrency application to supply chain management.[71]

C. *Consideration for Terms in Joining or Implementing a Blockchain and Smart Contract Supply Chain*

This section discusses risks and issues to consider in joining or implementing a blockchain and smart contract supply chain.

1. Service Levels and Performance

The willingness of vendors to commit to performance assurances is likely to be inconsistent, with vendors preferring to offer the technology and service on an "as is" basis, with limited service levels, and excluding warranties regarding performance. This arrangement can leave customers without any assurance that the technology will function as described or that the service will be reliable and available and for any business. Customers are unlikely to accept such a proposal. The balance of performance risk will therefore be a key issue to determining blockchain use.

2. Liability of Provider

The risk to customers of a systemic issue with a trading-related infrastructure, such as blockchain, could be material if trades are not settled or are settled incorrectly. Likewise, the risk relating to security and confidentiality would be a top risk issue.

One of the main issues of a public blockchain is the inability to control and stop its functioning. In the case of a private blockchain, the lack of control of the functioning of the platform does not apply, but whether or not this event would be sufficient to trigger the liability of the company managing the platform has not yet been tested. Therefore, parties must consider carefully, and not just at the vendor-customer level, the allocation and attribution of risk and liability for a malfunctioning blockchain.

3. Data Privacy

Blockchain's immutability characteristics raise serious implications for data privacy, especially where the relevant data is classified as personal data. The transparency of transactions on the blockchain often conflicts with privacy needs. Technology-based solutions for privacy-protecting blockchains might include limiting who can join the blockchain network to "trusted" nodes and encrypting the data on the blockchain, although such a solutions is not without its challenges, especially in an environment that rewards transparency.

71. Blockchain Overview, *supra* note 8.

In addition, the General Data Protection Regulation (GDPR), which became effective on May 25, 2018, further complicated data privacy.[72] Although enacted by the European Union (EU), GDPR has an extraterritorial effect and the regulations apply to all companies who process EU residents' and citizens' data, regardless of where the company is located.[73] Some of the GDPR threats to blockchain implementation are the GDPR's right of access, right to consent, right to be transported, right to minimize data, right to update data, and the right to be forgotten.[74] Specifically, the immutability of the blockchain seemingly conflicts with the right to be forgotten—also known as the "erasure right," which gives individuals the right to have personal information removed from various internet searches, databases, or sources.[75]

Currently, only one authority has issued guidance on blockchain compliance considering the GDPR's right to be forgotten. In 2018, the French Data Protection Authority (the Commission Nationale de L'informatique et des Libertés or CNIL) released guidance on blockchain and, in recognizing that it may not be possible for blockchain solutions to comply with Article 17 of the GDPR, proposed an option that "does not necessarily solve the conflict [between the right to be forgotten and blockchain technology] but merely mitigates its impact."[76] The CNIL proposed applying "cryptographic hash functions" to personal data to make such data on the blockchain virtually inaccessible once it is recorded.[77]

Because there is such limited guidance on this issue, developers and implementers of blockchain technologies that deal with personal data could argue that the right to be forgotten does not apply due blockchain's reliance on all data within the blockchain.[78] This approach shifts the argument away from "the right to be forgotten" to obligations under the GDPR regarding information of data subjects and the duration of data retention.[79] Clarification on

72. *Demonstrating Compliance with the GDPR*, Practical Law, https://us.practicallaw.thomsonreuters.com/w-005-2644 (last visited Aug. 11, 2020).

73. *Id.*

74. *Id.*; *see also* James Billieu & Jonathan Emmanuel, *Top Blockchain Considerations for Health, Life Sciences Cos.*, Law360 (Mar. 9, 2020), https://www.law360.com/articles/1249024/top-blockchain-considerations-for-health-life-sciences-cos-.

75. European Parliament and Council Regulation 2016/679, 2016 O.J. (L 119) art. 17.

76. Jonathan Emmanuel, *Regulatory, Legal Trends in the Blockchain Space for 2020*, Law360 (Jan. 6, 2020), https://www.law360.com/articles/1231337?scroll=1&related=1. For the original guidance (in French), see Commission Nationale Informatique & Libertés, *Blockchain: Premiers* éléments *d'analyse de la CNIL*, CNIL (Sept. 2018), https://www.cnil.fr/sites/default/files/atoms/files/la_blockchain.pdf.

77. Emmanuel, *supra* note 76.

78. Sonia Daoui, Thomas Fleinert-Jensen & Marc Lempérière, *GDPR, Blockchain and the French Data Protection Authority: Many Answers but Some Remaining Questions*, 2 Stan. J. Blockchain L. & Pol'y 244–45 (2019) ("[I]t can be considered that blockchains retain personal data for their duration [only] and that until the last server on which the part of the blockchain is stored is destroyed, the personal data of each member of the blockchain is necessary for the purpose of data processing, and therefore no right to be forgotten applies.").

79. *Id.* at 245.

what "erasure of data" means in the context of blockchain's unique characteristics is needed to help advise clients on how to best comply with the GDPR.

4. Exit Issues

The specific solution and the extent to which the blockchain vendor holds the customer's data largely will determine the need for exit assistance. If the customer does not have its own copy of the data, it will require data migration assistance to ensure that the vendor is obliged to hand over all such data on expiration, or earlier termination of the agreement, and a complete record of all transactions stored on the blockchain.

5. Coder Issues

Parties necessarily will need to rely upon and use a trusted technical expert to write and translate computer code (the implementing contractual tool) so as to capture the parties' agreement in code or confirm that third-party created code is accurate.

The traditional text contract could identify what data to enter into the smart contract, but franchisors and suppliers will still need an expert to test and confirm that the underlying code will actually perform its functions and there are no errors or additional protocols needed. If there is no template, the parties will need a programmer expert to create the code itself. This process requires more than giving the programmer a legal document from which to borrow, and the parties may need a term sheet on the smart contract. This circumstance means that the parties may need contracts with third-party programming services, and may need to obtain insurance to protect contracting third parties from programmer mistakes (or in instances where the code does not perform as expected). It will also be important to have the parties confirm that the code is written in an acceptable form.

Enforcement and interpretation of smart contracts present a number of issues, including interpretation of code. As noted later, in supply contracts it is necessary to also have a written contract between the parties, as it will assist greatly in enforcement and interpretation. Still, as the validity or performance of smart contracts become increasingly adjudicated, courts likely may need a system of court-appointed experts to help them decipher the meaning and intent of the code.

What happens when the code or smart contract and a written or ancillary contract conflict? Although a court would likely look at the text and code as a unified single agreement, issues could arise when the consistency between the traditional text agreement and the code do not align. The written contract will need to anticipate conflicts by providing which contract prevails and for a deemed amendment. As noted later, the written contract should spell out the parameters that go into resolving a conflict. For example, whether the code should be treated as a mutually agreed amendment to the written agreement or whether the text of the agreement should prevail.

D. *Enforcement, Jurisdiction and Venue, Choice of Law, and Dispute Resolution*

The ability to enforce a supply contract, or obtain damages for breach, under traditional contract law, is a critical supply contract issue. So too are terms relating to the resolution of disputes: choice of law, venue, and dispute resolution. There are additional challenges to consider in the blockchain and smart contracts context. Currently, there is neither case law guidance nor a comprehensive or even nascent regulatory framework overseeing blockchain and smart contract transactions.[80] The non-existent regulatory guidance, coupled with uncertainty over jurisdiction and enforcement of smart contracts and blockchain transactions generally, creates an environment among the blockchain user community that it is generally free of law and, therefore, of legal enforcement.[81] In this context, users naturally escape any sense of legal norms because the technology does not fall squarely under any form of jurisdiction.[82] Further, in many blockchain transactions, the parties are anonymous, which necessarily creates issues with the enforceability of smart contract blockchain transactions.[83]

However, for several reasons, parties can structure blockchain and smart contracts in the supply chain context to address enforcement and dispute resolution terms and overcome the issues present in the cryptocurrency context. That is, much of the current writing on the concerns over cryptocurrency jurisdiction and enforcement are not applicable to properly structured blockchain and smart contract uses in a supply chain.

That is not to say that some questions and issues surrounding enforceability and jurisdiction, specifically subject matter jurisdiction, diversity jurisdiction, personal jurisdiction, and federal question jurisdiction, are not present with smart contracts. Indeed, the concepts of physical presence, domicile and place of business, minimum contacts, consent, and performance are all different in this environment. Similarly, enforceability and remedies for breaches of smart contracts are unanswered, complicated questions.

For example, blockchain transactions cross jurisdictional boundaries because the nodes on a blockchain can be located anywhere in the world. And, because smart contracts are prewritten computer codes, how their use aligns with the traditional "contract" definition and laws of contracts is an open question. As is the degree to which whether basic contract legal

80. *See, e.g.*, Jeceaca An, *Framing Regulation Around the Potential Liabilities of Parties in the Blockchain & Smart Contract Industry*, 25 Fordham J. Corp. & Fin. L. 529, 540–41 (2020) (noting there are inconsistent approaches to regulating blockchain and smart contracts among self-regulatory bodies, agencies, and federal and state courts); *see also* Morgan Temte, *Blockchain Challenges Traditional Contract Law: Just How Smart Are Smart Contracts?*, 19 Wyo. L. Rev. 87, 102 (2019) ("Courts and policymakers thus far have not assessed the full potential of smart contracts, making it difficult to place them within a regulatory scheme.").

81. *See* An, *supra* note 80, at 540–41.

82. Eric C. Chaffee, *The Heavy Burden of Thin Regulation: Lessons Learned from the SEC's Regulation of Cryptocurrencies*, 70 Mercer L. Rev. 615, 617–26 (2019) (discussing the SEC's approach of applying its existing regulatory framework to cryptocurrency regulation).

83. There is a growing body of articles addressing these questions for cryptocurrency transactions, with less focus on other blockchain applications such as smart contracts.

elements, such as capacity and apparent or ostensible authority, and principles of title, apply. These realities can pose a number of complex jurisdictional issues that require careful consideration regarding the relevant contractual relationships.

The determination of applicable law(s) in supply chain transactions is a similarly complex analysis, which is enhanced with application of the blockchain, where within the decentralized environment parties may find it difficult to identify the applicable rules. Every transaction could potentially fall under the jurisdiction(s) of the location of each and every node in the network. This circumstance could result in the blockchain needing to be compliant with an unwieldy number of legal and regulatory regimes. If a fraudulent or erroneous transaction occurs, courts and the parties could have significant challenges in pinpointing its location within the blockchain for purposes of a traditional choice of law analysis.

The courts and legislature are beginning to weigh in on some of these questions surrounding jurisdiction and enforcement in the blockchain context. Although there is continuing debate on how concepts of offer and acceptance, certainty, and consideration work, especially in a code-only environment, states are taking steps toward expanding the enforceability of smart contracts. For example, several states have enacted legislation that recognize smart contracts and blockchain signatures as legally binding.[84] As a result, smart contracts and agreed-upon blockchain transactions have the same legal effect as traditional contracts.[85] State-sponsored blockchain initiatives underscore the legitimacy of blockchain technology.[86]

Moreover, it is likely a smart contract would pass a statute of frauds inquiry because smart contracts require parties to use their private keys to authenticate the transaction and private keys verify a party's identity.[87] Therefore, its likely use of private keys to authenticate satisfies the statute of frauds'

84. According to a Westlaw search of state statutes including the terms *smart contract* and/or *blockchain*, the following states have statutes recognizing the validity and legal effect of smart contracts: Arizona, Arkansas, Illinois, North Dakota, Tennessee, and Vermont. *See* Ariz. Rev. Stat. Ann. § 44-7061; Ark. Code Ann. § 25-32-122; 205 Ill. Comp. Stat. 730/10; N.D. Cent. Code § 9-16-19; Tenn. Code Ann. § 47-10-202; Vt. Stat. Ann. tit. 12, § 1913.

85. *See* Ariz. Rev. Stat. Ann. § 44-7061; Ark. Code Ann. § 25-32-122; 205 Ill. Comp. Stat. 730/10; N.D. Cent. Code § 9-16-19; Tenn. Code Ann. § 47-10-202; Vt. Stat. Ann. tit. 12, § 1913.

86. *See*, *e.g.*, Cal. Gov't Code § 11546.9 (establishing a blockchain working group to evaluation the uses of blockchain in state government and California-based businesses); Ky. Rev. Stat. Ann. § 42.747 (establishing Blockchain Working Group to evaluate feasibility and efficacy of using blockchain technology in state's "critical infrastructure"); Wyo. Stat. Ann. § 28-11-601 (establishing a "select committee on blockchain, financial technology and digital innovation technology"). In April 2020, the Kentucky General Assembly announced the establishment of a Blockchain Working Group to "evaluate the feasibility and efficacy of using blockchain technology to enhance the security of and increase protection for the state's critical infrastructure, including but not limited to the electric utility grid, natural gas pipelines, drinking water supply and delivery, wastewater, telecommunications, and emergency services." *U.S.: Kentucky Finalizes Creation of Blockchain Working Group*, Medium (Apr. 27, 2020), https://medium.com/@moonxfamily/u-s-kentucky-finalizes-creation-of-blockchain-working-group-b40ed7e9cafa.

87. *See* Neuburger, Choy & Milewski, *supra* note 36.

signature requirements.[88] Nevertheless, as more states, and potentially other countries, adopt smart contract statutes and regulations, the enforceability of smart contracts will continue to expand. Consequently, parties and the courts will need to revisit the applicability of current legal standards to smart contracts.

Code-only contracts can be enforceable under various laws governing these contracts such as the Uniform Electronic Transactions Act, which has been adopted by the majority of states and provides, with limited exceptions, that electronic records (including records created by computer programs) and electronic signatures using public key encryption technology are given the same legal effect as writings.[89] Similarly, the federal Electronic Signatures Recording Act recognizes the validity of electronic signatures and electronic records in interstate commerce.[90] It also provides that a contract or other record may not be denied legal effect solely because of its formation, creation, or delivery through one or more electronic agents, so long as the action of any such electronic agent is legally attributable to the person to be bound.[91]

To address choice of law, venue, and dispute resolution, parties should not rely solely on the smart contract in a supply chain (sometimes called a code-only contract). Rather, the smart contract is better used as a supplement or complement to a traditional written contract, and the smart contract can have the written contract imbedded into it. This approach facilitates the inclusion of an exclusive governing law and jurisdiction/forum-selection clause, which is essential to ensure that a parties have legal certainty as to the applicable law to determine the rights and obligations of the parties to the agreement and in which court disputes will be heard. We discuss these terms later.

The issues and questions, and non-traditional nature, of smart contract transactions make a compelling case for customized dispute resolution mechanisms. Because smart contracts are coded for and contemplate potential breaches, the parties can deal with a substantial number of enforcement situations through coding for a code-only smart contract or through an embedded traditional contract where the smart contract complements the traditional contract. Using smart contracts as a complement or supplement to a traditional contract is also attractive because only the traditional written contract can anticipate the need for subjectivity inherent in almost every business relationship—including mistakes, intentions of the parties, assessing standards of decision-making such as standards of reasonableness, best efforts, and materiality—which a smart contract cannot realistically address. Other attractive aspects of combining the smart contract with the traditional

88. *See id.*
89. Unif. Elec. Transactions Act §§ 2(5)–2(6).
90. 15 U.S.C. §§ 7001(h), 7006(3).
91. *Id.* § 7001(a)(2), (h).

written contract include reconciliation of inconsistencies among transactions and amendment or modification of the contract terms when needed.

One approach to dispute resolution in blockchain is "distributed jurisdiction."[92] Here, a system with third parties and pre-set streamlined rules are applied to resolve disputes.[93] Absent that, the parties can through the hybrid smart contract, address governing law, applicable laws, and venue and dispute resolution. The degree to which the franchisor can control the appropriate contract provisions to include on this point and other topics depends largely on whether the franchisor has the leverage to insist on the use of its form of supply chain contract or is required to negotiate from the supplier's form of contract. At any rate, choice of law, applicable law and venue, and dispute resolution provisions are important directional signs for any supply chain agreement, and, at a minimum, will likely be the subject of contract negotiations.

1. Choice of Law and Applicable Laws

Choice of law clauses provide the law to be applied to the contract. In the absence of a choice of law provision, courts will look to that jurisdiction's standards for determining the law to apply. Courts usually will enforce the parties' agreement to the choice of law, so long as there is a reasonable relationship between the chosen law and forum to the parties and the subject of the contract.[94] In the absence of a choice of law clause, courts hearing

92. *See generally* Wulf A. Kaal & Craig Calcaterra, *Crypto Transaction Dispute Resolution*, 73 Bus. Law. 109 (Winter 2017/2018); Wulf A. Kaal & Craig Calcaterra, *Blockchain Technology's Distributed Jurisdiction*, Wulf Kaal (June 20, 2017), https://wulfkaal.com/2017/06/20/blockchain-technologys-distributed-jurisdiction.

93. For example, several entities now offer online dispute resolution for smart contract disputes using either arbitration or crowdsourcing models. *See* Amy J. Schmitz & Colin Rule, *Online Dispute Resolution for Smart Contracts*, J. Disp. Resol. 104, 116–22 (2019). Aragon Network provides "a dispute resolution protocol that handles subjective disputes that cannot be solved by smart contracts." *Aragon Court*, Aragon, https://help.aragon.org/article/41-aragon-court (last visited Aug. 2, 2020). Similarly, Kleros is an online Ethereum-based arbitration system that is "the world's first decentralized court" and uses crowdsourced jurors to resolve disputes. *See One Pager*, Kleros, https://kleros.io/about (last visited Aug. 2, 2020). Jur is another company that offers various smart contracting services, including a dispute resolution mechanism. *See Whitepaper: V.2.0.2*, Jur AG (July 2019), https://jur.io/wp-content/uploads/2019/05/jur-whitepaper-v.2.0.2.pdf. Jur provides a platform for users to draft smart contracts and purchase smart contract templates. *Id.* at 12. It also offers three types of dispute resolution mechanisms: digitized commercial arbitration, participant- and game theory-based dispute resolution, and expert dispute resolution. *Id.*

94. *See Choice of Law and Choice of Forum: Key Issues*, Practical Law, https://us.practicallaw.thomsonreuters.com/7-509-6876 (last visited Aug. 2, 2020) ("Many states have adopted the ad hoc approach of the Second Restatement. Under the Second Restatement, courts generally enforce the parties' choice of law unless the selected state does not have a 'substantial relationship' with the parties or the transaction. There should be at least a 'reasonable basis' for the choice of law."). Most states will apply narrow exceptions to enforcing the parties' choice of law in certain circumstances. *See, e.g.*, Interface Kanner, LLC v. JPMorgan Chase Bank, N.A., 704 F.3d 927, 932 (11th Cir. 2013) (choice of law provisions are enforceable under Florida law "unless the law of the chosen forum contravenes strong public policy") (citations omitted). New York does not enforce choice of law provisions in contracts for labor or personal services. *See* N.Y. Gen. Oblig. Law § 5-1401.

a dispute will decide the law to apply before deciding the dispute, thereby increasing costs and uncertainty of the outcome. In a supply chain context, the choice of law clause should be specific and broad in scope such that the chosen law will apply to not only to contract interpretation, but also enforcement and claims of breach or non-performance and non-contractual obligations, such as claims in tort for damages caused by defective products provided pursuant to the supply contract. An example of a clause that demonstrates the parties' intent to designate the choice of law to be applied to all disputes and issues arising out of the contract provides: "This Agreement, the rights and obligations of the parties, and claims arising out of or related to this Agreement and performance under it. . . ."

Considerations of which law to choose for a supply contract include the jurisdiction's statutes and the existing case law interpreting and enforcing supply contracts. For example, the parties should consider the commercial code (generally referred to as the Uniform Commercial Code (UCC)), which can vary from state to state and country to country. In some cases, a supply contract should disclaim the application of certain UCC provisions to the agreement, including the express and implied warranties provided under UCC Article 2.[95] The parties should include any written warranties in an express agreement and clearly draft the appropriate disclaimers to avoid ambiguity.

The parties should also consider disclaiming applicability of the Convention on the International Sale of Goods (CISG), an international treaty developed by the United Nations Commission on International Trade Law. The CISG applies to international sales of goods between participants whose countries have adopted the CISG. As a ratified international treaty, the ICSG preempts state UCC law if not properly disclaimed. It is advisable for the parties to do so so that the contract's choice of law provisions will govern.

Many parties elect New York or Delaware law as choice of law (and choice of venue, as discussed later) for their supply contracts. A main reason for this selection is that both New York and Delaware have "bright-line requirements" allowing the parties to choose New York or Delaware to apply "even if the parties or the transaction have no connection to the state,"[96] and

95. Typically, these disclaimers benefit the seller. Article 2 provides that descriptions, samples, models, affirmations of fact, and promises are all express warranties. U.C.C. § 2-313. The UCC's implied warranties include: the implied warranty of merchantability, U.C.C. § 2-314(1); the implied warranty of fitness for particular purpose, U.C.C. § 2-315; the implied warranty of title, U.C.C. § 2-312(1); the implied warranty against infringement, U.C.C. § 2-312(3); the implied warranty from course of dealing, U.C.C. § 2-314(3); and the implied warranty from usage of trade, U.C.C. § 2-314(3).

96. *See Choice of Law and Choice of Forum: Key Issues*, Practical Law, https://us.practicallaw.thomsonreuters.com/7-509-6876 (last visited Aug. 2, 2020). Parties may choose New York law to apply if the transaction is worth at least $250,000, even if the transaction has no reasonable relationship to the state, with a few exceptions. N.Y. Gen. Oblig. Law § 5-1401. There are no exceptions to a New York court enforcing a New York choice of law provision if the transaction is worth at least $1 million. *Id.* § 5-1402. Similarly, Delaware allows parties to select Delaware

well-established precedent on commercial and contract issues. Given New York's and Delaware's predictable enforcement of choice of law provisions that designate the laws of New York and Delaware, respectively, as applicable law, as well as the established body of commercial decisions, it is no surprise that many agreements take advantage of the certainty of choosing New York or Delaware law to govern. There may be added benefits to choosing New York courts to resolve disputes in the supply contract context because sophisticated parties and cross-border transactions populate the jurisdiction and have undoubtedly influenced relevant case law.[97]

A related issue addresses the applicability of industry-specific laws and regulations, as well as the impact of industry standards on specific laws and regulations pertinent to the subject matter of the contract. Applicable law provisions directly incorporating industry-specific laws can be important, especially in cross-border agreements addressing whether the supplier is required to comply with laws pertinent to product origin and export in the United States, as well as the laws of the countries in which the products will be delivered and used. Additionally, the parties should address other laws that are likely to be implicated, such as industry-specific regulation in the food, transportation, and logistics areas.[98]

Further, the supply agreement should expressly incorporate laws pertaining to corporate social responsibility (CSR) to ensure compliance by suppliers with CSR-related due diligence and disclosure obligations.[99] Well-drafted CSR-policies and/or CSR-related provisions within supply agreements

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law to govern the agreement if (1) the transaction is worth at least $100,00; (2) the parties agree to adjudicate or arbitrate their disputes in Delaware; and (3) the parties may be served with legal process. Del. Code Ann. tit. 6, § 2708.

97. *See*, *e.g.*, *In re* Poseidon Concepts Secs. Litig., 2016 WL 3017395, at *9 (S.D.N.Y. May 24, 2016) (noting that as a financial center of the United States and the world, New York courts are accustomed to resolving securities disputes).

98. For example, the FDA has issued regulations applicable to the production of human or animal food under the Food Safety Modernization Act, including Current Good Manufacturing Practice, Hazard Analysis, and Risk-Based Preventive Controls for Human Food, 21 C.F.R. § 117.1 *et seq*.); Current Good Manufacturing Practice, Hazard Analysis, and Risk-Based Preventive Controls for Food for Animals, 21 C.F.R. § 507.1 *et seq*.; and Foreign Supplier Verification Programs for Importers of Food for Humans and Animals, 83 Fed. Reg. 3445 (May 25, 2018) (to be codified at 21 C.F.R. pt. 1).

99. In general, CSR refers to a company's business practices related to issues such as human rights, fair labor practices, the environment and ethical sourcing. *See* Paul Hirose, *Developing a CSR Supply Chain Compliance Program*, Practical Law, https://us.practicallaw.thomsonreuters.com/2-565-0547 (last visited Aug. 12, 2020). U.S. laws imposing supply chain due diligence and disclosure obligations include the Foreign Corruption Practices Act, 15 U.S.C. § 78dd-1 to 78dd-3; U.S. Travel Act, 18 U.S.C. § 1952; Food Safety Modernization Act, 21 U.S.C. §§ 2201–2252; Countering America's Adversaries Through Sanctions Act, Pub. L. No. 115-44, 131 Stat. 886 (2017)); United States-Mexico-Canada Agreement of 2018, Off. U.S. Trade Representative (Nov. 30, 2018), https://ustr.gov/trade-agreements/free-trade-agreements/united-states-mexico-canada-agreement/agreement-between (providing the full text of the treaty)); Conflict Minerals Rule, 17 C.F.R. § 240.13p-1; Federal Acquisition Regulations Anti-Trafficking Provisions (Strengthening Protections Against Trafficking in Persons in Federal Contracts), 77 Fed. Reg. 60,029 (Oct. 2, 2012). In addition, several states have enacted or proposed legislation mirroring federal law. *See* Cal. Civ. Code § 1714.43; Cal. Pub. Cont. Code § 10490; Md. Code Ann. State Fin. & Proc. § 14-413.

should, for example, require the supplier to meet minimum CSR-standards, cooperate with CSR audits and investigations, and report actual or potential CSR violations.[100]

2. Choice of Venue

The venue clause identifies the court in which a dispute will be heard. It is possible to have a different venue than the chosen law. Typically, a venue where the franchisor is located is the best option to reduce costs and other disruptions associated with these matters. Like applicable law provisions, courts generally will enforce the parties' choice of venue,[101] including in the limited court decisions considering choice of law and venue issues in the blockchain technology context.[102]

3. Alternative Dispute Resolution

Supply agreements often contain alternative dispute resolution (ADR) as a way to add certainty to the manner, location, and often speed at which disputes will be resolved. Considerations that go into whether to include an ADR clause include level of expense, complexity of procedures, and enforceability.

a. *Escalation of Claims Procedures, Mediation, and Conditions to Pursuing Claims*

Many supply agreements include a provision requiring the parties to make efforts to resolve a dispute before filing a claim (i.e., multi-tiered dispute resolution). Multi-tiered dispute resolution requires that the parties attempt to resolve a dispute with senior or executive-level settlement meetings and/or mandatory non-binding mediation with a third-party neutral before filing a claim. These provisions provide an opportunity to resolve potentially expensive litigation early. Further, many disputes concerning supply agreements/relationships often arise while the parties are still in business together and the opportunity to find business solutions not only present a potentially viable approach to achieving a resolution, but also a way to address the ongoing relationship and performance during the adjudicative and any winding down processes.

100. Neuburger, Choy & Mollod, *supra* note 30.

101. *See, e.g.*, Atl. Marine Constr. Co. v. U.S. District Court for the W. Dist. of Texas, 571 U.S. 49 (2013) (adopting, consistent with most federal courts and state courts, the standard from *Bremen v. Zapata Off-Shore Co.*, 407 U.S. 1 (1972), which requires a court find a choice of forum clause as presumptively valid unless doing so would be unreasonable). Most states and federal courts will apply only narrow exceptions to enforcing venue clauses under certain limited circumstances. *See Choice of Law and Choice of Forum: Key Issues*, Practical Law, https://us.practicallaw.thomsonreuters.com/7-509-6876 (last visited Aug. 2, 2020). For a description of historic analysis of foreign courts' evaluation and enforcement of forum selection clauses in cross-border contracts, *see* Hannah L. Buxbaum, *Forum Selection in International Contract Litigation: The Role of Judicial Discretion*, 12 Willamette J. Int'l L. & Disp. Resol. 185 (2004).

102. *See* Founder Starcoin, Inc. v. Launch Labs, Inc., 2018 WL 3343790, at *15 (S.D. Cal. July 8, 2018) (denying plaintiff's motion for preliminary injunction and implicitly accepting plaintiff's arguments that jurisdiction was proper in the U.S. District Court for the Southern District of California).

b. *Arbitration*

i. Scope

Defining the scope of the disputes and issues subject to arbitration is very important. Arbitration clauses are interpreted and enforced based on contract interpretation principles and the authority of the arbitrator is limited to the scope agreed to in the arbitration clause.[103] "Broad" clauses like "all disputes between the parties" and "all disputes arising out of the contract" are generally considered to encompass all disputes between the parties, including claims for fraudulent or negligent inducement of the entire supply agreement.[104]

An issue with recent court attention is whether the parties agreed to have the arbitrator decide "arbitrability," i.e. the scope of what is subject to the arbitration clause and what is not.[105] Generally, unless the parties clearly and unmistakably agree to have the arbitrability of a dispute decided by the arbitrator, it is for the court to decide.[106] Depending on the precise language, courts have split on whether a "broad" arbitration clause demonstrates a clear and unmistakable intent to authorize the arbitrator to decide the scope, as opposed to having a court decide the scope of the arbitrator's authority.[107]

It has become increasingly accepted that by incorporating rules of most arbitration organizations, parties to supply contracts clearly and unmistakably agree to have the arbitrator, and not the court, decide the scope of what is covered by the arbitrator. For example, the American Arbitration Association (AAA) Commercial Arbitration Rules, the Judicial Arbitration and Mediation Services (JAMS) Commercial Rules and many other ADR organizations expressly provide that the arbitrator(s) will decide the scope of the arbitration and the incorporation of such rules has frequently been

103. *See*, *e.g.*, First Options of Chicago, Inc. v. Kaplan, 514 U.S. 938, 944–45 (1995).

104. *See*, *e.g.*, Provident Bank v. Kabas, 141 F. Supp. 2d 310, 316 (E.D.N.Y. 2001) ("Arbitration clauses couched in language encompassing all disputes 'arising under' or 'in connection with' an agreement are referred to as the 'prototypical broad' arbitration provision justifying a presumption in favor of arbitration. . . . If the plaintiff's allegations 'touch matters covered by the parties'. . . agreements, then those claims must be arbitrated, whatever the legal labels attached to them.'") (citations omitted); *see also* Miller v. Flume, 139 F.3d 1130, 1136 (7th Cir. 1998); Pennzoil Exploration & Prod. Co. v. Ramco Energy Ltd., 139 F.3d 1061 (5th Cir. 1998); J.J. Ryan & Sons v. Rhone Poulenc Textile, 863 F.2d 315, 321 (4th Cir. 1988).

105. The Supreme Court, for example, recently reaffirmed that an arbitrator, not a court, should decide a threshold question of whether a dispute should be arbitrated if the parties have agreed that an arbitrator should decide questions of arbitrability. *See* Henry Schein, Inc. v. Archer & White Sales, Inc., 139 S. Ct. 524 (2019).

106. *See*, *e.g.*, *First Options*, 514 U.S. at 944.

107. "Questions of arbitrability . . . stay with the court *unless* there is clear and unmistakable evidence that the parties intended to submit such questions to an arbitrator." JPay, Inc. v. Kobel, 904 F.3d 923, 930 (11th Cir. 2018) (quotation and citation omitted); *see also* Metro. Life Ins. Co. v. Bucsek, 919 F.3d 184, 191 (2d Cir. 2019) (quoting Granite Rock Co. v. Int'l Bhd. of Teamsters, 561 U.S. 287, 296 (2010) ("[I]n the absence of an arbitration agreement that *clearly and unmistakably* elects to have the resolution of the arbitrability of the dispute decided by the arbitrator, the question whether the particular dispute is subject to an arbitration agreement 'is typically an issue for judicial determination.'") (emphasis added)).

held to remove from courts any authority to decide the scope.[108] The Ninth Circuit, for example, has held that incorporation of the AAA Commercial Arbitration Rules demonstrates the parties' intent to arbitrate questions of arbitrability,[109] and most other circuits have concluded the same.[110] However, this is not uniformly applied, particularly with respect to narrow arbitration clauses. For example, the Second Circuit has refused to compel arbitration notwithstanding the parties' incorporation of the AAA Commercial Arbitration Rules into their agreement because the arbitration clause carved out certain disputes from its purview.[111]

There may be some limits to this general rule in some of the jurisdictions that have recognized it. For example, although class actions are not common in supply contract disputes, some courts have limited application of the principle that incorporation of rules indicating arbitrability be decided by the arbitrator applies to class action waivers in arbitration clauses. Although a majority of circuit courts have held that an arbitration agreement's

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108. The AAA Commercial Arbitration Rules provide 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." Am. Arbitration Ass'n Com. Arbitration Rule 7(a). The FORUM's arbitrational rule similarly state: "An Arbitrator shall have the power to rule on all issues, claims, responses and objections regarding the existence, scope, and validity of the arbitration agreement, including all objections relating to jurisdiction. . . ." FORUM Code for Resolving Business to Business Disputes Rule 3.1(E). JAMS's rules similarly provides: "Jurisdictional and arbitrability disputes, including disputes over the existence, validity, interpretation or scope of the agreement under which Arbitration is sought, and who are proper Parties to the Arbitration, shall be submitted to and ruled on by the Arbitrator. The Arbitrator has the authority to determine jurisdiction and arbitrability issues as a preliminary matter." JAMS Comprehensive Arbitration Rules & Procs. Rule 11. Likewise, the International Institute for Conflict Prevention & Resolution (CPR) expressly provides that "The Tribunal shall have the power to hear and determine challenges to its jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement." 2018 CPR Non-Administered Arbitration Rule 8. CPR further provides: "This should allow arbitrators to decide all issues, including arbitrability questions, without the necessity for court intervention." *Id.* In its General Commentary to the Rules, CPR explains that Rule 8 is meant to express principles consistent with the U.S. Supreme Court's decision in *First Options of Chicago v. Kaplan*, 514 U.S. 938 (1995), and that the arbitrator(s) are to decide whether the arbitration will proceed in the face of a jurisdictional challenge. *Commentary to 2018 CPR Non-Administered Arbitration Rules*, CPR (Mar. 1, 2018), https://www.cpradr.org/resource-center/rules/arbitration/non-administered/2018-cpr-non-administered-arbitration-rules.

109. *See* Brennan v. Opus Bank, 796 F.3d 1125, 1130 (9th Cir. 2015).

110. Virtually every circuit court to address the issue has "concluded that the incorporation of arbitral rules substantively identical to those found in JAMS Rule 11(b) constitutes clear and unmistakable evidence of the parties' intent to arbitrate arbitrability." *See, e.g.*, Simply Wireless, Inc. v. T-Mobile US, Inc., 877 F.3d 522 (4th Cir. 2017), *abrogated on other grounds by* Henry Schein, Inc. v. Archer & White Sales, Inc., 139 S. Ct. 524 (2019); *see also* Richardson v. Coverall N. Am., Inc., 811 F. App'x. 100, 103 (3d Cir. Apr. 28, 2020) (holding that Rule 7(a) of the AAA Commercial Arbitration Rules is "about as "clear and unmistakable" as language can get"); Spirit Airlines, Inc. v. Maizes, 899 F.3d 1230 (11th Cir. 2018) (analyzing AAA Commercial Arbitration Rules, applying the AAA Supplementary Rules for Class Arbitrations, and holding the same).

111. NASDAQ OMX Grp., Inc. v. UBS Secs., LLC, 770 F.3d 1010, 1032 (2d Cir. 2014) (distinguishing Contec Corp. v. Remote Sol., Co., 398 F.3d 205, 208 (2d Cir. 2005) and holding that "[T]he . . . Agreement does not clearly and unmistakably direct that questions of arbitrability be decided by AAA rules; rather, it provides for AAA rules to apply to such arbitrations as may arise under the Agreement.").

incorporation of an arbitration forum's rules can reflect the parties' "clear and unmistakable" intent to delegate questions of arbitrability to the arbitrator, federal courts of appeals from the Third,[112] Fourth, Sixth and Eighth Circuits have held that incorporation of forum rules does not include delegation of authority to decide whether the parties' agreement permits class arbitration.[113] This same reasoning could be used to argue that whether the scope or enforceability of other waivers or limitations of claims in supply agreements are subject to arbitration must be decided by the courts unless the parties have clearly set forth their intent that those issues are also within the scope of the arbitration clause.

Because there may be situations in the supply chain context in which injunctive relief is important, it is typical to carve out from the scope of the arbitration requests for immediate injunctive relief. It is critical that the carve-out be express about both the scope of the carve-out and that injunctive relief is for the court to decide. It is recommended that the carve-out for injunctive relief indicate clearly that the relief is concurrent with arbitration; that is, a party seeking injunctive relief has the option to pursue the immediate injunctive relief in either arbitration or in a court (of the chosen venue).[114] Generally, the carve-out should relate to preliminary injunctive relief in aid of the arbitration, as well.

ii. Discovery

Most arbitration rules call for exchange of information and documents but traditionally have not included a right for the parties to take discovery or have permitted only limited discovery. Today, most commercial arbitration rules have some provisions concerning discovery, but it is often limited and heavily controlled by the arbitrator.[115] The parties, however, are permitted to agree in the arbitration clause to the limits and permitted scope of

112. The Third Circuit drew a questionable distinction between parties' ability to delegate some substantive issues of arbitrability from others. Despite acknowledging that federal courts of appeals have universally found that when parties agree to be bound by the AAA Commercial Rules, they delegate substantive arbitrability to arbitrators, the Third Circuit found that does not extend to the availability of class arbitration. *See* Chesapeake Appalachia, LLC v. Scout Petroleum, LLC, 2016 WL 53806, at *1 (3d Cir. 2015).

113. *See* Catamaran Corp. v. Towncrest Pharm., 864 F.3d 966, 972–73 (8th Cir. 2017); Dell Webb Cmty., Inc. v. Carlson, 817 F.3d 867, 876–77 (4th Cir. 2015); Reed Elsevier, Inc. *ex. rel.* LexisNexis Div. v. Crockett, 734 F.3d 594, 599–600 (6th Cir. 2013).

114. Most commercial arbitration rules, including the various international rules, have a process and procedure for emergency relief. *See*, *e.g.*, Am. Arbitration Ass'n Com. Arb. Rule 38; JAMS Comprehensive Arb. Rules & Procs. 2(c); 2018 CPR Non-Administered Arb. Rule 14. In the authors' experience, these procedures can be effective and efficient, but inconsistent in the speed with which injunctive relief is obtained. Further, if an injunction is obtained in arbitration, that award must be confirmed in a court to enforce it.

115. For example, JAMS has issued guidance on recommended discovery procedures in commercial cases. *See JAMS Recommended Arbitration Discovery Protocols for Domestic, Commercial Cases Effective January 6, 2010*, JAMS, https://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_Arbitration_ Discovery_Protocols.pdf (last visited Aug. 3, 2020).

discovery.[116] In the supply agreement dispute context, certain minimal discovery is likely to be very helpful to the franchisor, but permitting expansive (particularly electronically stored information (ESI)) discovery is of limited utility and significantly increases costs. Thus, the parties should review the rules they incorporate into an arbitration clause and include an arbitration provision with express rights and limits to permit an appropriate amount of discovery for a supply-related dispute, but limit the scope of discovery with respect to the number and length of depositions and document requests, especially with respect to ESI.

iii. Dispositive Motions

Because supply chain disputes, or substantial portions of them, are often susceptible to resolution by summary judgment, a franchisor should consider whether to include rules or procedures that expressly permit summary judgment.[117] Some arbitration rules permit parties to move for summary disposition,[118] but if not expressly provided in the rules or in the arbitration clause, there is an argument that the arbitrator does not have the authority to issue a summary judgment.[119] Even rules that permit a dispositive motion limit its application.[120] And even where there are clear grounds for authority, arbitrators remain wary of hearing and granting dispositive motions.[121] That said, where the parties clearly include the right to file dispositive motions in their

116. Volt Info. Scis., Inc. v. Bd. of Trs. of Leland Stanford Junior Univ., 489 U.S. 468, 478 (1989) (applying the FAA and holding that "[i]t . . . requires courts to enforce privately negotiated agreements to arbitrate, like other contracts, in accordance with their terms").

117. A number of issues may be decided on summary judgment based on the provisions and language of the supply contract. *See* Pinova, Inc. v. Quality Mill Serv., Inc., 2015 WL 1224611, at *3–4 (S.D. Ga. Mar. 17, 2015) (noting that the enforceability of loss profits or similar type damages barred by provisions limiting or barring consequential damages or limiting available remedies to repair or replace); Iron Dynamics v. Alstom Power, Inc., 2007 WL 3046430, at *5 (N.D. Ind. Oct. 15, 2007) (enforceability of disclaimed warranties). Another issue that may be decided is statutory or contractual limitations. For example, appellate courts have affirmed the grant of summary judgment decisions regarding whether the breach of contract claims had been brought within the four-year statute of limitations period provided under the UCC. *See* Apex Digital, Inc. v. Sears Roebuck & Co., 735 F. 3d 962, 966–67 (7th Cir. 2013); Badwey Oil, Inc. v. ConocoPhillips Petroleum Co., 352 F. App'x 276, 290 (10th Cir. 2009); Thein Well Co. v. Dresser Pump., 1996 WL 285828, at *1 (8th Cir. May 30 1996).

118. *See* Am. Arb. Ass'n Com. Arb. Rule 33 (arbitrator may allow party to file a dispositive motion if arbitrator determines moving party has shown likelihood of success to dispose or narrow case); JAMS Comprehensive Arb. Rules & Procs. 18 (arbitrator may permit party to file a motion for summary disposition so long as other parties have reasonable notice to respond to motion); Fin. Indus. Reg. Auth. Rules Code of Proc. § 9264 (outlining procedure for moving for summary disposition); 2018 CPR Non-Administered Arb. Rule 12.6 (dealing with early disposition of claims, defenses and other factual and legal issues).

119. A party may challenge disposal of claims or disposal of the entire case in arbitration on grounds that the arbitrator exceeded his or her authority in considering certain claims or making certain findings on which summary disposition depends. *See, e.g.*, Davis v. Chevy Chase Fin. Ltd., 667 F.2d 160 (D.C. Cir. 1981) (arbitrator exceeded authority in making certain findings because of narrowness of applicable arbitration clause).

120. *See supra* note 114 (citing various arbitral rules).

121. For example, a 2013 survey found that seventy percent of arbitrators had granted a dispositive motion fewer than five times. Edna Sussman, *The Arbitrator Survey—Practices, Preferences and Changes on the Horizon*, 26 Am. Rev. Int'l Arb. 517, 523 (2015).

arbitration clause, by express provision or incorporation of rules that so provide, courts will enforce the award granting a dispositive motion.[122] There are a few cases where courts vacated a summary award. Generally, these cases turn on a complete failure of the arbitrator to consider evidence.[123]

III. Conclusion

Blockchain is now recognized as the notorious "disrupter" of commercial contracting, on the verge of revolutionizing the nature of commercial contracting in any context, but particularly for supply networks where trust and verification are key relationship benchmarks, as is commonly also found in transportation, banking, finance, government, healthcare, and energy

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122. Sherrock Bros., Inc. v. DaimlerChrysler Motors Co., LLC, 260 F. App'x 497, 499 (3d. Cir. 2008) (affirming a summary adjudication issued on res judicata and collateral estoppel grounds); S. City Motors, Inc. v. Auto. Indus. Pension Trust Fund, 2018 WL 2387854, at *4 (N.D. Cal. May 25, 2018) (affirming summary disposition, citing a long line of precedent in stating that "[t]he purpose of arbitration is to permit parties to agree to a more expedited and less costly means to resolve disputes than litigation in the courts. Summary judgment by an arbitrator is consistent with that purpose"); Ozormoor v. T-Mobile USA Inc., 2010 WL 3272620, at *4 (E.D. Mich. Aug. 19, 2010) (affirming a summary adjudication issued on statute of limitation grounds); Global Int'l Reinsurance Co. Ltd. v. TIG Ins. Co., 2009 WL 161086, at *5 (S.D.N.Y. Jan. 21, 2009) (affirming a summary adjudication issued on plain meaning of contract grounds); LaPine v. Kyocera Corp., 2008 WL 2168914, at *10 (N.D. Cal. May 23, 2008) (affirming a summary adjudication issued on waiver and estoppel grounds); Hamilton v. Sirius Satellite Radio Inc., 375 F. Supp. 2d 269, 273, 277 (S.D.N.Y. 2005) (affirming a summary adjudication issued on insufficient evidence grounds); Warran v. Thacher, 114 F. Supp. 2d 600, 602 (W.D. Ky. 2000) (affirming a summary adjudication on failure to state a claim grounds); Max Marx Color & Chem. Co. Emps.' Profit Sharing Plan v. Barnes, 37 F. Supp. 2d 248, 255 (S.D.N.Y. 1999) (affirming a summary adjudication issued on standing and preemption grounds); Intercarbon Bermuda, Ltd. v. Caltex Trading & Transp. Corp., 146 F.R.D. 64, 74 (S.D.N.Y. 1993) (affirming a summary adjudication issued without holding in-person evidentiary hearings); Atreus Cmtys. Grp. of Ariz. v. Stardust Dev., Inc., 277 P.3d 208, 213 (Ariz. Ct. App. May 1, 2012) (affirming a summary adjudication even though the parties' arbitration agreement did not expressly allow for such authority); Pegasus Constr. Corp. v. Turner Constr. Co., 929 P.2d 1200, 1203 (Wash. Ct. App. 1997) (affirming a summary adjudication issued on failure to comply with contractual obligations grounds); Schlessinger v. Rosenfeld, Meyer & Susman, 47 Cal. Rptr. 2d 650, 659–60 (Cal. App. Ct. 1995) (upholding summary adjudication by arbitration). *See also* Samaan v. Gen. Dynamics Land Sys., 835 F.3d 593, 603–05 (6th Cir. 2016) (affirming summary adjudication issued without an evidentiary hearing); NFL Mgmt. Council v. NFL Players Ass'n, 820 F.3d 527, 547–48 (2d Cir. 2016) (affirming a summary adjudication issued for failure to state a claim); S. City Motors, Inc. v. Auto. Indus. Pension Trust Fund, 2018 U.S. Dist. LEXIS 88452, at *8 (N.D. Cal. May 25, 2018) (affirming a summary adjudication issued without full evidentiary hearing); McGee v. Armstrong, 2017 U.S. Dist. LEXIS 129734, at *10 (N.D. Ohio Aug. 15, 2017) (affirming a summary adjudication issued on all claims); Weirton Med. Ctr. v. Cmty. Health Sys., 2017 LEXIS 203725, at *13–14 (N.D. W. Va. Dec. 12, 2017) (upholding a summary award even though the parties' arbitration agreement did not expressly allow for such authority); Balberdi v. FedEx Ground Package Sys., 209 F. Supp. 3d 1160, 1162, 1168 (D. Haw. 2016) (affirming a summary adjudication issued on statute of limitations grounds); Kuznesoff v. Finish Line, Inc., 2015 U.S. Dist. LEXIS 71388, at *4, *11 (M.D. Pa. June 3, 2015) (affirming a summary adjudication issued on statute of limitation and failure to state a claim grounds); Tucker v. Ernst & Young LLP, 159 So. 3d 1263, 1285 (Ala. 2014) (affirming a summary adjudication issued on all claims).

123. *See, e.g.*, Int'l Union, United Mine Workers of Am. v. Marrowbone Dev. Co., 232 F.3d 383 (4th Cir. 2000) (arbitrator failed to consider evidence pertaining to the parties' current dispute).

transactions. Claims about blockchain technology range from praise of it being efficient, cost-reducing, and disciplined, to dismissive as it being over-hyped. It is no doubt evolving and maturing as are its users and customers. Its key benefits of use—existence, ownership, tracking and storage, particularly for food, apparel, and other goods—have improved the ability of supply chains to facilitate payment, trace, and track. At this point it seems likely that use of blockchain technology will expand into other industries, which will continue to drive improvements in quality, cost, service, and customer satisfaction. Determining whether blockchain technology is right for any company will require a keen assessment of business needs, available structure and flexibility, vendor engagement, and appetite for risk leading to potential building and testing of the technology. In the supply chain context, the drive to try and test should prove as irresistible as the drive to remain competitive.

Franchisors adopting blockchain technology and smart contracts will need to consider supply contract enforcement and dispute resolution issues. A well-drafted hybrid smart contract that addresses choice of law, choice of venue, and dispute resolution procedures will help franchisors avoid liability and create strong supply chain relationships while the franchisor operates on blockchain technology.

Enforcement of Settlement Agreements That Provide for Vacatur of Prior Rulings: Can Those Rulings Still Be Used as Collateral Estoppel?

*Charles G. Miller**

I. Introduction

Mr. Miller

Parties desiring to settle cases often attempt to do so after there has been a judicial decision in favor of one of the parties and against the other. The losing party may insist that as part of the settlement, the decision be vacated, especially where there might be other pending or anticipated litigation involving the same or similar issues.[1] Franchise litigation often involves disputes over the meaning of the terms of a standard franchise agreement or the application of standard franchise system policies or procedures. In this context, a franchisor that receives an adverse ruling on a key issue may want to do everything possible in a settlement to ensure that the ruling is not used against it in other litigation, either offensively or defensively, under the doctrine of collateral estoppel.[2] Another reason a franchisor may want to vacate a prior ruling is to attempt to avoid having to disclose the prior ruling in its franchise disclosure document (FDD).[3]

1. As discussed later at Part III, a vacation of a judgment may not prevent operation of res judicata or collateral estoppel.

2. Another franchisee who has the same issue as the franchisee who secured the favorable prior ruling may wish to proceed against the franchisor and will attempt to argue that the prior ruling is binding on the franchisor without having to relitigate the issue. This is known as offensive collateral estoppel. *See*, *e.g.*, Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326 n.4 (1979). Similarly, a franchisee may want to prevent the franchisor from bringing a claim against it that it lost in a previous matter. This is known as defensive collateral estoppel. *See*, *e.g.*, Blonder-Tongue Labs., Inc. v. Univ. of Illinois Found., 402 U.S. 313 (1971). In addition, even if not technically binding, the prior precedent in either situation is likely to be highly persuasive.

3. *See* 16 C.F.R. § 436.5(C)(3)(iii) (requiring disclosure of certain civil actions where the franchisor was held liable but not addressing the disclosure of those actions where the judgment has been vacated pursuant to stipulation).

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Of course, vacatur cannot be accomplished without a court order. Even if the parties stipulate to vacatur as part of a settlement, there is no guaranty the court will vacate the ruling. Litigants often assume that obtaining a vacatur in support of a settlement will be simple. After all, courts proactively encourage settlement and have adopted various procedures that require the parties to engage in some form of alternative dispute resolution. However, there are countervailing considerations to vacation, primarily avoidance of the public perception that private litigants can pay to remove bad precedent and the loss to the community of well-reasoned precedent. Currently, there is a split between the federal and state courts about whether a stipulation of the parties will result in the automatic vacation of an earlier judgment or decision.[4]

State courts generally allow the parties more control of the litigation process and will vacate judgments or rulings when requested by the parties in order to advance the overriding public purpose of settlement. Federal courts, led by the U.S. Supreme Court, permit vacatur pursuant to stipulation only in extraordinary circumstances. However, the trend is that when vacatur is a key condition of the settlement, federal courts will conclude there is an "extraordinary circumstance," even though the U.S. Supreme Court has cautioned that the "mere fact" that the settlement agreement provides for vacatur does not make a circumstance extraordinary. Further, if the settlement agreement provides that the vacated judgment should not be used as collateral estoppel, some courts will require the parties to show the impact of such a determination on the rights of non-parties before approving the settlement.[5] This could prove important in franchise cases involving an issue common to all or most franchisees and could be a stumbling block to obtaining court approval in those jurisdictions.

This article will discuss the leading state and federal cases dealing with the issue of stipulated vacatur (Part II); discuss whether a stipulated vacated judgment will nonetheless be given collateral estoppel effect (Part III); discuss whether the stipulated vacated judgment must be disclosed in an FDD (Part IV); and provide drafting suggestions to avoid some of the issues raised by the cases regarding vacatur (Part V).

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4. The subject of vacatur through stipulation has been the subject of a fair degree of academic commentary as well. *See*, *e.g.*, Jill E. Fisch, *Rewriting History: the Propriety of Eradicating Prior Decisional Law Through Settlement and Vacatur*, 76 Cornell L. Rev. 589 (1991); Steven R. Harmon, *Unsettling Settlements: Should Stipulated Reversals be Allowed to Trump Judgments' Collateral Estoppel Effects Under* Neary, 85 Cal. L. Rev. 479 (1997); Judith Resnik, *Whose Judgment? Vacating Judgments, Preferences for Settlement, and the Role of Adjudication at the Close of the Twentieth Century*, 41 UCLA L. Rev. 1471 (1994); Henry Klingerman, *Settlement Pending Appeal: An Argument for Vacatur*, 58 Fordham L. Rev. 233 (1989); Michael Loudenslager, *Erasing the Law: The Implications of Settlements Conditioned upon Vacation of Reversal of Judgments*, 50 Wash. & Lee L. Rev. 1229 (1993); Seth Nesin, *The Benefits of Applying Issue Preclusion to Interlocutory Judgments in Cases That Settle*, 76 N.Y.U. L. Rev. 874 (2002); William D. Zeller, *Avoiding Issue Preclusion by Settlement Conditioned upon the Vacatur of Entered Judgments*, 96 Yale L.J. 860 (1987).

5. *See, e.g.*, Bates v. Union Oil Co., 944 F.2d 647, 649–52 (9th Cir. 1991); Ringsby Truck Lines, Inc. v. W. Conf. of Teamsters, 686 F.2d 720, 722 (9th Cir. 1982).

II. The Legal Landscape of Vacatur Through Settlement

A. *State Court Decisions*

In 1992, the California Supreme Court decided *Neary v. Regents of the University of California*,[6] which is one of the leading state court cases on the subject of vacatur through settlement. In that case, the plaintiff had won a multimillion dollar jury verdict against the University of California based on a false report it had published concerning his ranch management practices. Both sides appealed, and while the appeal was pending, the parties settled the case. The settlement provided for the California Court of Appeal to vacate the judgment of the trial court, and the parties requested the appellate court do so. The appellate court rejected the request. The California Supreme Court reversed, holding that there is a presumption in favor of vacatur where the parties have so stipulated, unless there are extraordinary circumstances warranting against vacatur. The decision was controversial, so much so that seven years later the California legislature enacted legislation superseding *Neary*. The new legislation provided that an appellate court cannot reverse or vacate a judgment pursuant to a stipulation of the parties unless it determined that the interests of third parties or the public would not be adversely affected and the reasons for reversal outweigh the erosion of public trust.[7] *Neary* left open whether a court should consider the loss of collateral estoppel by a vacated judgment as a factor.[8] The amended statute, however, made clear that it is a consideration if the appellate courts were inclined to vacate the decision.[9]

Nonetheless, it is important to understand the reasoning of *Neary* because it is still good law as to the actions by California trial courts (as the statute applies only to actions by the appellate courts) and still may be persuasive in jurisdictions where the question is open. *Neary* is premised on the notion that courts exist for the litigants and not the other way around.[10] In reaching this conclusion, the California Supreme Court rejected many of the policy reasons against stipulated vacatur. The court explained that vacatur through settlement does not trivialize the judicial process. According to the court, "[t]he real value of the judicial pronouncement—what makes it a proper judicial resolution of a 'case or controversy' rather than an advisory opinion—is in the settling of some dispute *which affects the behavior of the*

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6. Neary v. Regents of the Univ. of Cal., 834 P.2d 119 (Cal. 1992).

7. *See* Cal. Civ. Proc. Code § 128(a)(8) ("(a) Every court shall have the power to do all of the following: . . . (8) To amend and control its process and orders so as to make them conform to law and justice. An appellate court shall not reverse or vacate a duly entered judgment upon an agreement or stipulation of the parties unless the court finds both of the following: (A) There is no reasonable possibility that the interests of nonparties or the public will be adversely affected by the reversal. (B) The reasons of the parties for requesting reversal outweigh the erosion of public trust that may result from the nullification of a judgment and the risk that the availability of stipulated reversal will reduce the incentive for pretrial settlement.").

8. *Neary*, 834 P.2d at 125.

9. *See* Cal. Civ. Proc. Code § 128(a)(8).

10. *Neary*, 834 P.2d at 123 ("The courts exist for litigants. Litigants do not exist for courts.").

defendant towards the plaintiff."[11] Vacatur thus advanced the overarching purpose of the judicial process: to resolve cases, including through settlement.[12]

Second, while preservation of precedent may be a laudable purpose, the court noted that trial court decisions do not make binding precedent on third-parties like appellate courts do.[13] To the extent that a decision may have precedential value, court records are still open to the public and still can provide a resource to the public.[14] The dissenting opinion, however, argued that a stipulated settlement calling for vacatur had the effect of eroding public confidence in the judiciary as it could be viewed as simply buying a particular result.[15] The majority seemingly answered this concern by emphasizing that the purpose of court proceedings is to resolve cases.[16]

Other state courts that have dealt with the issue have, as a general rule, followed the stipulation of the parties and vacated the earlier ruling, and they have not taken into consideration the collateral estoppel effects.[17] As discussed later in Part III, some courts that have decided that a judgment vacated through settlement can still be used for collateral estoppel purposes. However, where the law in a particular jurisdiction is that a judgment vacated pursuant to a settlement cannot be used for collateral estoppel purposes, it would not be surprising for a court to consider the potential collateral estoppel effect of the decision in determining whether to approve the settlement. This would certainly undermine one of the primary reasons a franchisor would want to settle—to vacate a prior adverse ruling.

11. *Id.* at 124 (quoting Hewitt v. Helms, 482 U.S. 755, 761 (1987)).

12. *Id.* ("This conclusion is based on the Court of Appeal's faulty premise that litigation is a search for 'legal truth,' not 'simply a dispositional act.' This puts the abstract cart before the practical horse. The primary purpose of the public judiciary is 'to afford a forum for the settlement of litigable matters between disputing parties.' We do not resolve abstract legal issues, even when requested to do so. We resolve real disputes between real people. This function does not undermine our integrity or demean our function. By providing a forum for the peaceful resolution of citizens' disputes, we provide a cornerstone for ordered liberty in a democratic society.") (internal citations omitted).

13. *Id.* at 124.

14. *Id.*

15. *Id.* at 127 ("Public respect for the courts is eroded when this court decides that a party who has litigated and lost in the trial court can by paying a sum of money sufficient to secure settlement conditioned on reversal, purchase the nullification of the adverse judgment.") (Kennard, J., dissenting).

16. *Id.* at 124.

17. State v. Charlotte Hungerford Hosp., 60 A.3d 946 (Conn. 2013) (judgment vacated due to mootness on settlement); Schlitz v. Schlitz, 138 So. 2d 806 (Fla. Dist. Ct. App. 1962) (judgment vacated based on stipulation for settlement); Barnett v. Moss, 106 S.E.2d 60 (Ga. Ct. App. 1958) (judgment vacated based on stipulation for settlement); State *ex rel.* Nixon v. Vacation Travel, LLC, 241 S.W.3d 433 (Mo. Ct. App. 2007); State *ex rel.* Chastain v. City of Kansas City, 968 S.W.2d 232 (Mo. Ct. App. 1998) (judgment vacated due to mootness on settlement); Young Materials Corp. v. Smith, 4 S.W.3d 84 (Tex. App. 1999) (on settlement, court had authority to vacate under applicable appellate rules); Polley v. Odom, 963 S.W.2d 917 (Tex. App. 1998) (the court took an interesting approach by publishing the decision but vacated the judgment, perhaps getting the best of both worlds); *but see* Kerr v. Bradbury, 131 P.3d 737 (Or. 2006) (following federal court decisions and holding that vacation would not result from a settlement due to the fact that by settling the parties gave up their right to appeal).

B. *Federal Decisions*

1. The U.S. Supreme Court

The leading federal case on vacation of judgments as part of a settlement is the U.S. Supreme Court's decision in *U.S. Bancorp Mortgage Co. v. Bonner Mall Partnership*.[18] Despite being handed down several years after *Neary*, the decision did not even mention *Neary*. In fact, *Bonner Mall* held the opposite of *Neary*: that vacatur should not be granted unless there were extraordinary circumstances shown in its favor.[19]

In *Bonner Mall*, the case was settled after the Ninth Circuit had affirmed a ruling by the district court reversing the bankruptcy court[20] and certiorari had been granted. The parties agreed that the case was moot by virtue of the settlement, which was embodied in a bankruptcy confirmation plan, but did not address whether the judgment of the Ninth Circuit affirming the district court's reversal of the bankruptcy court should be vacated.[21] One of the parties requested the Supreme Court vacate the Ninth Circuit's judgment and the other party opposed it. The confirmation plan was not conditioned upon a vacation of the judgment, which would prove to be important, as noted by later federal cases distinguishing *Bonner Mall*.[22]

The Court denied the motion to vacate the judgment on settlement or mootness grounds because settlement constituted a voluntary choice to forego what might happen on appeal.[23] In other words, the Court reasoned that one result of a successful appeal would be vacation or reversal of the judgment, but by settling, the parties had given up the possibility of that outcome. The Court also stressed the "public interest factor"—the public's interest in the creation and certainty of judicial precedent—which it held cannot be surrendered to private parties and is not the "property of private litigants."[24] This conclusion was the opposite to the reasoning in *Neary*.[25] The most logical argument advanced in favor of vacatur was that it facilitated settlement, a worthwhile goal, and the one relied upon in *Neary*.[26] However, that argument was still not good enough for the Court because it found that the availability of vacatur encourages parties to "roll the dice" if they think

18. U.S. Bancorp Mortgage Co. v. Bonner Mall P'ship, 513 U.S. 18 (1994).

19. *Id.* at 29.

20. The bankruptcy court had suspended the automatic stay of the bank's foreclosure because it determined that the reorganization plan (the foundation for the automatic stay) was not confirmable as a matter of law. *Id.* at 20.

21. *Id.* at 20.

22. *See*, *e.g.*, *infra* Part II(B)(2).

23. *Bonner Mall*, 513 U.S. at 25. The Court's focus on voluntariness stemmed from its decision in *United States v. Munsingwear*, Inc., 340 U.S. 36, 40 (1950), where it chose not to vacate a judgment in a companion antitrust case that had become moot because of a change in the challenged regulation. The Court indicated that it likely would have vacated the decision if someone had moved it to do so because the mootness was caused by happenstance, not the voluntary act of the parties. *Bonner Mall*, 513 U.S. at 39.

24. *Id.* at 27.

25. *See supra* Part II(A).

26. Neary v. Regents of the Univ. of Cal., 834 P.2d 119, 125 (Cal. 1992).

they can get the judgment vacated upon settlement. In the Court's view, that failsafe diminished litigants' skin in the game, which fosters more, not less, litigation.[27] The Court did leave the door open to approve vacatur in "exceptional circumstances," but did not define what would constitute exceptional circumstances.[28] The Court made clear, however, that exceptional circumstances did not include the "mere fact" that the settlement agreement provided for vacatur.[29]

2. Subsequent Federal Decisions

Bonner Mall did not involve a situation where the parties expressly conditioned settlement on vacatur. Several subsequent cases, discussed next, latched onto this factual nuance to distinguish *Bonner Mall* and find that exceptional circumstances existed. These cases regard the court's involvement in the settlement process as impacting the voluntariness of the settlement.

In *Motta v. Immigration & Naturalization Services*, the First Circuit found "exceptional circumstances" to vacate a lower court judgment because the court was in some way involved in urging settlement.[30] In that case, the First Circuit suggested that the parties settle during oral argument.[31] The INS indicated an interest in settlement if the lower court's judgment was vacated.[32] The parties then discussed settlement and the INS informed the First Circuit that it was agreeable to settle, but did not state that its agreement was conditioned on vacatur.[33] Nonetheless, the court vacated the judgment on its own initiative holding that "exceptional circumstances" existed.[34] The court distinguished *Bonner Mall* because the settlement resulted from the court's prompting.[35] The court explained its involvement supported a determination that the decision to settle was not entirely voluntary and, thus, would not be considered a voluntary relinquishment of an appeal.[36] Because of the court's involvement, the case also did not implicate the other concern raised in *Bonner Mall*—giving the parties "undue control over judicial precedents."[37] The decision also emphasized that the primary purpose of settling by the INS was to avoid bad precedent, which may not be the case if the settling party is not a repeat player, like the INS.[38] A franchisor could find itself in a similar

27. *Bonner Mall*, 513 U.S. at 28.
28. *Id.* at 29.
29. *Id.* ("It should be clear from our discussion, however, that those exceptional circumstances do not include the mere fact that the settlement agreement provides for vacatur—which neither diminishes the voluntariness of the abandonment of review nor alters any of the policy considerations we have discussed.").
30. Motta v. INS, 61 F.3d 117 (1st Cir. 1995).
31. *Id.* at 118.
32. *Id.*
33. *Id.*
34. *Id.* at 119.
35. *Id.* at 118.
36. *Id.*
37. *Id.*
38. *Id.*

position when it faces potential suits by other franchisees involving a common provision in the franchise agreement.

In *Major League Baseball Properties, Inc. v. Pacific Trading Cards, Inc.*,[39] the Second Circuit followed *Motta* and also found exceptional circumstances justifying vacatur.[40] In that case, the defendant was threatening to distribute baseball cards depicting major league players in major league approved uniforms without first obtaining a license from Major League Baseball (League). The trial court denied a motion by the League for a preliminary injunction. The League appealed and sought an injunction pending appeal. The Second Circuit encouraged mediation, and the parties advised that they would settle if the district court's order was vacated.[41] Vacatur was important to the League because the case involved trademark infringement and having that adverse precedent remain would be risky for future litigation. Specifically, if the trial court decision remained in place, the League could be deemed to have acquiesced to the use of its trademarks, which would run the risk of losing trademark protection for its extremely valuable marks. These were exceptional circumstances that might not be present in commercial disputes not involving trademarks. However, another important factor was that the decision to settle was instigated by the court, impacting the voluntariness of the decision.

It is not surprising that vacatur might be granted where it is a key condition of a settlement, notwithstanding that the settlement was not in any way prodded by the court. In *Board of Trustees of the University of Alabama v. Houndstooth Mafia Enterprises LLC*, the U.S. District Court for the Northern District of Alabama enforced a settlement agreement that vacated a prior ruling of the U.S. Patent and Trademark Office's Trademark Trial and Appeal Board precisely because the settlement agreement was conditioned on vacatur of that earlier ruling.[42] The district court expressly distinguished *Bonner Mall* because it did not involve a settlement provision that required vacatur and explained:

> Indeed, there was no provision in the [Bonner Mall] settlement where the parties agreed to ask the Court to vacate the circuit court's decision. Thus, the question the Supreme Court actually faced in [Bonner Mall] was this: Is the mere settlement of a case on appeal (or certiorari review) grounds, in and of itself, enough for a reviewing court to vacate the civil judgment of a subordinate court?[43]

39. Major League Baseball Props., Inc. v. Pac. Trading Cards, Inc., 150 F.3d 149 (2d Cir. 1998).

40. *Id.* at 152.

41. *Id.* at 151.

42. Trs. of the Univ. of Ala. v. Houndstooth Mafia Enters., 163 F. Supp. 3d 1150 (N.D. Ala. 2016).

43. *Id.* at 1158.

After distinguishing *Bonner Mall*, the district court relied on *Motta* and *Major League Baseball* and enforced the consent judgment that vacated the prior order.[44]

A few months later, the Eleventh Circuit made it clear in *Hartford Casualty Insurance v. Crum & Forster Specialty Insurance*[45] that a settlement expressly conditioned on vacatur of an earlier judgment could justify vacatur. There, the parties settled while an appeal was pending, expressly conditioning the settlement on vacation of the lower court's judgment.[46] The parties then sought a vacatur from the trial court. It refused to grant the joint motion to approve the settlement, reasoning that, despite the fact that the settlement was conditioned on vacating the judgment, the settlement was nonetheless voluntary and, thus, it acted as a waiver of appellate rights and the judgment was final.[47] The district court further rejected the reasoning of *Motta* and *Major League Baseball.*[48]

The Eleventh Circuit reversed, making it clear that conditioning the settlement on vacatur was not the same as forfeiting the right to appeal, thus paving the way for vacatur to be achieved where it was a key condition of the settlement, even if the court had no involvement.[49] By its very nature, requiring vacatur as part of the settlement was implicitly viewed as recognizing what could happen on appeal and was not the same as an abandonment or relinquishment of rights on appeal.[50] The Eleventh Circuit also correctly predicted that a contrary view would result in vacatur never being granted:

> Although any valid settlement will, of course, be "voluntary" and in some sense put an end to the dispute at hand, to conclude that a settlement *conditioned* on vacatur indicates a voluntary forfeiture of appellate review would eliminate the possibility that any settlement would ever warrant vacatur. Adopting such a reading of "exceptional circumstances"—that is, categorically denying that any such "exceptional circumstances" exist—would be inconsistent with the Supreme Court's express language in [*Bonner Mall*] and the equitable nature of that decision.[51]

It is interesting that the Eleventh Circuit did not refer to *Bonner Mall's* caution that "exceptional circumstances do not include the mere fact that the settlement agreement provides for vacatur—which neither diminishes the voluntariness of the abandonment of review nor alters any of the policy considerations we have discussed."[52] Ignoring this statement was potentially justifiable because it is technically dicta. Bonner Mall did not involve

44. *Id.* at 1161.
45. Hartford Cas. Ins. v. Crum & Forster Specialty Ins., 82 F.3d 1331 (11th Cir. 2016).
46. *Id.* at 1333.
47. *Id.*
48. *Id.*
49. *Id.* at 1336.
50. *Id.* ("As that agreement is expressly conditioned on the District Court's orders being vacated, this is not the case of an appellant 'voluntarily forfeit[ing] his legal remedy by the ordinary processes of appeal or certiorari.' *Cf. Bancorp*, 513 U.S. at 25–26.").
51. *Id.*
52. U.S. Bancorp Mortg. Co. v. Bonner Mall P'ship, 513 U.S. 18, 29 (1994).

a settlement agreement that was conditioned on vacatur. Also, this standard could be interpreted as inapplicable where vacatur is the key consideration to a settlement. If it were the key consideration, then it would not be a "mere fact" in a settlement agreement. The Eleventh Circuit, however, did not discuss these points.

Based on this precedent from three circuit courts, it is likely that most federal courts will vacate prior orders when requested to do so by the parties where the vacatur is a key component of the settlement agreement. It obviously adds more weight when one of the parties is a repeat player, which is likely to happen in franchise litigation where decisions are handed down regarding franchise agreements or practices that impact a large number of franchisees. Indeed, a franchisor wishing to avoid bad precedent will be in the same shoes as the INS or the League and should rely heavily on *Motta* and *Major League Baseball*. Where a franchisee challenges a provision in the franchise agreement that similarly affects other franchisees and wins, there is a strong likelihood that other franchisees will want to take similar action and rely on that judgment. The franchisor would want to avoid that by vacating the ruling. Also, many franchise disputes involve trademark issues. A franchisor would have a strong interest in setting aside an adverse decision concerning its mark in order to avoid any argument that it has acquiesced or abandoned its mark.

On the other hand, other factors could mitigate against vacatur, where, for example, the prior decision is well reasoned and has been relied upon by other courts. An important consideration will be whether the decision sought to be vacated should be given collateral estoppel effect, as discussed in Part III. The determination on vacatur will likely have to be made case-by-case.

III. Can the Vacated Judgment Be Used for Collateral Estoppel Purposes?

A. *Is it final or sufficiently firm?*

As noted earlier, one of the primary purposes for parties to seek a vacatur as part of a settlement is to prevent the judgment from being used in future litigation. In franchise litigation, this is a prime motivator where there exists the possibility that other franchisees will want to take advantage of an adverse ruling through offensive or defensive collateral estoppel, even though they were not parties to the litigation.

The elements of collateral estoppel are well settled. They are 1) the issue sought to be precluded must be the same as that involved in the prior action, 2) the issue must have been actually litigated, 3) the determination of the issue must have been essential to the final judgment, and 4) the party against whom estoppel is invoked must be fully represented in the prior action.[53]

53. La Preferida, Inc. v. Cerveceria Modelo, S.A. de C.V., 914 F.2d 900, 905–06 (7th Cir. 1990); *see also* e.Digital Corp. v. Futurewei Techs., Inc., 772 F.3d 723, 726 (Fed. Cir. 2014)

Collateral estoppel can be used offensively and defensively by parties who were not parties to the original litigation. Defensive collateral estoppel is when a defendant seeks to use a prior ruling to prevent a plaintiff from raising a claim or issue that the plaintiff previously asserted and lost. Offensive collateral estoppel is when a plaintiff seeks to use a prior ruling to prevent a defendant from relitigating an issue.[54] A good example of offensive collateral estoppel is where one franchisee has been successful against a franchisor and a different franchisee attempts to use that earlier judgment against the franchisor. It is not necessary that the second franchisee be bound by the earlier judgment in order to be able to use it. It is enough that the defendant was afforded a "full and fair opportunity" to litigate.[55]

Finality of the judgment plays an important role in determining if collateral estoppel will apply. The general rule in many jurisdictions is that a judgment that has been vacated cannot be used for purposes of collateral estoppel because there is no final judgment.[56] Yet, some federal courts dealing with this issue have held that a judgment or order vacated *as part of a settlement* may nonetheless be used against the losing party in subsequent litigation so long as it is suffiently firm to qualify as fully litigated.[57] The key issue is whether the requirement of "finality" is met even though the prior judgment has been vacated pursuant to stipulation or settlement.[58] It would seem logical that a vacated judgment should not be considered final, but that may not be the case where, before vacatur or settlement, the case had reached a point that the decision would be considered "sufficiently firm," as discussed later. A related issue is whether the court asked to approve a settlement calling for vacatur should consider the collateral estoppel implications, assuming that vacatur would cause the judgment to lose any preclusive effect.

(collateral estoppel applies if: "(1) the issue necessarily decided in the previous proceeding is identical to the one which is sought to be relitigated; (2) the first proceeding ended with a final judgment on the merits; and (3) the party against which collateral estoppel is asserted was a party or in privity with a party at the first proceeding.").

54. *See*, *e.g.*, Parklane Hosiery Co. v. Shore, 439 U.S. 322, 326 n.4 (1979) ("In this context, offensive use of collateral estoppel occurs when the plaintiff seeks to foreclose the defendant from litigating an issue the defendant has previously litigated unsuccessfully in an action with another party. Defensive use occurs when a defendant seeks to prevent a plaintiff from asserting a claim the plaintiff has previously litigated and lost against another defendant.").

55. *Id.* at 332.

56. *See*, *e.g.*, Harris Trust & Sav. Bank v. John Hancock Mut. Life Ins., 970 F.2d 1138, 1146 (2d Cir. 1992) (noting that a judgment vacated pursuant to a settlement agreement which provides it shall not be given collateral estoppel effect will not be given collateral estoppel effect); Nestle Co. v. Chester's Mkt., Inc., 756 F.2d 280, 282 (2d Cir. 1985) (explaining that it is an abuse of discretion for a district court to refuse to enter a vacatur pursuant to a settlement providing that the vacated order would not have collateral estoppel effect in any subsequent action).

57. *See* Watermark Senior Living Ret. Cmtys., Inc. v. Morrison Mgmt. Specialists, Inc., 905 F.3d 421, 429 (6th Cir. 2018); Sentinel Trust Co. v. Universal Bonding Ins., 316 F.3d 213, 218–23 (3d Cir. 2003); Bates v. Union Oil Co., 944 F.2d 647, 649–52 (9th Cir. 1991); Chemetron Corp. v. Bus. Funds, Inc., 682 F.2d 1149, 1187–92 (5th Cir. 1982), *vacated on other grounds*, 460 U.S. 1007 (1983).

58. *Chemetron Corp.*, 682 F.2d at 1189–90. In order to be able to use a judgment as collateral estoppel, it must be deemed to be final, which in the usual sense means that it is no longer appealable. Restatement (Second) Judgments § 13 (1982).

In *Chemetron Corporation v. Business Funds, Inc.*, the defendant fully litigated a companion case and the court made findings adverse to the defendant.[59] The case was one of many relating to a stock manipulation scheme. The defendant then decided to settle the companion case (where there was only a six figure judgment) and advised the court hearing that case that it would only settle if the prior findings were set aside and the court entered an order barring their use as collateral estoppel because there were still pending cases against it.[60] The court issued an order that withdrew and set aside the prior findings, but said nothing about collateral estoppel.[61] In the *Chemetron* case, that court issued a pretrial order that the prior findings could be used (offensively) as collateral estoppel.[62] The district court dealt with the issue of finality of the decision in the companion case by viewing it in terms of the ministerial need to have a final judgment entered and ignored the impact of the vacatur itself.[63] The defendant appealed, but the Fifth Circuit agreed that collateral estoppel could be applied and ordered that, on remand, it would apply.[64] Even though no final judgment was formally entered in the companion case, the Fifth Circuit held it was not required for offensive collateral estoppel use so long as the case was "fully litigated."[65]

In *Sentinel Trust Company v. Universal Bonding Insurance*, Sentinel Trust was the indenture trustee on a series of corporate notes and was sued by noteholders for dereliction of its fiduciary duties and negligent management of a financing arrangement.[66] Sentinel Trust brought various claims against third parties for indemnity. It was nonetheless found liable to the noteholders, and thereafter dismissed its claims for indemnity against third parties without prejudice. It then settled with the noteholders on the basis that the judgment would be vacated, which it was. Sentinel Trust then filed a separate claim for indemnity against the third parties it had previously dismissed, who responded that Sentinel Trust was collaterally estopped by virtue of the prior judgment.[67] The Third Circuit agreed, even though the prior findings and judgment had been vacated.[68] The court looked to the applicable state law (Tennessee) to determine finality, but there were no cases on point.[69] The Third Circuit attempted to predict how Tennessee would resolve the issue by looking to Section 13 of the Restatement (Second) of Judgments, which

59. *Chemetron Corp.*, 682 F.2d at 1187–88.

60. *Id.* at 1189.

61. *Id.* at 1188.

62. *Id.* at 1187–88.

63. *Id.* at 1191.

64. *Id.* at 1192. The court also relied on a Ninth Circuit case to the same effect. *See* Aetna Casualty & Surety Co. v. Jeppesen & Co., 440 F. Supp. 394 (D. Nev. 1977) (ruling on motion for summary judgment), 463 F. Supp. 94 (1978) (judgment), *vacated on other grounds and remanded*, 642 F.2d 339 (9th Cir. 1981).

65. *Id.* at 1191.

66. Sentinel Trust Co. v. Universal Bonding Ins., 316 F.3d 213, 216 (3d Cir. 2003).

67. *Id.* at 219.

68. *Id.* at 223.

69. The judgment that was vacated had been entered in Tennessee pursuant to Tennessee judicial proceedings. This fact meant that Tennessee law on finality applied. *Id.*

accords res judicata treatment to final judgments, including "any prior adjudication of an issue in another action that is determined to be sufficiently firm to be given preclusive effect."[70] The court further noted that in other situations where technical finality was never achieved, such as a situation where a voluntary dismissal occurred before judgment was entered or where there was a reversal on other grounds, collateral estoppel was still applied. A stipulated settlement calling for vacatur was given similar treatment, giving the judgment preclusive effect.[71]

In *Watermark Senior Living Retirement Communities, Inc. v. Morrison Management Specialists, Inc.*, the Sixth Circuit held that a judgment vacated pursuant to stipulation can still be used for collateral estoppel purposes.[72] In *Watermark*, a jury returned a verdict against the operator of a nursing home for the death of one of its Alzheimers patients who drank detergent from an open cabinet in the kitchen.[73] The operator thereafter settled with the plaintiff and filed an action for contractual indemnification and breach of contract against the company (Morrison) responsible for kitchen operations.[74] After the case was removed to federal court, Morrison moved to dismiss the complaint based on principles of collateral estoppel.[75] The earlier judgment (which was vacated on settlement) determined that Watermark was negligent.[76] The indemnity provision relied on by Watermark against Morrison essentially provided that indemnification was unavailable if the loss arose from Watermark's negligent act.[77] Morrison argued that since the prior verdict determined that the loss was caused by Watermark's negligent act, contractual indemnification was unavailable.[78]

Watermark countered that the prior jury verdict could not support the collateral estoppel argument because it had been vacated.[79] The Sixth Circuit rejected the argument that vacatur as a result of settlement operated to render the prior judgment inoperative.[80] It noted that its task was to apply Michigan law and if there was nothing on point, to attempt to predict how the Michigan Supreme Court would rule on the issue.[81] The court found no Michigan Supreme Court decision on point, but looked to cases from other jurisdictions and the Restatement (Second) of Judgments for guidance.[82] The Sixth Circuit noted that the general rule is that prior judgments that had

70. *Id.* at 221–22.
71. *Id.* at 223.
72. Watermark Senior Living Ret. Cmtys., Inc. v. Morrison Mgmt. Specialists, Inc., 905 F.3d 421, 427 (6th Cir. 2018).
73. *Id.* at 424.
74. *Id.* at 423.
75. *Id.* at 425.
76. *Id.* at 424.
77. *Id.*
78. *Id.* at 431.
79. *Id.* at 425.
80. *Id.* at 427.
81. *Id.* at 426.
82. *Id.* at 426–27.

been vacated after reversal on appeal would not be given res judicata effect.[83] The court even mentioned *United States v. Munsingwear, Inc.*[84] as an example of a situation where a judgment that was vacated "by happenstance" would not be given preclusive effect. "Similarly, a party who obtains vacation of a judgment when a case becomes moot on appeal through no fault of that party may be able to avoid the application of issue preclusion against it in future litigation."[85] However, the Sixth Circuit pointed out that exceptions to the general rule could be found in cases involving judgments that were vacated by reason of settlement, such as *Sentinel Trust* and *Chemetron.*[86] The court then concluded that this case was an exception to the general rule and collateral estoppel applied.

It is clear from these cases that to satisfy the "finality" requirement, it is only necessary to show that the prior decision or judgment was "sufficiently firm," as that term is used in the Restatement. Dismissal or vacation of a judgment or decision that does not implicate the merits underlying the prior decision or judgment will not affect its finality for purposes of collateral estoppel. Two cases cited in *Sentinel Trust* make clear that "sufficiently firm" means that the prior adjudication is not altered by subsequent rulings about the merits of the decision. In *Employees Own Federal Credit Union v. City of Defiance*,[87] the plaintiff had filed an action in state court claiming that its civil rights were violated when the city failed to extend water rights to a site it was purchasing. The state court granted a motion to dismiss in a lengthy memorandum of findings and conclusions. Judgment was not entered immediately, because the plaintiff was given leave to amend. Instead of amending, the plaintiff voluntarily dismissed and filed a similar case in federal court. The memorandum issued by the state court was found to be "sufficiently firm," and plaintiff was held to be collaterally estopped.[88] The formal findings were held to be "sufficiently firm" because nothing occurred that marred those findings, only a voluntary dismissal that did not impact those findings.[89]

In *Birgel v. Board of Commissioners of Butler County*, the Sixth Circuit held that a prior decision by a state court, concluding that the plaintiff's pleadings were insufficient, was binding in a later filed federal court action. The prior decision was held to be a "conclusive decision," even though no final judgment had entered (plaintiff had filed a voluntary dismissal before that occurred) on the breach of contract claim for res judicata purposes regarding

83. *Id.* at 427.

84. United States v. Munsingwear, Inc., 340 U.S. 36 (1950). In *Munsingwear*, the case became moot after judgment had been rendered by virtue of a change in the rules which decontrolled the commodity at issue, which the Court characterized as "happenstance." *Id.* at 40. The Court recognized that in such a case, the judgment as an established practice would be vacated, but the government was faulted for not moving the lower court to vacate the judgment. *Id.* at 39.

85. Watermark Senior Living Ret. Cmtys., Inc. v. Morrison Mgmt. Specialists, Inc., 905 F.3d 421, 427 (6th Cir. 2018).

86. *Id.* at 427.

87. Emps. Own Fed. Credit Union v. City of Defiance, 752 F.2d 243 (6th Cir. 1985).

88. *See id.* at 244.

89. *Id.* at 245.

the issues decided.[90] According to Sentinel Trust, a stipulation for vacatur of prior rulings also does not impact the merits in the same way that a reversal on the merits would act to prevent res judicata implications.[91]

Does *Watermark* mean that no matter how hard one tries to obtain vacation of a prior ruling, it will still be given collateral estoppel effect in all cases? The answer is no. That is because the parties in *Watermark* did not address collateral estoppel in the stipulation, and the order vacating the prior decision did not either. Where the stipulation provides that the prior ruling cannot be used through collateral estoppel or otherwise, the result should be different, assuming that the court issues an order that tracks the stipulation. In *Harris Trust v. John Hancock Mutual Life Insurance*, a prior action had found that the insurance company was a fiduciary with respect to certain funds held by it. The parties thereafter settled and sought vacatur as part of the settlement. The order vacating the prior judgment specifically provided that the vacated judgment would not act as collateral estoppel on the issue of whether the insurance company was a fiduciary.[92] Accordingly, in a later lawsuit, the court did not apply collateral estoppel because of the statement in the prior order.[93] The drafting tip that results from this case is obvious: it is important to ensure that the settlement agreement or stipulation requires the court to order that collateral estoppel is inapplicable for the vacated decision and that the court's order tracks the stipulation or settlement agreement.

B. *Should the court take into consideration collateral estoppel concerns before approving a settlement calling for vacatur?*

In the Ninth Circuit, the rule is that a judgment vacated as a result of settlement will not be given collateral estoppel effect, but in determining whether to vacate the judgment, the court must balance "the competing values of finality of judgment and right to relitigation of unreviewed disputes."[94] This balancing test was applied in *Bates v. Union Oil Company*. There, a group of Unocal dealers filed suit against Union Oil and obtained a favorable jury verdict in a first case (referred to as the Amos case).[95] While on appeal, the parties reached a settlement in the Amos case, which was conditioned on vacation of the jury verdicts.[96] The trial judge thereupon vacated the jury verdicts.[97] Similar cases were later filed against Union Oil, and the judge was asked to apply collateral estoppel offensively against the same defendant based on the vacated jury verdicts.[98] The court applied collateral estoppel,

90. *See* Birgel v. Bd. of Comm'rs of Butler Cnty., 125 F.3d 948, 952 (6th Cir. 1997).
91. Sentinel Trust Co. v. Universal Bonding Ins., 316 F.3d 213, 221 (3d Cir. 2003).
92. Harris Trust & Sav. Bank v. John Hancock Mut. Life Ins., 970 F.2d 1138, 1146 (2d Cir. 1992).
93. *Id.* (relying on Nestle Co. v. Chester's Mkt., Inc., 756 F.2d 280, 282 (2d Cir. 1985)).
94. Ringsby Truck Lines, Inc. v. W. Conference of Teamsters, 686 F.2d 720, 722 (9th Cir. 1982).
95. Bates v. Union Oil Co., 944 F.2d 647, 649 (9th Cir. 1991).
96. *Id.*
97. *Id.*
98. *Id.*

claiming that it never indicated in its order vacating the verdicts that collateral estoppel would not apply.[99] On appeal, the Ninth Circuit affirmed on the basis that it was proper to apply collateral estoppel offensively, even though the jury verdicts had been vacated, so long as the trial court performed the balancing test set forth above.[100] It then granted the request, determining that "relitigation of the liability and punitive damage issues in this case 'after a full and fair jury trial' of those same issues . . . would be a waste of judicial resources."[101]

The end result in *Bates* was that even though the verdicts were vacated, they could be used to collaterally estop Unocal from relitigating the issues determined. What could Unocal have done to avoid this? As noted by the Ninth Circuit, "Unocal could have conditioned the dismissal of its appeal and settlement of the Amos case not merely on vacatur, but on vacatur following the district court's consideration of the *Rigsby* factors and determination that the judgment would not have preclusive effect."[102] In that way, if the court refused to vacate the award, Unocal would have avoided paying large sums to settle the matter.

It may not be that easy to convince a court to approve a settlement that is conditioned on there being no preclusive effect where there are third parties, like other franchisees, who will want to use the vacated judgment as offensive collateral estoppel. The court will have to strike a balance between public versus private interests. The public interest is served by applying collateral estoppel to preserve judicial resources and give effect to precedent. The franchisor may have to argue that the vacated judgment was not well reasoned or simply wrong to counter the public interest factor. It also could argue that the decision has no precedential value if it is only a trial court decision. Another possible countervailing argument is that re-litigation will not be much of a burden on the franchisee or the court system if in fact it would not involve substantial time.

An important note of caution. *Sentinel Trust* pointed out that it was an open question whether such an order determining the collateral estoppel issue could be binding on absent third parties.[103] This caveat is obviously important because the main purpose of such an order is not only to prohibit the prevailing party from using the vacated judgment offensively, but also to preclude non-parties from doing so. If there is the possibility of similar litigation, as often occurs in franchise cases, the court may require a showing as to the impact of vacatur and a determination as to collateral estoppel on third parties or other franchisees. Other franchisees may have a good argument that a court determination that a vacated judgment cannot be used as collateral estoppel is a determination that denies them due process, as

99. *Id.*
100. *See* Ringsby Truck Lines, Inc. v. W. Conf. Teamsters, 686 F.2d 720, 722 (9th Cir. 1982).
101. Bates v. Union Oil Co., 944 F.2d 647, 649 (9th Cir. 1991).
102. *Id.* at 652.
103. Sentinel Trust Co. v. Universal Bonding Ins., 316 F.3d 213, 222 & n.3 (3d Cir. 2003).

it purports to bind them without giving them an opportunity to be heard. This issue only comes up if the court is asked to order that the vacated judgment not be given collateral estoppel effect. If the issue does not come up, the default rules above likely will govern: the judgment might be treated as "sufficiently firm" to apply collateral estoppel or vacation of the judgment renders it a nullity, depending on the applicable law of the jurisdiction.

IV. Will the Vacated Judgment Have to Be Disclosed in the FDD?

One of the primary motivations for a franchise case settlement that includes vacatur of an earlier judgment, in addition to minimizing collateral estoppel effects, is to potentially avoid disclosure of the vacated judgment in the FDD. Under the Federal Trade Commission (FTC) franchise regulations, often referred to as the Franchise Rule, "Litigation" needs to be disclosed as follows:

> (c) Item 3: Litigation.
>
> (1)(iii) Has in the 10-year period immediately before the disclosure document's issuance date:
>
> (A) Been convicted of or pleaded nolo contendere to a felony charge.
>
> (B) Been held liable in a civil action involving an alleged violation of a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive practices, or comparable allegations. "Held liable" means that, as a result of claims or counterclaims, the person must pay money or other consideration, must reduce an indebtedness by the amount of an award, cannot enforce its rights, or must take action adverse to its interests.
>
> * * *
>
> (3)(ii) For prior actions, the date when the judgment was entered and any damages or settlement terms.[104]

A judgment against a franchisor certainly would mean it was held liable if it was ordered to pay money or other consideration or is unable to enforce its rights.[105] The question is whether it must be disclosed if it has been vacated pursuant to settlement. The comments to the Franchise Rule are silent on the subject of vacatur and its impact. There is also no case law on this point. However, the terms of a settlement must be disclosed,[106] so it is likely that the agreement to vacate the judgment as part of the settlement will have to be disclosed, especially if the franchisor is required to pay money under the terms of the settlement. While an argument can be made that vacatur resulted in the franchisor not being held liable so as not

104. 16 C.F.R. §§ 436.5(c)(1)(iii), (3)(ii). For a more detailed discussion on strategies to be considered in disclosing settlements, see Brian Siljander, *Not Just Between Us: Strategies for Disclosure of Settlement Agreements*, 38 Franchise L.J. 401 (2019).

105. 16 C.F.R. § 436.5(c)(1)(iii)(B).

106. *Id.* § 426.5(c)(3)(ii).

to require disclosure, when vacatur becomes part of the settlement, it more than likely needs to be disclosed under the requirement that the terms of a settlement must be disclosed. In order to accurately disclose the terms of the settlement, it would appear that the drafter would have to say that the parties agreed to a vacation of an earlier ruling. How much more has to be disclosed is in the discretion of the drafter, but strong arguments can be made that a prospective franchisee should be made aware of the nature of the prior ruling as it is likely material. The comment and guides are silent on how much disclosure needs to be made.

Some guidance may be found in the FTC Franchise Rule Compliance Guide.[107] While disclosure is required of prior actions where the franchisor has been found "liable," "dismissals, including a dismissal concluding an adversarial proceeding, need not be disclosed." This guidance is somewhat ambiguous because it only refers to dismissals, not the judgment itself, so that arguably the judgment still must be disclosed but not the dismissal, which makes little sense. It is likely that the Compliance Guide drafters had in mind that dismissals would be based on determinations that the case had no merit, the usual result of the granting of a motion to dismiss, so that the judgment would not have to be disclosed. It is unlikely they had in mind dismissals pursuant to a settlement agreement. The FTC is currently considering revisiting and revising the Franchise Rule. This area is one that could benefit from further clarity.

V. Conclusion and Drafting Tips

State courts will be favorably receptive to a motion to vacate a prior judgment as a condition of settlement. They largely will honor the desires of the parties. Caution is required when navigating settlements that call for vacatur in the federal courts. The *Bonner Mall* case could still be read as standing for the proposition that "extraordinary circumstances" needed to vacate a judgment do not include the fact that the parties have stipulated to a vacatur.[108] Although the lower courts seem to have backed off from that position, there has been no final word from the U.S. Supreme Court to support the view that an extraordinary circumstance would be that the settlement is conditioned upon vacation of the prior judgment. In addition, a procedure similar to the Ninth Circuit's procedure, which requires a court to have a hearing to determine if a vacated judgment is entitled to collateral estoppel effect, should be considered.

The settlement papers therefore need to be drafted to provide that the vacated judgment cannot be used to collaterally estop any party to the settlement, and steps need to be taken to ensure the court adopts that. This means mustering the arguments for why settlement is more important than

107. Fed. Trade Comm'n, Franchise Rule Compliance Guide 36 (2008).

108. Of course, this can be argued to be dicta because *Bonner Mall* did not involve such a stipulation. *See* discussion *supra* Part II(B)(4).

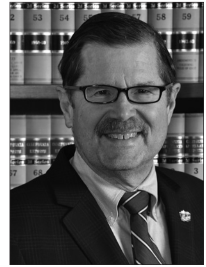
allowing the judgment to be given collateral estoppel effect. Whether or not it is binding on third parties may require notice to be given to third parties, which could have a negative impact on the settlement. If the settlement involves a pending state court action, the chances are better for obtaining court approval. If the settlement involves a federal proceeding, it should contain sufficient language that makes clear the settlement is totally dependent on vacation of the judgment. Further consideration should also be given to language that provides that if the court orders that the judgment be given collateral estoppel effect, the settlement will be ineffective.

Nuts, Bolts, and Outline for Teaching Franchise Law; Would Socrates Approve?

*David Gurnick & Peter Lagarias**

I. Introduction

Mr. Gurnick



Mr. Lagarias

In 1870, Franklin Fessenden, later a Massachusetts Superior Court Judge, arrived as a student at Harvard Law School.[1] He enrolled in a course taught by Christopher Langdel, the dean of the law school, using the new and then-controversial case-method of teaching. The president of Harvard asked students their opinion of Dean Langdel's class.[2] Fessenden replied that he could attend the usual classes and hear professors read from law books.[3] But when Fessenden attended classes taught using the case-method, he got something not found in any book.[4]

The case-method of teaching law is based on the idea that law is a science, learned best through studying and analyzing appellate decisions.[5] Studying cases is combined with questions and answers, a kind of dialogue first

1. Bruce A. Kimball, The Langdell Problem: Historicizing the Century of Historiography, 1906-2000s, 22 Law & Hist. Rev. 277, 298 (2004).
2. *Id.*
3. *Id.* Christopher Langdel's new methods—including teaching by Socratic dialog, requiring students to pass tests to stay in school and to graduate, and teaching from actual cases—revolutionized the teaching of law and instruction in other professions.
4. *Id.*
5. Sean M. Kammer, *"Whether or Not Special Expertise is Needed": Anti-Intellectualism, the Supreme Court, and the Legitimacy of Law*, 63 S.D. L. Rev. 287, 330–31 (2018). The view of law as

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invoked by Socrates (later purloined by television detective Colombo).[6] This teaching style thus became known as the Socratic method. Professors engaged students to participate, drawing out rules from discussion of cases and applying those rules to similar, but slightly different, cases or scenarios. This new method contrasted with the more common classroom process of lecture and memorization.[7]

Legal education in a classroom setting reflected an evolution in training. Until the twentieth century, most people became lawyers through on-the-job legal education, mainly through an apprenticeship with an experienced lawyer.[8] Legal education has continued to evolve over the years away from simply the classic case-method or Socratic model. So too have methods of teaching and learning the law changed. Tools used in teaching law have expanded, evolving to include films, tapes, television, computer aided research,[9] and now the Internet. The COVID-19 pandemic has brought about more use of remote teaching options, such as the use of video conferencing technologies. Law faculties also increasingly recognize the need to include practical training in the curriculum.[10] Courses taught in law schools have expanded and diversified over the years:

> In the old days, the law school curriculum encompassed mostly doctrinal courses taught in a large classroom setting by a professor resembling Charles Kingsfield in "The Paper Chase." The traditional model of teaching focused largely on core bar-related courses, the Socratic Method, and thick textbooks. The ultimate goal

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a science originated with Dean Langdell at Harvard. He developed the case method, rooted in this view. He stated as much in the preface to his casebook, *Contracts*, writing:

> Law . . . considered as a science, consists of certain principles or doctrines. To have such a mastery of these as to be able to apply them with constant facility and certainty to the ever-tangled skein of human affairs, is what constitutes a true lawyer; and hence to acquire that mastery should be the business of every earnest student of law. Each of these doctrines has arrived at its present state by slow degrees; in other words, it is a growth, extending in many cases through centuries. This growth is to be traced in the main through a series of cases; and much the shortest and best, if not the only way of mastering the doctrine effectually is by studying the cases in which it is embodied.

Lawrence M. Friedman, A History of American Law 613–14 (2d ed. 1985). It seemed to Dean Langdell that it was "possible to take such a branch of the law as Contracts, for example," and to "select, classify, and arrange all the cases which had contributed in any important degree to the growth, development, or establishment of any of its essential doctrines; and that such a work could not fail to be of material service to all who desire to study that branch of law systematically and in its original sources." Kammer, *supra*, at 330–31.

6. *See*, *e.g.*,John J. Knoll, *Traffic Stops and Normal Incidents Thereto*, 79 J. Kan. St. Bar Assoc. 31, 33 (2010) (describing question-and-answer tactics of fictional television detective Columbo played by actor Peter Falk).

7. Michael J. Greenlee, *Theory*, *Practice*, *Specialization*, *and Interdisciplinary Perspectives: Pulling It All Together at the College of Law*, 52 Advoc., no. 11/12, 2009, at 25.

8. Charles R. McManis, *The History of First Century American Legal Education: A Revisionist Perspective*, 59 Wash. U. L.Q. 597, 617–18 (1981) (cited in Peter A Joy, *The Uneasy History of Experiential Education in U.S. Law Schools*, 122 Dick. L. Rev. 551, 552 (2018)).

9. Steve Sheppard, *Casebooks, Commentaries, and Curmudgeons: An Introductory History of Law in the Lecture Hall*, 82 Iowa L. Rev. 547, 634 (1997).

10. H.F. Hoeflich, *Plus Ça Change*, *Plus C'Est La Meme Chose: The Integration of Theory & Practice in Legal Education*, 66 Temp. L. Rev. 123, 141 (1993).

> was to prepare students for the bar exam, and the first year curriculum was the most important set of courses to study towards this end. . . . As a result of the 2008 financial crisis and the decline in law applications since then, the focus of law schools has changed. In a buyer's market, students prefer a legal educational experience that they can put on a C.V. and that enables them to practice law while in law school to impress future employers.[11]

Also in recent years, franchising has gained recognition as its own discipline, and franchise law is taught as a course in a number of law schools around the nation.[12] This article will provide practical advice on teaching a franchise law course, including setting forth fundamental objectives and topics, discussing teaching methods and potential teaching materials, offering grading advice, and providing multiple sample syllabi.

II. Fundamental Teaching Objectives

In addition to the case study method, the classic model for most law school classes involves covering a specific field of law beginning with real property, contracts, torts, criminal law, civil procedure, and other first year classes. Franchise law is a body of laws that, at a minimum, concern offers, sales, investments in, operation, termination, nonrenewal, and regulation of franchised businesses. The practice of franchise law encompasses a potentially wide range of legal disciplines. The history and nature of franchising informs the various disciplines of franchise law.

To cover the field of franchise law, a comprehensive course outline in the field should address certain basic subjects. A teaching objective for such a comprehensive course should include that students gain an introductory understanding to each of these areas:

- the business history of franchising, and the corresponding history of the development of franchise law;[13]

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11. Klint W. Alexander, *The Changing Nature of Legal Education*, 41 Wyo. Law. 48 (2018). The article refers to the well-known novel The Paper Chase, written by Harvard Law School Graduate John Jay Osborn Jr. *See* John Jay Osborn Jr., The Paper Chase (1971). The novel was later adapted into a movie and television show. *See* The Paper Chase (20th Century Fox 1973); *The Paper Chase* (CBS 1978). All three tell the fictional story of first-year student James Hart and his experiences with his demanding Harvard Law School contracts Professor Charles Kingsfield.

12. *See* David C. Gurnick & Alexander M. Meiklejohn, *Teaching Franchise Law: A Role for Experienced Franchise Lawyers*, 36 Fran. L.J. 505, 509 n.13 (2017) (noting survey indicating franchise law courses had been offered at law schools at Emory University; Fordham University; Georgetown University; University of LaVerne; University of Memphis, University of Michigan, Nova Southeastern University, Shepard Broad University; Quinnipiac University; University of West Los Angeles; Southern Methodist University, Temple University; University of Virginia; and Western New England University). The authors are also aware of franchise law courses offered at these additional law schools: Baylor University; Bond University (Australia); Boston University; Case Western Reserve University; Creighton University; University of California, Irvine; John F. Kennedy University; University of Memphis; Nova Southeastern University; Robert Morris University; University of Adelaide (Australia); Western New England University; Western University (Canada); and University of Toronto.

13. *See, e.g.*,Douglas C. Berry, David M. Beyers & Daniel J. Oates, *State Regulation of Franchising: The Washington Experience Revisited*, 32 Seattle U. L. Rev. 811 (2009); David Gurnick &

- franchising as a method of distribution, compared to alternative distribution methods (such as pure trademark licenses, product distributorships, employer-employee and company-owned chain operations, partnerships, and joint ventures, sales agencies, consignments, and distribution through business cooperatives);
- the contract aspects of franchising (franchising as a contractual relationship, formation of the relationship, performance, express provisions, implied provisions such as the covenant of good faith and fair dealing, renewal, breach, and termination);
- contract drafting (structure of the franchise agreement addressing the grant of a license, limitations on the license, allocations and limitations of liability, obligations undertaken by each party, conditions included in the agreement, termination and nonrenewal provisions, transfer restrictions, restrictive covenants, and boilerplate provisions);
- regulatory and consumer protection laws (embodied in presale registration and disclosure requirements of various states, cooling-off periods, and implications of acting in violation of these requirements);
- the Federal Trade Commission (FTC) Franchise Rule,[14] and other applicable administrative law (including the Administrative Procedures Act,[15] which provides insight on the process by which the FTC investigated, proposed, and adopted the FTC Franchise Rule,[16] and the actions of the FTC to enforce the Franchise Rule);
- various lines of commerce in which franchising and franchise regulation occurs, and statutes that regulate franchising in specific industries like alcohol beverage distribution, cannabis distribution, farm equipment dealerships, automotive dealerships, gas stations, and construction equipment dealerships;
- alternative forms of the business relationship (addressing variant agreements such as area development agreements, multi-unit development agreements, subfranchising agreements, and area representative agreements);

Steve Vieux, *Case History of the American Business Franchise*, 24 Okla. City U. L. Rev. 37 (1999); Paul Steinberg & Gerald Lescatre, *Beguiling Heresy: Regulating the Franchise Relationship*, 109 Penn St. L. Rev. 105 (2004).

14. 16 C.F.R. § 436.1 et seq.

15. 5 U.S.C. § 551 et seq.

16. Disclosure Requirements and Prohibitions Concerning Franchising, Disclosure Requirements and Prohibitions Concerning Business Opportunities, 72 Fed. Reg. 15444 (Mar. 30, 2007); Franchise Rule, 64 Fed. Reg. 57294 (Oct. 22, 1999); Request for Comments Concerning Trade Regulation Rule on Disclosure, Requirements and Prohibitions, Concerning Franchising and Business, Opportunity Ventures, 60 Fed. Reg. 17656 (Apr. 7, 1995); Statement of Basis and Purpose, 43 Fed. Reg. 59621 (Dec. 21, 1978).

- intellectual property law (the law of trademarks, copyrights, trade secrets, patents, and personality rights);[17]
- the law of vicarious liability;[18]
- antitrust laws (free market economic principles, agreements in restraint of trade, the Sherman Act,[19] state antitrust laws, vertical restraints, horizontal restraints, and specific kinds of restraints such as price fixing, territory restrictions, tying, per se violations, rule of reason, and noncompetition restrictions/covenants not to compete);
- dispute resolution and alternative dispute resolution (litigation, arbitration, including the Federal Arbitration Act,[20] and mediation in the context of franchising); and
- ethical responsibilities (due diligence and conflicts of interest arising in franchising lawyer-client relationships).[21]

The ABA Forum on Franchising has published the first casebook on franchise law which comprehensively covers the field of franchise law as a discipline, including the vast majority of these topics.[22]

III. Additional Objective

Increasingly, law schools require courses to have teaching objectives which extend beyond an academic coverage of a field of law. Such objectives now cover a broad range of practical skills of lawyers as counselors and advocates. Any course on franchising could include a range of such additional objectives, including focusing on experience and practice, which could include as objectives, practical experience in the following:

- understanding a modern complex business contract by reading and dissecting an actual franchise agreement;
- drafting a franchise disclosure document and/or franchise agreement;
- preparing and prosecuting an application for registration of a franchise at the state level;
- negotiating the terms of a franchise agreement;

17. *See, e.g.*, David Gurnick, *Intellectual Property in Franchising: A Survey of Today's Domestic Issues*, 20 Okla. City U. L. Rev. 347 (1995).

18. *See, e.g.*, Joseph H. King, Jr., *Limiting the Vicarious Liability of Franchisors for the Torts of Their Franchisees*, 62 Wash. & Lee L. Rev. 417 (2005); Heather Carson Perkins, Sarah J. Yatchak & Gordon M. Hadfield, *Franchisor Liability for Acts of the Franchisee*, 29 Franchise L.J. 174 (2010).

19. 15 U.S.C. § 1 et seq.

20. 9 U.S.C. § 1 et seq.

21. *See, e.g.*, Beverly Hills Concepts v. Schatz & Schatz, 1997 Conn. Super. LEXIS 178, *aff'd in part & rev'd in part*, 717 A.2d 724 (Conn. 1998).

22. Franchising: Cases, Materials & Problems (Alexander M. Meiklejohn ed., 2013) [hereinafter Franchising]. Twenty-nine franchise law practitioners and professors served as chapter authors for the casebook. The ABA Forum on Franchising receives all proceeds of sales; the contributors did not and do not receive monetary compensation.

- advocating for a client in a franchise-related dispute, whether in mediation, arbitration, or litigation;
- conducting legal analysis and advising a client faced with a challenging situation in a franchise relationship; and
- undertaking how to approach a new statutory scheme, including legislative purposes, definitions, substantive provisions, remedies, regulations and more.

Other courses may address additional related academic subjects. Some business schools address franchising as a business discipline, and at least one business school teaches a joint MBA/law school class, which combines the business and legal aspects of franchising.[23] In a course focused more on academic aspects and historic evolution of franchising, additional or alternative learning objectives could include an analysis of historical development, such as changes over time in antitrust jurisprudence,[24] or an analysis of historical developments in intellectual property law, such as risk of the loss of trademark rights from licensing, and the evolution of the related company doctrine.

Many law schools now require statements of learning outcomes, both for their overall programs and for individual courses. Course learning outcomes address teaching objectives from a student perspective. The prospective professor may be required to present class objectives in this format. For example, a sample class objective would be: "Students will learn how to review a complex commercial contract, namely a modern franchise agreement. Students will become adept at analyzing a franchise disclosure document. Class members will become conversant in several related bodies of statutory law including trademark law, franchise disclosure law, and antitrust law."

IV. Teaching Methodologies

A course in franchising lends itself to alternative teaching approaches. Among these are traditional lecturing and reading, Socratic question-and-answer dialogue, and more practical law practice modules. A course can involve some or all of these approaches.

Many of the subject areas in a franchise law course can be presented as lectures. Franchising is filled with disputes that involve interesting facts. These include cases of misconduct, ingenious ways of complying with or violating franchise agreements, and creative excuses. Franchises are often

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23. This combined MBA/law school class is taught at Ohio State University Fisher College of Business.

24. *Compare*, *e.g.*, United States v. Arnold, Schwin & Co., 388 U.S. 365 (1987), *with* Cont'l Television, Inc. v. GTE Sylvania, Inc., 433 U.S. 36 (1977) (vertical territorial restraints evaluated under rule of reason rather than per se unlawful); *compare* Dr. Miles Med. Co. v. John D. Park & Sons Co., 220 U.S. 373 (1911), *with* Leegin Creative Leather Prods., Inc. v. PSKS, Inc., 551 U.S. 877 (2007), *and* State Oil Co. v. Khan, 527 U.S. 3 (1997) (vertical price fixing evaluated under rule of reason rather than per se unlawful).

owned by family members, so some disputes have the added complexity that often comes with family relationships. Franchising cases have also been important in the development of law; many seminal decisions on both substantive and procedural law arise from franchise relationships, including in the areas of personal jurisdiction and arbitration.[25]

Because franchising law is steeped in tort, contract, and other kinds of case law and involves the study of reported decisions, the subject lends itself nicely to the case method of teaching. An outline for a franchise law course can have court decisions at its center, and it can include Socratic dialogue eliciting discussions of facts, challenging students to apply rules of law from one case to the facts of another scenario.

Franchise law classes can place practical lawyering skills at their core. Every law student should be required to examine, parse, and understand today's complex business agreements. And few, if any, agreements are more complex and comprehensive than a modern franchise agreement. Every law student, whether desiring to practice criminal, divorce, corporate, or some other area of law, should learn general principles of business law and regulation. Many of these can be presented through a franchise law course and through a review of a typical franchise disclosure document.

A franchising course also lends itself to practice and experiential methods of teaching covering contract drafting, negotiating, and advocating. With so many law offices, government regulatory personnel, and businesses involved in franchising, there can be opportunities for speakers and field trips to see franchising and franchising law in action.

V. Typical Topical Coverage in One, Two, and Three Unit Classes

Courses typically are offered for either one, two, or three units. Each unit requires sixteen hours of teaching: a one-unit course usually requires sixteen hours of teaching, with two-unit and three-unit courses generally mandating thirty-two and forty-eight hours respectively. Coverage and depth will be broader and/or deeper for the courses that involve more units. The one-unit course is popular with many students and is generally a survey course or one with limited objectives, such as an introduction to understanding franchising and drafting complex business agreements. The short duration of the one-unit course lends itself to unusual teaching times such as evenings and weekends, and may be taught over semester breaks in as little as one or two weeks.

25. *See*, *e.g.*, State Oil v. Khan, 522 U.S. 3 (1997) (landmark antitrust decision on vertical minimum pricing arising from petroleum franchise relationship); Burger King Corp. v. Rudzewicz, 471 U.S. 462 (1995) (landmark decision on personal jurisdiction arising from Burger King franchise relationship); Southland Corp. v. Keating, 465 U.S. 1 (1984) (landmark decision on arbitration arising from convenience store franchise relationship).

VI. Teaching Materials

A wide range of teaching materials are readily available to teach a course in franchising law. As noted earlier, the ABA Forum on Franchising has published the first casebook on franchise law.[26] The book contains chapters written by twenty-nine experienced franchise law practitioners and professors, and is edited by Alexander Meiklejohn, who is a law professor and Co-Chair of Forum on Franchising's Professors Committee. It includes cases, commentaries, questions, and problems for students to consider. A teacher who uses the book can also obtain the accompanying teachers' manual that provides the thoughts of chapter authors concerning possible answers to the questions and problems.

An actual franchise disclosure document (FDD) also can be a useful teaching tool. Numerous FDDs are available, whether from franchisors themselves, or online at websites of states that make their FDDs publicly available. Currently, these states include California, Indiana, Minnesota, and Wisconsin.[27] A teacher can also obtain FDDs by making a public records request to any of the thirteen states that currently require presale registration of offers and sales of franchises.[28] FDDs contain extensive information about the franchisor and include the forms of agreements that the franchisor intends to enter into with franchisees.[29] FDDs provide students the opportunity to work and study documents that are actually used in offering and selling franchises and to see how different practitioners approach the same requirement or regulation.

A third useful category of teaching materials consists of principal cases in franchising law and related disciplines. Cases may be downloaded, printed, and provided to students in paper form. Increasingly, as part of their law school benefits, law schools provide students free access to cases online through Westlaw and Lexis. The professor should provide case citations to the students sufficient for them to obtain cases on either platform and also possibly on Google and other case research platforms such as Fastcase.[30]

The business and advertising marketplace and news media are filled with additional ancillary materials. A professor can readily obtain samples

26. *See generally* Franchising, *supra* note 22.

27. *See* Cal. Dep't Fin. Prot. & Innovation, *Self Service Portal*, https://docqnet.dfpi.ca.gov/search; Ind. Sec'y of State, Secs. Div., *Securities Portal*, https://securities.sos.in.gov/public-portfolio-search; Minn. Commerce Dep't, *Commerce Actions and Regulatory Documents Search (CARDS)*, https://www.cards.commerce.state.mn.us/CARDS; Wis. Dep't of Fin. Insts., Franchise Search, https://www.wdfi.org/apps/FranchiseSearch/MainSearch.aspx.

28. Cal. Corp. Code § 31110; Haw. Rev. Stat. § 482E-3(c); 815 Ill. Comp. Stat. §§ 705/5; 705/10; Ind. Code § 23-2-2.5-9; Md. Code Ann. Bus. Reg. § 14-214; Minn. Stat. § 80C.02; N.Y. Gen. Bus. Law § 683.1(1); N.D. Cent. Code § 51-19-03; Or. Rev. Stat. § 650.005 et seq.; R.I. Gen Laws § 19-28.1-5; S.D. Codified Laws § 37-5B-4; Va. Code Ann. § 13.1-560; Wash. Rev. Code § 19.100.020(1); Wis. Stat. § 553.21.

29. 16 C.F.R. §§ 436.3–436.5.

30. Fastcase is an online, subscription-based legal research database, comparable in some ways to Lexis and Westlaw. *See, e.g.*, Mary Whisner, *Getting to Know Fastcase*, 106 L. Libr. J. 473 (2014).

of franchisor advertising on the internet. News media often discuss developments affecting franchising and at franchised businesses. Providing students with news helps the students recognize that the subject of the course is something vibrant and active, and that the law discussed in the course has real-life application.

VII. Examination, Grading, and Other Administrative Issues

Most franchise law classes are taught by franchise law practitioners as adjunct professors, who are initially unfamiliar with law school administrative requirements. These may include taking daily attendance, office hours, preparing and administrating examinations, delivering grades or pass/fail reports, and complying with a host of other administrative rules. Some law schools invite adjunct faculty to attend some faculty meetings. Some require attendance. Some do not include adjunct faculty in such meetings.

Additional administrative matters include personal conduct mandates, both guidance for and restrictions on interrelations with students, as well as sexual harassment policies, and becoming familiar with a range of the institution's other policies and procedures. There is also the mundane—issues such as assignment of a classroom, gaining access to the building, and arrangements for parking. All of these may be substantially impacted by responses to COVID-19, often mandating virtual classes presented over the internet on platforms such as Zoom.[31]

The brave new world of teaching law may involve various modalities of presentation from traditional in-person teaching, to online teaching, to a mixture of both. A few law schools now teach exclusively online,[32] and a growing number of established schools offer online programs.[33] Many started online coursework for the first time in 2020 and may need to do so for the foreseeable future. These evolving circumstances require the professor to become proficient with Zoom or other web-based formats, like Webex or Microsoft Teams, used by the law school. Often the law school will provide tutorials and equipment such as headsets. Professors will learn how to use the shared screen function to post written materials, and creative professors will search for visual materials to aid teaching. Internet presentations can be synchronous with all students watching and participating in real

31. *See*, *e.g.*, Gregory W. Bowman, *Law School in the Age of Covid*-19, W. Va. Law., Summer 2020, at 10 (due to COVID-19, faculty and staff moved quickly to transform West Virginia University Law School to a virtual, online law school).

32. *E.g.*, Abraham Lincoln Law School, www.alu.edu; American Heritage University School of Law, https://ahulaw.com; Concord Law School, www.concordlawschool.edu; St. Francis School of Law, https://stfrancislaw.com; Taft Law School, www.taftu.edu/.

33. *See e.g.*, Yvonne M. Dutton, Margaret Ryznar & Kayleigh Long, *Assessing Online Learning in Law Schools: Students Say Online Classes Deliver*, 96 Denv. U. L. Rev. 493, 494 (2019) ("Law schools in the United States are increasingly embracing the benefits of new technology and meeting student demand for increased flexibility by investing in online education"; and noting that as of July 2018 at least thirty of the top one hundred law schools offered online courses as part of their curriculum).

time, or asynchronous which means students watch videos by themselves. Often professors will assign written responses of various forms to monitor and consider each student's progress.

Professors may offer courses on a graded basis or pass-fail. Methods of evaluating student progress and mastery of the subject resemble methods available in other courses. The professor typically administers an examination, which can be in-class or take-home. Examinations may consist of long or short essay questions addressing hypothetical fact scenarios. Questions may ask students to recognize whether a franchise relationship is present, identify issues, evaluate issues, make a judgment or decision, or state how they would resolve issues as a counselor or advocate. Another type of question might ask students to develop a practical, plan of action. Typically, take-home examinations would both require and provide students an opportunity to perform a more in-depth analysis of the questions asked because they allow students more time and freedom to investigate. Examinations can also consist of multiple-choice questions and can be closed-book or open-book. The professor can modulate the difficulty of the questions based on whether the exam is open or closed book.

VIII. Conclusion

What is the best method to teach franchise law? Socrates famously peppered his students with questions, compelling them to think critically analyze an issue, and by this process of dialectic, arrive at deeper understandings of consequential matters, even if definitive answers were rarely, if ever, attained. By questioning, examining, and experimenting with objectives, curriculum, and methodologies, better franchise law courses will evolve. Franchising law is an increasingly recognized subject area. The subject is of interest to students and provides room for creativity by those who teach the subject. Accompanying this article are sample course outlines that may be a useful resource for a professor developing one's own outline and may also be useful to anyone seeking to have a deeper understanding of the subject.

APPENDIX

This appendix includes sample course outlines. These are based on and modified from samples collected by the ABA Forum Professors Committee.

1. Sample Course Outline I[34]

Course Title: Franchise Law

Outline for a Course Taught Over Four Days, Three-Hours of Lecture Per Class

Units: 1

Course Overview

Franchising is important to the economy. It is important in Orange County, California, home to the head offices of Del Taco, El Pollo Loco, Wienerschnitzel, Yogurtland, PIP Printing, and Money Mailer. Thousands of franchised businesses provide millions of jobs, and billions of dollars of business. With quick service restaurants, gas stations, hotels, and others, all consumers are customers of franchised businesses.

This course examines the business laws, the nature of franchising in its legal context, and laws that apply to business franchises, including key contract and trademark issues; contract formation, good faith performance, breach, termination, renewal, and assignment; trademark creation, protection, and infringement; and remedies.

Abuses in franchising led the federal government, California, and several states to adopt special rules for franchises. This course considers these regulations. This course also considers antitrust issues (e.g., price fixing, tying, vertical non-price restraints) and trade secrets.

After this course, students will have an overview of many different areas of business law, and a background in the business sector, providing students with a head start toward a position with one of the nation's thousands of franchisors or one many law firms that practice franchising law.

Course Materials

Franchising: Cases, Materials & Problems (Alexander M. Meiklejohn ed. 2013) [hereinafter Franchising]

Actual Franchise Agreement and Franchise Disclosure Document, to be provided.

34. Adapted from the syllabus for the franchise course taught by David Gurnick at University of California, Irvine School of Law.

Course Syllabus

Class Session 1: 3 hours

Franchising—Introduction and Overview

Course overview:

- History of franchising (Selections from Chapter 1 of FRANCHISING).
- Different distribution methods (e.g., pure trademark licenses, product distributorships, employer-employee and company-owned chain operations, partnerships, joint ventures, and sales agencies) (Selections from Chapters 7 and 12 of FRANCHISING).

Formation, Structure, Contents, and Performance of Franchise Agreements

Goals: This section of the course will cover the following topics related to franchise agreements:

- Review contract formation elements (offer, acceptance; consideration).
- Do black-letter contract formation elements and provide full legal background for entering into franchise contracts.
- Understand additional requirements of the law (disclosure and cooling-off periods), practical conditions (exchange of documents and approvals) before entering into a franchise agreement, and impacts on franchisor and franchisee if rules are not satisfied.
- Review a franchise agreement, discuss structure, and key elements.
- Review and discuss variant and related agreements: area development agreements, multi-unit development agreements, subfranchising agreements, and area representative agreements.
- Understand scope of mutual obligations under a franchise agreement and covenant of good faith and fair dealing implied in business contracts and unconscionability.
- Participate in negotiation and contract drafting exercise.

Reading Requirements: Students should review sample franchise agreement and franchise disclosure document.

Learning Outcomes: Students will: (1) learn the interesting history of the development of franchising from early forms of distribution to today's widespread integration in the economy; (2) be introduced to and understand there are different methods of distributing goods and services; (3) be introduced to the format, structure and contents of a typical franchise agreement; (4) review and see basic contract concepts (offer, acceptance, consideration, etc.) applied in the franchise context; (5) gain an understanding of additional conditions to formation imposed by franchise law/regulations; (6) receive an introduction to ancillary agreements (area development agreements, multi-unit development agreements, subfranchising agreements, etc.); (7) review

the covenant of good faith and fair dealing; and (8) engage in a negotiation and drafting exercise.

Class Session 2: 3 hours

Franchise Regulation

Goals: This section of the course will cover the following topics related to franchise regulation:

- The abuses in franchising as well as the legislative and administrative response (including that of the FTC) involving registration and presale disclosure requirements and regulation of the ongoing relationship.
- The presale registration and disclosure requirements that are conditions to offering and selling franchises.
- The interplay between federal and state franchise registration and disclosure laws; issues relating to a regime of government enforcement compared to private enforcement actions.
- Government investigations by the FTC and by state enforcement agencies.
- The constitutionality of regulation.

Reading Requirements: Students should read portions of Chapters 8, 9, 10 and 11 of FRANCHISING.

Performance and Breach

The section of the course will discuss elements of performance of a franchise agreement, and ways it can be breached and related issues, such as encroachment.

Termination, Expiration, and Renewal

Goals: This section of the course will cover the following topics related to termination, expiration, and renewal:

- Contractual breaches that can result in termination of a franchise.
- Reasons one party desires to end the relationship
- Effects of termination and remedies for wrongful termination.
- Expiration compared to termination or completion of other kinds of contracts (like, discreet transactions).
- Laws that restrict grounds for termination or non-renewal of a franchise agreement.

Reading Requirements: **Students should read portions of Chapter Eleven of FRANCHISING.**

Learning Outcomes: Students will gain a deeper understanding of (1) the approach used by the federal and state governments to regulate offers and sales of franchises; (2) characters and issues in the ongoing relationship,

contrasted with discreet transactions like sales of goods or one-time services; (3) the grounds, conditions and procedures for contract termination and nonrenewal and significant implications of termination and nonrenewal.

Class Session 3: 3 hours

Intellectual Property in Franchising: Trademarks Copyrights, Trade Secrets, Patents; Issues Related to Intellectual Property—Vicarious Liability; Covenants Not to Compete

Goals: This section of the course will cover the following topics related to intellectual property in franchising:

- The various forms of intellectual property with an emphasis on what is a trademark; how it is selected; how it is used; and its resulting importance to a franchise system.
- The various ways trademark rights can be lost by misuse; rules of infringement; laws that apply to trademarks; and trademark disputes in franchise relationships.
- The related company doctrine; its intersection with the law of agency; and resulting vicarious liability issues in franchising.

Reading Requirements: Students should read portions of Chapters 2, 3, and 4 of Franchising.

Learning Outcomes: Students will gain an introduction, overview and survey of the fundamental areas of intellectual property and competition law: trademarks, copyrights, trade secrets, patents, vicarious liability in its relationship to intellectual property and licensing/franchising; and reasons for and restrictions in covenants not to compete in their relationship to intellectual property and licensing.

Class Session 4: 3 hours

Antitrust

Goals: This section of the course will cover antitrust basics, including rules against dealer termination, rules against price fixing, vertical restraints, and tying, and how these issues arise in franchising.

Reading Requirements: Students should read portions of Chapter 5 of Franchising.

Disputes Resolution: Mediating, Arbitrating and Litigating Franchise Disputes

Goals: This section of the course will cover practical issues in litigating franchise disputes, including the importance of jurisdiction and venue in franchising, litigation strategies, arbitration and mediation; implications of procedural choices, financial considerations, insurance, and the impact of franchisee associations on litigation.

Mediation exercise.

Guest Speaker: This class should include a presentation by counsel from a local franchise company and time for question and answer.

Ethical Responsibilities

Goals: This section of the course will identify ethical and professional responsibility issues in franchise law representation. This section will include a course review.

Reading requirements: Students should read *Beverly Hills Concepts v. Schatz*.[35]

Learning Outcomes: Students will be introduced to antitrust law, as well as to dispute resolution, including understanding and distinguishing between mediation, arbitration, and litigation, and to a discussion and analysis of the ethical responsibilities of lawyers, applied in the real-world context of practicing franchising law and business franchise relationships.

2. Sample Course Outline II[36]

Course Title: Franchise Law

Outline for a one unit course taught on one weekend day over two consecutive weekends, eight hours per day (sixteen hours total).

Course Overview

Franchising has an enormous impact on the American economy with estimates of as much as fifty percent of all retail sales occurring through franchise outlets.[37] This survey course will review and dissect a modern franchise agreement, providing a detailed examination of practical contract law in the business world. The class will also study many other fields of business law including agency, antitrust, arbitration, trade secrets, and trademark law. Two state franchise statutes will be carefully examined, providing a road map for working with new and unfamiliar statutes. The class is recommended not only for those interested in business law, but those planning in practicing in other areas of law who seek an overview of business and contract law.

35. Beverly Hills Concepts v. Schatz & Schatz, 1997 Conn. Super. Lexis 178, *aff'd in part & rev'd in part*, 717 A.2d 724 (Conn. 1998) (found on page 619 of Franchising, *supra* note 22).

36. Adapted from the syllabus for franchise course taught by Peter Lagarias at John F. Kennedy School of Law.

37. David J. Kaufmann, *An Overview of the Business and Law of Franchising*, 2013 WL 3773409, at *1 (June 2013) ("Franchising is an economic force so remarkably powerful that today it accounts for approximately 40 percent of all retail sales transacted in the United States."); Howard Yale Lederman, *What Makes a Franchise*, 87 Mich. B.J. 23 (Sept. 2008) (noting that franchising accounts for fifty percent of all retail sales and one trillion dollars in sales annually in the United States) (citing U.S. Gen. Accounting Off., GAO-01-776, Federal Trade Commission Enforcement of the Franchise Rule 5 (2001)).

Course Objectives

The course seeks to present an overview of franchise and distribution law. This field of law is a certified specialization area of the Office of Legal Specialization of the State Bar of California.[38]

The course seeks to provide students with an understanding of a complex business contract from the business world, an exemplar modern franchise agreement. This course will examine not only why particular provisions are included in franchise agreements, but also how and why provisions might be changed from franchisor and franchisee perspectives.

The course seeks to review an exemplar real world franchise disclosure document. Students will be asked whether the disclosures are useful, complete, or overwhelming and confusing.

The course seeks to study two consumer protection statutes in depth: the California Franchise Investment Law[39] and the California Franchise Relations Act.[40] Students will address these statutes for typical California statutory attributes: legislative purposes, definitions, coverage and liability, remedies, and other provisions.

Syllabus

Topic 1: Introduction to Franchising.

a. History of Franchising.
b. Legal Specialization in California and Franchise and Distribution Law.

Topic 2: Overview of Franchise Disclosure Laws and Franchise Disclosure Document (FDD).

a. The Federal Trade Commission Franchise Disclosure Rule.[41]
b. FDD Items 1 through 23.
c. The California Franchise Investment Law.[42]
d. Definition of a franchise.[43]
e. Disclaimers in franchise disclosure.[44]

Topic 3: Overview of a Franchise Agreement—Table of Contents

Topic 4: Preambles and Grant—(Franchise Agreement preambles and grant provisions).

38. See requirements for certification as a specialist at www.calbar.ca.gov/Attorneys/Legal-Specialization/Becoming-a-Certified-Specialist.
39. Cal. Corp. Code § 31000 et seq.
40. Cal. Bus. & Prof. Code § 20000 et seq.
41. 16 C.F.R. § 436.1 et seq.
42. Cal. Corp. Code § 31000 et. seq.
43. Gentis v. Safeguard Bus. Sys., Inc., 71 Cal. Rptr. 2d 122 (Ct. App. 1998).
44. Courad, LLC v. Kidville Franchise Co., 109 F. Supp. 3d. 615 (S.D.N.Y. 2015).

Topic 5: Franchised Location and Territorial Rights.[45]

Topic 6: Royalties (royalties provision).

Topic 7: Operational Manual (operation manual provision).[46]

Topic 8: Operating Assistance (operating assistance provision).

Topic 9: Franchisee's Operational Covenants.

Topic 10: Advertising.

Topic 11: Quality Control and Product Restrictions, Sherman Antitrust Act.[47]

Topic 12: Trademarks.

- a. The Lanham Act.[48]
- b. California Franchise Relations Act.[49]
- d. *Autozone, Inc. v. Tandy Corp*oration.[50]
- e. *S & R Corp. v. Jiffy Lube International, Inc.*[51]

Topic 13: Reports.

Topic 14: Transfer.

Topic 15: Term and Renewal.

Topic 16: Default and Termination.

Topic 17: Business Relationships.

- a. Vicarious liability and agency law.[52]

Topic 18: Non-compete Provisions.[53]

Topic 19: Trade Secrets.[54]

Topic 20: Choice of Law.

Topic 21: Jury Trial Waiver.[55]

45. Burger King Corp. v. Weaver, 169 F.3d 1310 (11th Cir. 1999); Scheck v. Burger King Corp., 756 F. Supp. 543 (S.D. Fla. 1991).

46. Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts*, 42 Stan. L. Rev. 927 (1990).

47. 15 U.S.C. § 1 et seq.; State Oil Co. v. Khan, 522 U.S. 3 (1997).

48. 15 U.S.C. §§ 1111, 1124–1125.

49. Cal. Bus. & Prof. Code § 21000 et. seq.

50. Autozone, Inc. v. Tandy Corp., 373 F.3d 786 (6th Cir. 2004).

51. S & R Corp. v. Jiffy Lube Int'l, Inc., 968 F.2d 371 (3d Cir. 1992).

52. Patterson v. Domino's Pizza, LLC, 177 Cal. Rptr. 3d 539 (Ct. App. 2014).

53. Cal. Bus. & Prof. Code §16600.

54. Uniform Trade Secrets Act, 14 U.L.A. 433; *see also*, *e.g.*, Cal. Uniform Trade Secrets Act, Cal. Civ. Code § 3426.1 et seq.

55. Grafton Partners L.P. v. Superior Court, 32 Cal. Rptr. 3d 5 (Ct. App. 2005).

Topic 22: Limitation of Remedies and Class Actions.

Topic 23: Mandatory Arbitration.[56]

Topic 24: Transactional and Other Business Considerations.

a. Franchisor perspective: franchising and alternatives to franchising.
b. Franchisee perspective: obtaining a franchise versus starting own business.
c. FDD and franchise agreement drafting for the franchisor.
d. FDD review and franchise agreement negotiation for the franchisee.
e. Subfranchisors, area developers, and other agreements.
f. Franchisee associations and group actions.

3. Sample Course Outline III[57]

Course Title: Franchise Law

Outline for a Course Taught Over six weeks, one class per week, two hours per class.

Students should expect to spend approximately two hours outside of class on reading and preparation for each hour in class.

Casebook*:* Franchising: Cases, Materials & Problems (Alexander M. Meiklejohn ed. 2013) [hereinafter Franchising]

Other materials: will be provided by the Professor.

Syllabus

Week 1: 2 hours

Introduction to franchise law; administrative matters; summary of subjects to be covered.

Assignments: Franchising xxv–xxxi in the Introduction;

Franchising 19–26.

Sample brief submitted by instructor to federal court.

Week 2: 2 hours

The FTC Franchise Rule:[58]

56. Federal Arbitration Act, 9 U.S.C. § 1 et. seq.; AT&T Mobility LLC v. Concepcion, 563 U.S. 333 (2011); Doctor's Assocs., Inc. v. Casarroto, 517 U.S. 681 (1996); Bridge Fund Cap. Corp. v. Fastbucks Franchise Corp., 2008 WL 3876341 (E.D. Cal. 2008), *aff'd*, 622 F.3d 996 (9th Cir. 2010).

57. The authors thank Stanley Dub who kindly provided the outline that this sample is based on, for a course taught by Mr. Dub at Case Western Reserve School of Law.

58. 16 C.F.R. § 436.1 et seq.

i) Coverage and exemptions.

ii) The franchise disclosure document.

iii) Enforcement, including state legislation.

Assignments: FRANCHISING read Chapters 8 and 9, pp. 363–443.

Also provided is an FDD for a restaurant franchise. Students are encouraged to briefly review this while studying Chapter 9. Note that the FDD includes a number of required exhibits, including the franchise agreement.

For week 3, students will write their own section of a hypothetical franchise agreement. Students will be provided materials in the Week 2 class, describing a contract provision to be included in a hypothetical franchise agreement.

Week 3: 2 hours

Discussion of franchise agreements.

The class will discuss franchise agreements generally and discuss the homework assignment and other contract drafting examples.

In the writing assignment and the Week 3 discussion, students may wish to refer to the restaurant franchise agreement referred to above. This is optional.

Assignment: Read Chapter 6 of the FRANCHISING ("Typical Contract Terms") In reading these sixty-four pages, students need not read the cases, and need not read the "Questions." Students should read the various discussions of subjects typically included and the samples of contract language provided.

Week 4: 2 hours

First hour—Relationship and termination laws.

Second hour—Begin common law litigation issues.

Assignment: Chapters 11 and 13 of FRANCHISING. (You need not read the cases in Chapter 11. Read all of Chapter 13.)

Week 5: 2 hours

Continue Common Law Litigation issues; Discussion of *Bower v. Zounds Hearing Franchising, LLC* case.[59]

Assignment: Discussion will continue based on Chapter 13 of FRANCHISING. Read these cases:

1. *Tele-Save Merchandising Co. v. Consumers Distributing Company*[60]
2. *Cottman Transmission Systems, LLC v. Kershner*[61]

59. Bower v. Zounds Hearing Franchising, LLC, 2017 WL 898042 (N.D. Ohio Mar. 7, 2017).
60. Tele-Save Merch. Co. v. Consumers Distrib. Co., 814 F.2d 1120 (6th Cir. 1987).
61. Cottman Transmission Sys., LLC v. Kershner, 492 F. Supp. 2d 461 (E.D. Pa. 2007).

3. *Zounds Hearing Franchising, LLC v. Bower*[62]

Week 6: 2 hours

First 45 minutes—Review for exam.

Rest of Class Period—Final exam (60 minutes recommended, 90 minutes allowed).

Assignment: Study for final exam.

4. Sample Course Outline IV[63]

Course Title: Franchising

Outline for a course taught over ten weeks, two classes per week, seventy minutes per class.

Week One, Class 1:	History of Franchising
Week One, Class 2:	Structure of Franchise Relationships
Week Two: Class 3:	Trademarks and Trade Dress
Week Two, Class 4:	Trademarks and Trade Dress
Week Three, Class 5:	Common Law Doctrines in Franchising
Week Three, Class 6:	Anti-Trust Principles Affecting Franchise Law
Week Four, Class 7:	Franchise System Trade Secrets—Copyright
Week Four, Class 8:	The FTC Franchise Rule—FDD—Drafting, interpretation, requirements.
Week Five: Class 9:	The FTC Franchise Rule—FDD—Drafting, interpretation requirements—the Franchise Agreement
Week Five: Class 10:	The FTC Franchise Rule—Franchise Agreement, continued.
Week Six: No Class—	Spring Break
Week Seven, Class 11:	State Franchise Relationship Laws
Week Seven, Class 12:	Realties of Franchising—Guest Speaker, CEO of Franchising Company, Presentation and Time for Questions and Answers
Week Eight, Class 13:	State & Federal Disclosure Requirements & Issues

62. Zounds Hearing Franchise, LLC v. Bower, 2017 WL 4399487 (D. Ariz. Sept. 9, 2017).
63. The authors thank Roger Schmidt who kindly provided the outline on which this sample is based for a franchise law course taught by Mr. Schmidt at Baylor Law School.

Week Eight, Class 14: Mergers & Acquisitions in Franchising

Week Nine, Class 15: Protecting Private Data in a Franchise System

Week Nine, Class 16: Controlling Your Franchise Brand on Web 2.0—Internet & Social Medias

Week Ten, Class 17: Dispute Resolution in Franchising

Week Ten, Class 18: Classes End, review if schedule and time permits.

5. Sample Course Outline V[64]

Course Title: Franchise Law

Outline for a course taught over fifteen weeks (one class per week for fourteen weeks and one week for final exam), one hour and fifty minutes per class

Text: *Franchising Cases, Materials & Problems*, Alexander M. Meiklejohn, Lead Editor

This syllabus is provided prior to the start of the course and is subject to change. Grading will be based on one short writing assignment, an oral and visual presentation, and class participation. Grades may be raised or lowered by 1/3 (a plus or minus) for class participation (or lack thereof). We may have guest lecturers and participants from time to time.

Students are expected to complete reading assignments prior to the class that week and come to class ready to discuss the material. Note taking during class is encouraged; audio and/or visual recording are prohibited.

Learning Outcomes for this Course:

First Tier Learning Outcomes

Outcome 1: Graduates are expected to demonstrate competency in legal analysis and reasoning and legal problem solving.

Specific Criteria

Graduates are expected to demonstrate competency in the following:

1. Reading cases, statutes and regulations effectively to glean rules and—if in play—the developmental history and policies underlying the rules.
2. Recognizing issues and possible rules implicated in new and unfamiliar factual situations.
3. Applying applicable rules effectively to understand potential arguments and counter-arguments in new and unfamiliar factual situations.

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64. The authors thank Nichole Micklich, who kindly provided the outline on which this sample is based for a course taught by Ms. Micklich at Quinnipiac University School of Law.

4. Assessing what additional facts may need to be gathered for appropriate analysis of a legal issue.
5. Assessing the relative strength of arguments and predicting likely outcomes effectively for legal issues.
6. Analyzing applicable rules and facts to formulate and evaluate potential solutions to legal problems.

Outcome 2: Graduates are expected to demonstrate competency in oral and written communication in the legal context.

Specific Criteria

Graduates are expected to demonstrate the following:

1. Competency in cogently communicating analysis and advice orally in a range of settings and contexts.
2. Competency in listening effectively to clients and others.
3. Competency in cogently communicating analysis and advice in writing across a range of types of writings (e.g., memos, briefs, and client letters).
4. At least a basic understanding of principles of logic and rhetoric.
5. At least novice-level understanding of and competency in a spectrum of advocacy skills.

Second Tier/IP Learning Outcome 2: Concentration graduates are expected to demonstrate at least a novice-level competency in oral and written communication in the legal context as relates to intellectual property matters.

Specific Criteria

Concentration graduates are expected to demonstrate the following:

1. Competency in listening effectively to clients and others in order to understand and address clients' IP matters.
2. Understanding of, and competency in, a spectrum of oral and written advocacy skills on behalf of IP clients.
3. Competency in listening and in oral and written communication modes.

Standard 310 of the American Bar Association's Accreditation Standards requires that for each credit hour earned, a student must do an amount of work that reasonably approximates at least 50 minutes of classroom instruction per week and at least an average of 120 minutes of out-of-class work per week for fifteen weeks.[65] Out-of-class work includes class preparation,

65. Am. Bar Ass'n, ABA Standards and Rules of Procedure for Approval of Law Schools 2020–2021, at 22 (2020), www.americanbar.org/content/dam/aba/administrative/legal_education_and_admissions_to_the_bar/standards/2020-2021/2020-21-aba-standards-and-rules-for-approval-of-law-schools.pdf.

post-class review, outlining, time spent on written and other class assignments, meeting with study groups, meeting or otherwise communicating with the professor to discuss course- related topics, and exam preparation. The fifteen-week period includes one week for examinations.

Based on the average length and difficulty of the reading assignments and the number and average difficulty of other course exercises and assignments, four (4) or more hours of out-of-class work will be required on average per week to prepare adequately for class, complete all assignments, master the course material, and perform satisfactorily on all course assessments.

At the end of the course, students will be asked to indicate approximately how much out-of- class time they have spent per week per credit hour in this course, so please be mindful of this requirement as the course progresses.

Class 1—Introduction to Franchising

Class 2—The Franchise Agreement

Assignment: Chapter 6, pp. 237–99 mandatory

Familiarize yourselves with the sample coffee house Franchise Agreement

Class 3—Registration & Disclosure, The Federal Trade Commission Rule, Chapter 8

Class 4—State Franchise Sales Laws & Relationship Laws, Chapter 10, pp. 445–500 and 531–35; Chapter 11, Introduction

Class 5—Trademark Law, Chapter 2, pp. 27–59

Class 6—Trademark Law, continued, Chapter 2, pp. 59–88

- *TracFone Wireless, Inc. v. Clear Choice Connections, Inc.*[66]
- *Oakville Hills Cellar, Inc. v. Georgallis Holdings, LLC67*

Class 7—Copyright Law
Chapter 3, pp. 89–94, 97–103 (skip Problem 3.2), 104–11, 123–38, and 142–45; *Bill Graham Archives v. Dorling Kindersley, Ltd.68*

Class 8—Copyright Law, continued

Hand in Draft Writing Assignment

Chapter 4

Class 9—Antitrust Principles – Chapter 5, pp. 185–210 and 229–36, Chapter 5, pp. 210–29 (optional)

Class 10—Termination

66. TracFone Wireless, Inc. v. Clear Choice Connections, Inc., 102 F. Supp. 3d 1321 (S.D. Fla. 2015).
67. Oakville Hills Cellar, Inc. v. Georgallis Holdings, LLC, 826 F.3d 1376 (Fed. Cir. 2016).
68. Bill Graham Archives v. Dorling Kindersley, Ltd., 448 F.3d 605 (2d Cir. 2006).

HAND IN FINAL WRITING ASSIGNMENT

Chapter 11, pp. 537–68 and 579–94

Class 11—Post-Term Obligations

- *Outdoor Lighting Perspectives Franchising, Inc. v. Harders*[69]
- *Novus Franchising, Inc. v. Dawson*[70]
- *Jackson Hewitt, Inc. v. Davis Dupree-Roberts*[71]
- *SmallBizPros, Inc. v. Terris*[72]

Class 12—Who Owns the Goodwill?; Catch-Up and Review

Chapter 11, Section III pp. 568–79

- *Neptune T.V. Appliance Service, Inc. v. Litton Microwave Cooking Products Division, Litton Systems, Inc.*[73]
- *LaGuardia Associates v. Holiday Hospitality Franchising, Inc.*[74]
- Conn. Gen. Stat. § 42-133f

Class 13—Dispute Resolution, Remedies, Recovery

- *Sanford v. Maid-Rite, Corp.*[75]
- *Fowler v. Cold Stone Creamery, Inc.*[76]
- *Michelin No. Am., Inc. v. InterCity Tire & Auto Center, Inc.*[77]
- *Dunkin' Donuts Franchising, LLC v. SAI Food Hospitality, LLC*[78]
- *Powerhouse Motorsports Group, Inc. v. Yamaha Motor Corp.*[79]

69. Outdoor Lighting Persps. Franchising, Inc. v. Harders, 747 S.E.2d 256 (N.C. Ct. App. 2013).
70. Novus Franchising, Inc. v. Dawson, 725 F.3d 885 (8th Cir. 2013).
71. Jackson Hewitt, Inc. v. Davis Dupree-Roberts, 2013 WL 4039021 (D.N.J. Aug. 7, 2013).
72. SmallBizPros, Inc. v. Terris, 2014 WL 12573673 (M.D. Ga. June 10, 2014).
73. Neptune T.V. Appliance Serv., Inc. v. Litton Microwave Cooking Prods. Div., Litton Sys., Inc., 462 A.2d 595 (N.J. Super. Ct. App. Div. 1983).
74. LaGuardia Assocs. v. Holiday Hosp. Franchising, Inc., 92 F. Supp. 2d 119 (E.D.N.Y. 2000).
75. Sanford v. Maid-Rite, Corp., 2014 WL 1608301 (D. Minn. Apr. 21, 2014).
76. Fowler v. Cold Stone Creamery, Inc., 2013 WL 6181817 (D.R.I. Nov. 25, 2013).
77. Michelin N. Am., Inc. v. InterCity Tire & Auto Ctr., Inc., 2013 WL 4525144 (D.S.C. Aug. 26, 2013).
78. Dunkin' Donuts Franchising, LLC v. SAI Food Hosp., LLC, 2013 U.S. Dist. LEXIS 181752 (E.D. Mo. Dec. 31, 2013).
79. Powerhouse Motorsports Grp., Inc. v. Yamaha Motor Corp., 164 Cal. Rptr. 3d 811 (Ct. App. 2013).

Franchising in Indonesia

*Abhishek Dube & Norma Mutalib**

I. Introduction

Indonesia is a sovereign archipelago in Southeast Asia and the fourth most populous country in the world, after China, India, and the United States, with approximately 270 million people.[1] The gross domestic product (GDP) of Indonesia was worth 1.2 trillion U.S. dollars in 2019.[2] With this kind of economic base, Indonesia should be a ripe market for franchising. But, as of December 2, 2019, only eighty franchisors were registered with the Indonesia Ministry of Trade (MOT).[3] Of the eighty, fifty-six were foreign franchisors, and twenty-three were local franchisors. Additionally, twenty-three local master franchisees were registered in Indonesia and were operating master franchised businesses (for both local and foreign brands).[4] One of the reasons that franchising may not be as expansive in Indonesia as one may expect is that Indonesia has had extensive franchise regulations in place since 1997.[5] Since that time, however, the Indonesian franchise regulatory regime has undergone a number of changes—notably, with a significant revision

Mr. Dube

Ms. Mutalib

1. *Indonesia*, The World Bank (Dec. 3, 2019), https://data.worldbank.org/country/indonesia.
2. *Id*. Indonesia's GDP value represents 1.68% of the world economy. GDP in Indonesia averaged about 270 billion U.S. dollars from 1967 until 2018, reaching an all-time high of 1.2 trillion U.S. dollars in 2019 and a record low of 5.67 billion U.S. dollars in 1967.
3. Kementerian Perdagangan Republik Indonesia [Ministry of Trade of the Republic of Indonesia], *Data Waralaba* (Dec. 2, 2019), https://www.kemendag.go.id/en.
4. *Id.*
5. Government Regulation No. 16/1997 on Franchising and Decree of the Minister of Industry and Trade No. 259/MPP/Kep/7/1997 on the Provisions and Procedure for the Implementation of Franchise Business Registration [hereinafter Regulation 16].

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on September 3, 2019.[6] This article will provide a brief history of franchise regulation in Indonesia, provide an overview of the current franchise regulations in Indonesia, and discuss some notable cases applying Indonesia's franchising laws.

II. Regulation of Franchising in Indonesia

Arguably no country's franchise regulations and administration have been more characterized by politically motivated activities, or "social supervision," than Indonesia. Far more than most other countries, protectionism and, for many years, a lack of transparency, have characterized Indonesia's regulatory regime. Indonesia introduced its first franchise regulations[7] in June 1997, and the then Ministry of Industry and Trade (currently MOT), the government agency of Indonesia that directs the formulation of policies related to the development of trade in the country (including franchise activities), adopted the implementing regulations, known as Regulation 16, in July 1997.[8] In part, Regulation 16 required disclosure and registration of the franchise agreement with the MOT.

Over the years, Indonesian franchise regulations have evolved, and, before September 2019, a number of MOT regulations governed franchising. In brief, on July 23, 2007, Government Regulation No. 42 of 2007 on Franchising (Government Regulation 42) replaced Regulation 16. Then, on August 24, 2012, Indonesia issued the implementing regulation of Government Regulation 42 Regulation of the Minister of Trade No. 53/M-DAG/PER/8/2012 on the Implementation of Franchising (Regulation 53) as amended by Regulation of the Minister of Trade No. 57/M-DAG/PER/9/2014 (Regulation 57). These regulations collectively formed the framework for franchising in Indonesia.

Over time, the MOT also issued specific regulations related to franchising in food, beverage, and modern stores (which are stores with a self-service system that sell a variety of goods and retail in the form of minimarkets, supermarkets, department stores, hypermarkets, or wholesale outlets), including (1) Minister of Trade No. 07/M-DAG/PER/2/2013 on the Development of Partnerships in the Franchising of Food and Beverages Services Business Activities (Regulation 7) as amended by Regulation No. 58/M-DAG/

6. Minister of Trade Regulation No. 71 of 2019 on the Implementation of Franchises [hereinafter Regulation 71].

7. *See generally* Regulation 16, *supra* note 5.

8. *See generally* Kementerian Perindustrian Republik Indonesia [Ministry of Industry of the Republic of Indonesia] (Dec. 5, 2019), https://kemenperin.go.id/profil/69/sejarah-kementerian-perindustrian (noting that the Indonesia Ministry of Industry and Trade was changed into the MOT. Under the presidency of Susilo Bambang Yudhoyono in 2009, the Industry and Trade Department was separated into two different departments, the Industrial Department and the Trade Department, which led to the separation of the Ministry of Industry and Trade).

PER/9/2014;[9] (2) Minister of Trade Regulation No. 60/M-DAG/PER/9/2013 concerning Obligations on the Use of a Franchise Logo (Regulation 60);[10] (3) Minister of Trade Regulation No. 68/M-DAG/PER/10/2012 on Modern Store Franchising (Regulation 68);[11] and (4) Decision of the Director General of Domestic Trade No. 16/PDN/KEP/3/2014 concerning Technical Guidelines for Franchise Implementation and Monitoring.[12]

Of course, foreign franchisors have historically expressed a great deal of concern about Indonesia's requirements. For example, Regulation 53 required that franchisors and franchisees must use domestically produced goods and/or services for at least eighty percent of their raw materials, business equipment, and trade goods in the franchised business.[13] Similarly, Regulation 7 capped the number of outlets that each franchisee could own in the food, beverage, and modern store business sectors.

Perhaps recognizing that some of the regulatory hurdles to franchising in Indonesia were a significant disincentive to foreign investment (and due to an apparent desire by the current government in Indonesia to promote foreign investment), Indonesia issued a new franchise regulation on September 3, 2019, which came into force on September 4, 2019. The intent of the new regulation, Minister of Trade Regulation No. 71 of 2019 on the Implementation of Franchises (Regulation 71), was to simplify the registration process and facilitating investors. It has replaced all of the previous ministerial-level franchise regulations referred to above (including Regulations 7, 53, 57, 60, and 68). Only Regulation 42 remained in effect. This paper refers to Regulation 42 and Regulation 71 collectively as the Franchise Regulations. Despite the introduction of Regulation 71 and the intent of it to promote foreign business investment, there still remains a number of administrative impediments—especially for foreign franchisors—to enter the Indonesian market.

A. *Franchise Sales in Indonesia*

The Franchise Regulations provide that a "franchise" must meet the following criteria to be sold in Indonesia: (1) have specific business characteristics; (2) have at least a five year history of experience and showing of profitability; (3) have a written standard operating procedure and a description of the proposed goods and/or services; (4) be easy to teach and apply;

9. *See generally* Minister of Trade No. 07/M-DAG/PER/2/2013 on The Development of Partnerships in the Franchising of Food and Beverages Services Business Activities as amended by Regulation No. 58/M-DAG/PER/9/2014.

10. *See generally* Minister of Trade Regulation No. 60/M-DAG/PER/9/2013 concerning Obligations on the Use of a Franchise Logo.

11. *See generally* Minister of Trade Regulation No. 68/M-DAG/PER/10/2012 on Modern Store Franchising.

12. *See generally* Decision of the Director General of Domestic Trade No. 16/PDN/KEP /3/2014 concerning Technical Guidelines for Franchise Implementation and Monitoring.

13. Government Regulation of the Minister of Trade No. 53/M-DAG/PER/8/2012 on the Implementation of Franchising, art. 19 [hereinafter Regulation 53].

(5) provide continuous support to the franchisee; and (6) have a registered trademark or other registered intellectual property right.[14]

Under the Franchise Regulations, "franchisors"[15] are individuals or entities that grant the right to use and/or exercise the franchise to "franchisees"[16] (which may include, both franchisees and subfranchisees). The Franchise Regulations also define *franchise agreement* as a written agreement between the franchisor and a franchisee (or master franchisee and subfranchisee).[17] As such, the disclosure and registration requirements of the Franchise Regulations (discussed in Sections B.1 and B.2 ahead) apply both to direct- and master-franchises.

Further, and based on local practice, the Franchise Regulations apply to a sale or offer to sell a franchise that occurs in Indonesia, is made to citizens of Indonesia in Indonesia, or is for a franchised business that will operate in Indonesia. The Franchise Regulations do not apply to the offer or sale of a franchise originating in Indonesia to citizens of a foreign country or Indonesian citizens in a foreign country for a franchised business that will operate outside of Indonesia.[18]

1. Disclosure Document

A franchisor must provide a pre-sale disclosure document (also sometimes called a "franchise offering prospectus") disclosing its business data and other information to a prospective franchisee at least two weeks before execution of the franchise agreement.[19] A disclosure document is a written document from the franchisor that provides the prospective franchisee with various pieces of information, which are detailed below.[20] This time requirement is to give the prospective franchisee sufficient time to review the information to decide whether or not to engage in the franchise arrangement, to consider the reputation and goodwill of the franchisor, and to ensure that the prospect fully understands the parties' respective rights and obligations. Further, a franchisor must obtain a Franchise Registration Certificate (called a "Surat Tanda Pendaftaran Waralaba" or STPW) from the MOT before providing the disclosure document to any prospective franchisee.[21] The franchisee must also obtain a separate STPW under its name after the franchise agreement is signed.[22] The requirements for obtaining the STPW (including registering the franchise agreement and disclosure document with the MOT) are discussed in Section B.2 ahead.

14. *See generally* Regulation 71, *supra* note 6.
15. *Id.* art. 2(3).
16. *Id.* arts. 2(4), 2(6).
17. *Id.* art. 1(8).
18. International Franchise Sales Laws 217 (Andrew P. Loewinger & Michael K. Lindsey eds., 2d ed. 1995).
19. Regulation 71, *supra* note 6, art. 5(1).
20. *Id.* art. 1(7).
21. *Id.* art. 10.
22. *Id.*

The disclosure document must include the following information (as set forth in Attachment I of Regulation 71):

a. data on the identity of the franchisor, which is a photocopy of the identity card or passport of the business owner if an individual and photocopies of the identity cards or passports of the shareholders, commissioners, and directors if it is an entity;
b. the business legality of the franchisor, including information on the franchisor's business license;
c. the business history of the franchisor, including information regarding the establishment of the franchisor, its business activities, and the development of the franchisor's business;
d. the organizational structure of the franchisor, covering the management hierarchy, from board of commissioners and board of directors to the operating division(s);
e. audited financial statements or balance sheets of the franchisor for the past two years;
f. the number of franchised businesses, organized by the country of the domicile of the outlet/business place for an overseas franchisor;
g. the list of franchisees both in Indonesia and overseas;
h. the rights and obligations of:
    i. the franchisor, such as the right to receive royalties and the obligation to provide continuous assistance to the franchisee; and
    ii. the franchisee, such as the obligation to keep confidential the intellectual property rights and business characteristics; and
    iii. the intellectual property rights that are granted by the franchisor, including the registration status of the intellectual property rights. [23]

Further, if the franchisor originally prepared the disclosure document in a foreign language, the franchisor must also provide a separate sworn Indonesian translation.[24]

2. Applicable Government Regulations

To engage in franchise transactions in Indonesia, both the franchisor and franchisee must each hold their own business licenses (i.e., the franchisor's STPW and franchisee's STPW).[25] Pursuant to Government Regulation No. 24 of 2018 on Electronic Integrated Business Licensing Services, passed on June 21, 2018 (Regulation 24), before applying for the STPW with the MOT, franchisors (both foreign and domestic) must first apply for a Business Identification Number (Nomor Izin Berusaha or NIB) and Business License (i.e., an STPW that will be effective only after MOT approval) through the Online Single Submission (OSS) system.[26]

23. *Id.*, Attachment I.
24. *Id.* art. 5(3).
25. *Id.* art. 10.
26. Government Regulation No. 24 of 2018 on Electronic Integrated Business Licensing Services, passed on June 21, 2018, arts. 21, 31 [hereinafter Regulation 24]. The intention of the OSS is to reduce wait times and increase the efficiency of issuing business licenses. The Coordinating Ministry for Economic Affairs administers the OSS. Upon the enactment of Regulation 24, any business or commercial activity registration and licensing application (including

The NIB includes information about the business, such as the authorized representative's name, passport number, address, country of origin, telephone number, and e-mail address. The Business License (STPW) issued by the OSS system will state that it becomes effective upon verification of the requirements under the Franchise Regulations.[27] As such, because the MOT is the authority in charge for franchised businesses, the applicant must still submit certain documents to the MOT for verification. If the documents are in order, the MOT will issue a STPW, and the previously issued STPW (via the OSS system) automatically takes effect.[28]

Based on practice, the following chart lists the required documents needed to obtain verification from the MOT.

No.	Document	English Version	Indonesian Version	Indonesian Sworn Translation	Remarks
1.	STPW Application Form	-	√	-	-
2.	Disclosure Document	√	-	√	Must be legalized by a notary public and authenticated by the Indonesian Embassy in the home country of the franchisor.
3.	Statement Letter/ Reference Letter Issued by the Relevant Trade Attaché or Indonesian Consulate in Franchisor's Home Country	√	-	-	-
4.	Audited Financial Reports for the Last Two Years	√	-	√	-
5.	Business License and/ or Technical License of Franchisor	√	-	√	Applicable only if required in the home jurisdiction of the franchisor.
6.	Deed of Establishment/ Certificate of Incorporation of Franchisor	√	-	√	-

STPWs) is obtained through OSS, and certain technical requirements should be complied with to effectuate the licensing issued by the OSS.

27. Regulation 71, *supra* note 6, art. 11.
28. Regulation 24, *supra* note 26, art. 41.

No.	Document	English Version	Indonesian Version	Indonesian Sworn Translation	Remarks
7.	Company Group Chart or Organizational Structure	√	-	√	-
8.	Indonesian Trademark Certificates/ Application Forms	-	√	-	Copies of the trademark certificates/ applications attached to the application must match the trademarks listed in the disclosure document, franchise agreement, and that are relevant to the franchised business.
9.	Power of Attorney	√	√	-	A power of attorney is required if the application is submitted by a local counsel. The power of attorney must be signed by a person authorized to represent the franchisor under its by-laws, and if it is signed outside Indonesia, it must be legalized by a notary public and further authenticated by the Indonesian Embassy in the home jurisdiction of the franchisor.
10.	Passport of Franchisor's Representative	√	-	-	The passport should be a color copy.

As noted in the above chart, among other requirements, the franchisor must have the disclosure document notarized and legalized. For a foreign language disclosure document, the franchisor must provide a certified translation of the disclosure document. In addition, the Franchise Regulations technically require a sworn Indonesian translation of the franchise agreement,[29] but an unofficial version usually suffices in practice.

29. Regulation 71, *supra* note 6, arts. 5(1), 6(4).

Indonesia will serve a franchisor with up to three written warnings for not complying with the disclosure document registration requirements. Further, Indonesia will fine the franchisor up to IDR100,000,000 if it fails to respond to the registration requirements warnings within two weeks of the expiration of the third warning.[30] The same sanctions apply to a franchisee for not complying with the franchise agreement registration requirements.[31]

B. *Regulation 71*

Regulation 71 revoked Regulation 53, with the intent of simplifying the franchise registration process. The most important aspects of Regulation 71 are discussed below.

1. Local Sourcing

Regulation 71 substantially eases the previous requirements of Regulation 53 that franchisors and franchisees must use domestically produced goods and/or services for at least eighty percent of their raw materials, business equipment, and trade goods in the franchised business.[32] Regulation 71 relaxes this standard by simply requiring franchisors to "prioritize" the use of domestic goods and services as long they meet (1) the standards of the franchisor, and (2) the requirements under the relevant technical/sectoral regulations (if applicable). However, the annual report on franchise business activities that the franchise must submit to the MOT by the end of June of each year still must report information about the use of local products,[33] and it is unclear how the authorities will interpret and apply the "priority" requirement.

2. Franchise Registration Certificate (STPW)

As noted in Section B.1 above, before entering into a franchise agreement with, and providing the disclosure document to, a prospective franchisee in Indonesia, a franchisor must obtain an STPW. Under Regulation 71, STPWs are valid until (1) the franchisor or franchisee ceases doing business, (2) the franchise agreement expires, or (3) if the pending trademark application is not approved by the Directorate General of Intellectual Property or the trademark registration expires (or is not renewed).[34] This represents a change from the prior regulations, where a STPW was valid for five years and could be renewed.[35] Existing STPWs issued under the Regulation 53 remain valid until their expiration dates, after which a franchise must submit

30. Government Regulation No. 42 of 2007 on Franchising art. 18 [hereinafter Regulation 42].

31. *Id.*

32. Regulation 53, *supra* note 13, art. 19.

33. Regulation 71, *supra* note 6, art. 27, Attachment IV.

34. *Id.* art. 12.

35. Regulation 53, *supra* note 13, art. 19.

a new application for a STPW, and that application should follow the registration requirements discussed earlier.[36]

3. Experience Requirement of Franchisor or Master Franchisee

Regulation 71 requires the franchised business being sold to have a proven track record as a profitable business, according to the experience of the franchisor over a period of at least five years.[37] As such, and unlike the other requirements that otherwise lift onerous impediments, now a franchisor (or master franchisee) seemingly must operate for at least five years before being able to offer a franchise (or subfranchise) of its business to another party. The five-year period can take place either in Indonesia or in another country. Based on the author's experience, it appears that the MOT strictly enforces this provision of Regulation 71. This requirement is a change from the prior regulations under which the franchisor (or master franchisee) could simply provide a two-year audited financial report.

4. Audited Financial Statement

Under the required criteria, a franchisor must, among other things, provide audited financial statements for the past two years.[38] In the authors' experience, the current MOT regime appears to interpret this requirement to mean that the franchisor must submit audited financial statements for each franchised brand, and the statements must show the profitability of that specific brand. Said differently, Indonesia will not accept consolidated financial statements for multi-brand franchisors. For a franchisor entity that manages multiple brands, this requirement creates an extra burden. That franchisor must now prepare a separate audited financial statement specifically for the particular brand to be franchised in Indonesia. Further, this unwritten policy is, in the authors' experience, non-negotiable.

5. Direct or Indirect Ownership in Franchisees

Regulation 53 provided that the franchisor cannot appoint one of its subsidiaries or affiliates as its franchisee either directly or indirectly in Indonesia.[39] Regulation 71 removed this restriction regarding the direct or indirect control relationship between franchisor and franchisee. The practical effect is that a franchisor can appoint its subsidiary or affiliate as its franchisee or even hold a share in the franchisee entity depending on whether the franchise business is open for foreign investment under the Indonesia Negative Investment List. The Negative Investment List identifies which sectors are open to foreign investment in Indonesia as well as the percentage of foreign ownership permitted. Indonesia regularly revises this list, with the most recent version being Presidential Regulation No. 44/2016 on List of

36. Regulation 71, *supra* note 6, art. 33.
37. *Id.* arts. 2(2)(b), 2(3).
38. *Id.* at Attachment I(5).
39. Regulation 53, *supra* note 13, art. 7.

Business Fields Closed to Investment and Business Fields Conditionally Open to Investment.[40]

6. Master Franchisees

Regulation 71 removes the requirement to appoint one master franchisee. A franchisor can now appoint multiple franchisees in Indonesia.[41]

7. Limitation on Number of Outlets and Number of Master Franchisees

Previously, franchisors or franchisees in the food and beverage sector were only allowed to establish up to 250 self-owned outlets.[42] Those engaged in the modern store business were permitted to operate up to 150 company-owned units.[43] Regulation 71 removes these limitations on the number of outlets that a franchisee can operate in Indonesia by implication and through the express revocation of Minister of Trade Regulation No. 68/M-DAG/PER/10/2012 on Modern Store Franchising.[44]

8. Clean Break Letter

Under Regulation 53, a franchisor could not appoint a new franchisee within the same territory before the franchisor and the franchisee reached a "clean break" or there was a final and binding court ruling to solve the dispute between the franchisor and the franchisee.[45] Regulation 71 does not contain a clean-break requirement, and, as such, it would appear that a clean break is no longer required. It remains to be seen whether Indonesia will nonetheless continue to require a clean-break letter upon the termination of a franchisee.[46] In any event, it may be good to obtain and maintain a clean-break letter for proper internal records.

9. Language of Franchise Agreement

Regulation 71 requires franchise agreements to be written in Indonesian.[47] This requirement is a slight deviation from Regulation 53, which had required that a franchise agreement could be made in a different language

40. Presidential Decree No. 44/2016.

41. Regulation 71, *supra* note 6, art. 9.

42. Minister of Trade No. 07/M-DAG/PER/2/2013 on the Development of Partnerships in the Franchising of Food and Beverages Services Business Activities, as amended by Regulation No. 58/M-DAG/PER/9/2014.

43. Minister of Trade Regulation No. 68/M-DAG/PER/10/2012 on Modern Store Franchising.

44. Regulation 71, *supra* note 6, art. 34.

45. Regulation 53, *supra* note 13, art. 8.

46. *See* Regulation 71, *supra* note 6, at Attachment II(11) (providing that, although there is no "clean break" requirement, within the franchise agreement there should be a clause that states that "[t]he procedure for an extension or termination of the [f]ranchise [a]greement, such as the termination of the [f]ranchise [a]greement cannot be performed unilaterally or the [f]ranchise [a]greement terminates automatically when the term stated in the [f]ranchise [a]greement ends. The [f]ranchise [a]greement can be extended if desired by both parties under the terms set forth together.").

47. Regulation 71, *supra* note 6, art 6(4).

but then translated into Indonesian by a translator.[48] As such, bilingual form agreements (e.g., English and Indonesian) are still permitted, but, as noted later, the Franchise Regulations require that Indonesian law must govern the franchise agreement.[49]

10. Annual Reporting Deadline

Regulation 71 extended the deadline for submitting the required annual report for the franchise business activities by three months to the end of June of each year (compared to the end of March under Regulation 53).[50] In practice, the MOT may conduct a site inspection of the location of the franchise business and may question the information provided in the annual report, in particular about the use of local products. The sanctions for failure to submit the annual report remain the same (from written warnings up to revocation of the business license, applied progressively).[51]

* * *

Although some questions remain about Regulation 71, overall, it does appear that Indonesia has relaxed some of its franchising regulations. However, the new five-year profitable-experience requirement appears to be an unexpectedly onerous requirement under Regulation 71 that will cause considerable headache for less established franchisors and will provide more established franchisors with a competitive advantage in the Indonesian marketplace.

C. *Foreign Exchange Controls and Taxes*

1. Limits on Currency Conversion

Indonesia has certain foreign exchange controls. For any transaction involving the movement of foreign currency worth USD10,000 or more, the facilitating bank in must report the transaction to Bank Indonesia, which is Indonesia's central bank.[52] In addition, Bank Indonesia must obtain the supporting documents for the transaction underlying the outgoing transfer in foreign currency from its customer or the foreign party if they wish to purchase foreign currency against the Indonesian Rupiah, if the total amount exceeds USD100,000 (or its equivalent in other currencies) per month per customer.[53]

48. Regulation 53, *supra* note 13, art. 5(4).
49. Regulation 71, *supra* note 6, art. 6.
50. Regulation 53, *supra* note 13, art. 30, 31(3) (providing that the annual report by submitted by January 31 each year); Regulation 71, *supra* note 6, art. 27(3).
51. Regulation 71, *supra* note 6, arts. 30, 31.
52. Bank Indonesia Regulation No. 17/15/PBI/2015 on Foreign Exchange Transactions against Rupiah between Banks and Domestic Parties art. 12.
53. *Id.*

2. Taxes

Indonesia collects income tax primarily through a tax withholding system. If a particular item of income is subject to withholding tax, the payor is generally held responsible for withholding or collecting the tax on that item.[54] Indonesian franchisees must withhold tax from payments to foreign franchisors at a basic rate of twenty percent.[55] If the recipient is resident in a country that has a tax treaty with Indonesia, the withholding tax rate may be reduced or exempted.[56]

Indonesia levies value-added tax (VAT) on supplies of goods and services within the Indonesian customs area and those imported into the customs area.[57] VAT also applies to services performed abroad but consumed in Indonesia.[58] Therefore, VAT is payable on the provision of services by the franchisor to the franchisee, regardless of the place of performance. The general VAT rate is ten percent.[59]

Indonesia has a double tax treaty with the United States.[60] According to the treaty, the basic rate for royalties is a maximum of ten percent. To enjoy this benefit under the treaty, a U.S. company must have a certificate of domicile, which the Indonesian company (the franchisee) must then submit to the Indonesian Tax Authority. The franchisor is not required to submit their tax residency certificates.[61]

D. *Commercial Agency*

Indonesia has a commercial agency or distributorship law, which is mainly regulated under two ministerial regulations: (1) Minister of Trade Regulation No. 11/M-DAG/PER/3/2006 on the Provisions and Procedures for Issuance of Agency Certificates of Registration or Distributors of Goods and/or Services;[62] and (2) Minister of Trade Regulation No. 22/M-DAG/PER/3/2016 on the General Provisions on the Distribution of Goods as amended by

54. Law Number 7 of 1983 on Income Tax (as amended) art. 21.

55. *Id.* art. 26.

56. *Id.* art. 32A.

57. Law Number 8 of 1983 on Goods and Services and Sales Tax on Expensive Goods (as amended) art. 4(1).

58. *Id.*

59. *Id.* art. 7(1).

60. Convention between the Government of the Republic of Indonesia and the Government of the United States of America (as amended by 1996 Protocol) for the Avoidance of Double Taxation and the Prevention of Fiscal Evasion with Respect to Taxes on Income, art. 13(2), July 24, 1996, S. Treaty Doc. 104-32 (according to this treaty between Indonesia and the United States, the rate of tax imposed by a contracting state on royalties derived from sources within that contracting state and beneficially owned by a resident of the other contracting state shall not exceed ten percent of the gross amount of royalties).

61. Director General of Tax Regulation No. PER-25/PJ/2018 of 2018 on Procedures on Implementing the Approval for Avoiding Double Taxation, art. 3.

62. *See generally* Minister of Trade Regulation No. 11/M-DAG/PER/3/2006 on the Provisions and Procedures for Issuance of Agency Certificates of Registration or Distributors of Goods and/or Services.

Minister of Trade Regulation No. 66 of 2019.[63] However, according to Minister of Trade Regulation No. 22/M-DAG/PER/3/2016, distribution business actors distributing goods through a franchising distribution chain must "comply with the laws and regulation in the field of franchise."[64] Given this requirement, practitioners in Indonesia generally do not consider franchise arrangements subject to the commercial agency or distributorship law.

E. *Privacy Laws*

1. Applicable Privacy Laws

There is no specific privacy law that applies to a franchise relationship. However, there are certain regulations on the use of electronic data. The primary sources of the management of electronic information and transactions are Law No. 11 of 2008 regarding Electronic Information and Transaction (as amended),[65] Minister of Communications & Informatics Regulation No. 20 of 2016 regarding the Protection of Personal Data in an Electronic System (Regulation 20/2016),[66] and Government Regulation No. 71 of 2019 on Organization of Electronic Systems and Transactions.[67] As the general rule, these regulations require the consent of a data owner in order to acquire, collect, display, publish, transmit, distribute, and/or access opening of its personal data.

2. Effect on Franchising

Regulation 20/2016 provides that any party intending to conduct a cross-border transmission of personal data must coordinate with the authorized ministerial institution and comply with the prevailing laws and regulations. Further, the coordination with the ministerial institution must be conducted by way of:

a. providing a personal data transmission plan to the authorized ministry containing, at minimum, the clear name of the receiving country, the recipient, the transmission date, and the purpose of the personal data transmission;
b. requesting advice from the authorized minister or official, if necessary; and
c. submitting the cross-border personal data transmission report.[68]

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63. *See generally* Minister of Trade Regulation No. 22/M-DAG/PER/3/2016 on the General Provisions on the Distribution of Goods as amended by Minister of Trade Regulation No. 66 of 2019.

64. *Id.* art 5.

65. *See generally* Law No. 11 of 2008 regarding Electronic Information and Transaction (as amended).

66. *See generally* Minister of Communications & Informatics Regulation No. 20 of 2016 regarding the Protection of Personal Data in an Electronic System (Regulation 20/2016).

67. *See generally* Government Regulation No. 71 of 2019 on Organization of Electronic Systems and Transactions.

68. Minister of Communications & Informatics Regulation No. 20 of 2016 regarding the Protection of Personal Data in an Electronic System art. 22.

F. *Governing Law and Dispute Resolution*

1. Governing Law

The Franchise Regulations require that Indonesian law must govern a franchise agreement.[69] As a consequence, and as a principle of the Indonesian Civil Code, the Indonesian Civil Code will apply to the franchise agreement, including its principle of good faith.[70] Local courts will not adjudicate disputes arising under a franchise agreement governed by laws of a foreign country; if a matter is filed in an Indonesian court, it will apply Indonesian law because the Franchise Regulations require Indonesian law to govern Indonesian franchises.[71]

2. Arbitration

Law No. 30 of 1999 on Arbitration and Alternative Dispute Resolution (Arbitration Law) governs arbitrations in Indonesia.[72] Pursuant to New York Convention, offshore (outside of Indonesia) arbitration is permitted.[73] The most popular international arbitration administrators in Indonesia are the Singapore International Arbitration Centre, followed by the International Chamber of Commerce, and the United Nations Commission on International Trade Law.

The Arbitration Law provides that the courts cannot involve themselves in the resolution of a dispute if the contracting parties have chosen arbitration for the settlement of disputes.[74] Therefore, Indonesian courts should respect the choice of foreign arbitration in the agreement.

Indonesia is party to the New York Convention.[75] Under the convention, the Central Jakarta District Court can enforce a foreign arbitration award if it is awarded by an arbitrator or a panel of arbitrators in a country with which Indonesia is bound by a bilateral or multilateral agreement on the confirmation and implementation of foreign arbitration awards (e.g., the New York Convention).[76] Enforcement is limited to awards related to commercial matters.[77] A party can enforce a foreign arbitral award through an Indonesian court proceeding if the party has obtained a writ of execution (exequatur) of the award from the Chairman of the Central Jakarta District Court. The party obtains that writ by registering the foreign arbitral award in the Central Jakarta District Court.[78] The party must comply with addi-

69. Regulation 71, *supra* note 6, art. 6.
70. Indonesian Civ. Code art. 1338(1).
71. *Id.*
72. Law Number 30 of 1999 on Arbitration and Alternative Dispute Resolution.
73. Convention on the Recognition and Enforcement of Foreign Arbitral Awards art. XVI, June 10, 1958, 21 U.S.T. 2517.
74. Law Number 30 of 1999 on Arbitration and Alternative Dispute Resolution art. 3.
75. *Contracting States*, New York Arb. Ctr. (Nov. 18, 2020), http://www.newyorkconvention.org/countries.
76. Law Number 30 of 1999 on Arbitration and Alternative Dispute Resolution art. 65.
77. *Id.* art 5.
78. Law No. 30 of 1999 on Arbitration and Alternative Dispute Resolution art. 66.

tional requirements and procedures for the enforcement of the foreign arbitral award.[79] Thus, in practice, the actual enforcement of an international arbitration award in Indonesia can be a difficult process, and some foreign arbitral awards have failed due to uncertainties in the Indonesian judicial system. Based on practice, however, it appears that the failure rate has been reduced in recent years.

3. Foreign Judgments

Indonesian courts are not bound to enforce order or rulings handed down by foreign courts. A party must instead submit a new lawsuit in an Indonesian court, and the party can only use the prior foreign court ruling as a reference or piece of evidence (i.e., the prior award does not have binding effect).[80]

4. Injunctive Relief

Indonesian courts may provide a provisional ruling instructing the disputing party to cease carrying out a certain act.[81] However, the plaintiff generally must submit a request for a provisional ruling along with its lawsuit (or the defendant, if the defendant files a counter-lawsuit), except for obtaining a provisional ruling due to the intellectual property infringement. Under the applicable Supreme Court Regulation, certain procedural steps apply to filing an application for a provisional ruling, and parties should take care to ensure that they follow these steps.[82]

G. *Indonesia Case Law*

Few cases in Indonesia have involved franchises and interpretation of the Franchise Regulations. The most notable cases, however, are summarized below.

1. Harvey Nichols Case[83]

Harvey Nichols is a well-known chain of British luxury department stores. On January 23, 2007, PT Hamparan Nusantara (PT HN), PT Mitra Adiperkasa Tbk. (PT MAP), and Harvey Nichols and Company Limited (Harvey) signed an exclusive license agreement (ELA) under which Harvey granted PT HN an exclusive right to use the Harvey Nichols name, trading style, know-how, and trademarks, and an exclusive right to distribute branded products in Jakarta. In 2008, PT HN opened a Harvey Nichols store in Jakarta. In 2010, PT HN and PT MAP (collectively PT) filed an unlawful act lawsuit in the South Jakarta District Court, in which PT asked

79. *Id.* arts. 66–69.
80. Reglement op de Burgerlijke rechtsvordering art. 436.
81. Het Herziene Indlandsch Reglement art. 180; Reglement Voor de Buitengewesten art. 191(1).
82. Supreme Court Regulation No. 5 of 2012 on Provisional Decisions.
83. PT Hamparan Nusantara & PT Mitra Adiperkasa, Tbk. vs. Harvey Nichols, District Court of South Jakarta, Case No. 394/Pdt.G/2010/PN.JKT.SEL, Dec. 13, 2010.

the court to annul the ELA and declare it non-binding and without legal effect for PT HN, PT MAP, and Harvey. PT argued that Harvey had committed an unlawful act because the ELA was not merely a license agreement under Indonesian law, but instead a franchise agreement. PT asserted that the ELA's content was not only about the granting of a license from the licensor to the licensee, but also about granting a special right to use the business characteristics to market goods and/or services. Further, according to PT, the content of the ELA did not comply with the Franchise Regulations. Among other things, PT argued that it did not call for the application of Indonesian law, they had not received a franchise offering prospectus, an Indonesian translation was not available, and Harvey had never registered with the MOT. In response, Harvey argued that the ELA had never been construed as a franchise agreement, and PT agreed to and approved of a draft of the ELA before executing it. Harvey also argued that if the ELA was considered a franchisee agreement, PT signed the ELA in bad faith and otherwise failed to comply with their obligations under the ELA.

In 2011, the panel of judges at the South Jakarta District Court ruled that the ELA was a franchise agreement because the ELA granted PT the rights to utilize and use Harvey Nichols' intellectual property, discoveries, and special features in supplying and selling goods and services.[84] Furthermore, the ELA violated the intellectual property rights laws and relevant franchise regulations, so the ELA had no binding or legal effect for PT.[85] Because the business was conducted in Indonesia, the panel of judges also ruled that Harvey had committed an unlawful act for its failure to comply with its obligations under the then current franchise regulations. The panel ordered Harvey to pay compensation to PT.[86]

Harvey appealed to the Jakarta High Court, arguing that the ELA was not a franchise agreement, but simply was a cooperation agreement between the parties.[87] In 2012, the Jakarta High Court handed down its ruling dismissing the appeal and upholding the ruling of the court of first instance. Harvey subsequently filed an appeal in the Supreme Court against the Jakarta High Court's ruling, but the Supreme Court dismissed the appeal.[88]

2. Mrs. Fields Case[89]

In February 2012, DRA Tini Widjaya (Widjaya) and PT Mitra Beka Mandiri (PT MBM) and Tjio Liesar (collectively, the Master Franchisees) entered into a franchise agreement verbally for a Mrs. Fields franchise. On March 6, 2012, Widjaya paid IDR 200 million to the Master Franchisees for the franchise fee. Further, the Master Franchisees requested an IDR

84. *Id.* at 75–76.
85. *Id.* at 78.
86. *Id.*
87. *Id.* at 46.
88. Supreme Court Ruling No. 278/K/Pdt/2013, Apr. 28, 2014.
89. DRA Tini Widjaya v. PT Mitra Beka Mandiri & Tjio Liesar, Dist. Ct. of West Jakarta, Case No. 501/Pdt.G/2013/PN.JKT.BRT, May 13, 2014.

350 million down payment for the construction of the franchise outlet, but Widjaya only paid IDR 150 million. The franchise outlet was supposed to open on May 12, 2012, but that opening was postponed until May 18, 2012, because Widjaya did not make the full payment for the outlet. For the outstanding amount owed by Widjaya, the Master Franchisees decided to take over the outlet (including the operations and its income to cover for the outstanding amount). The take-over period ended on June 17, 2012, after Widjaya had paid the remaining IDR 200 million.

After the take-over period, Widjaya made the remaining payments along with the agreed royalty fee. However, throughout the post-take-over period, Widjaya felt that the Master Franchisees were neither supportive nor helpful. Widjaya argued that the Master Franchisees charged Widjaya for the operational costs during the take-over period, the Master Franchisees did not complete Widjaya's orders in a timely manner and did not deliver one oven.[90] For these reasons, Widjaya filed a lawsuit in the West Jakarta District Court claiming that the actions of the Master Franchisees were unlawful acts and that the court should annul the franchise agreement because it was not made in writing and the Master Franchisees never presented Widjaya with a franchise offer prospectus.[91]

The panel of judges in the West Jakarta District Court determined that the failure to make a franchise agreement in writing, and the failure to provide a prospectus did not materially affect the verbal agreement between Widjaya and Master Franchisees. This was because, under Regulation 42, there is no clear legal impact on the enforceability of the agreement simply because it was made orally and without the delivery of a prospectus.[92] Thus, the verbal Agreement was valid and binding on the parties.[93]

Furthermore, the panel concluded that the Master Franchisees properly did not deliver the disputed oven because Widjaya had not fully paid the royalty fee.[94] The panel excused the failure to deliver cookies by the Master Franchisees because the cookies were imported from the United States and the Master Franchisees did not have control over the timing of those deliveries.[95] In addition, the panel concluded that it was the duty of Widjaya to pay for the operational costs of the outlet because Widjaya was the owner of the outlet.[96] For the foregoing reasons, the panel ruled that the actions of the Master Franchisees were lawful.[97] Widjaya subsequently filed an appeal in the Jakarta High Court against the West Jakarta District Court's ruling, but the Jakarta High Court dismissed the appeal.[98]

90. *Id*. at 9.
91. *Id*. at 14–15.
92. *Id*. at 76.
93. *Id*.
94. *Id*. at 77.
95. *Id*.
96. *Id*.
97. *Id*.
98. Ruling No. 407/PDT/2015/PT.DKI.

3. Sari Salon & Day Spa Case[99]

In this case, PT Star Abadi Ratu Indonesia (Plaintiff) and Mr. Subandi (Subandi) entered into a franchise agreement in 2007 authorizing Subandi to use and utilize Plaintiff's franchise named Sari Salon & Day Spa (SARI). After signing the agreement, Subandi opened and operated a SARI franchise located in Jakarta. In March 2008, Subandi, without the prior express or written consent of Plaintiff, reduced the operations of the franchise and converted the location into one with other business activities unrelated to a SARI franchise. Due to the actions of Subandi, Plaintiff submitted written notifications to Subandi to the effect that Subandi should not reduce the operations of the SARI franchise or convert the area to a non-SARI business and asked Subandi to comply with the franchise agreement.

Subsequently, Subandi submitted a letter stating that he had unilaterally terminated the Agreement because he did not profit from the franchise.[100] Under the agreement, a unilateral termination resulted in the terminating party having to pay an IRD500 million penalty to the other party. Due to the unilateral termination by Subandi, the Plaintiff filed a breach of contract lawsuit against Subandi in the District Court of Central Jakarta.

To rule that Subandi had committed a breach of the agreement, the panel of judges in the District Court of Central Jakarta needed to first rule that the agreement was valid and binding on the parties.[101] Subandi argued that the agreement was not valid and binding because it did not satisfy the requirements of Law No. 30 of 2004 regarding Notaries, as the agreement did not explicitly state the identity or rights of the witness(es) as required under that law. However, the panel did not view this requirement as a legal reason to annul the agreement.[102] Instead, they adopted the conventional approach of using Article 1320 of the Civil Code to prove the validity of the Agreement.[103] The panel went on to conclude that Subandi's unilateral termination breached the agreement and that Subandi must pay the contractually required penalty.[104]

This case is an example showing how franchisees must respect the franchise agreement. As franchisors may suffer losses because of arbitrary actions of their franchisees, franchise agreements should include a penalty clause to prevent such actions from happening as well as to protect the reputation of the intellectual property owned by the franchisor. Any negative impact on the corporate image or intellectual property of the franchisor will affect the business of the franchisor as it relies heavily on its reputation.

99. PT Star Abadi Ratu Indonesia v. Subandi, Dist. Ct. of Central Jakarta, Case No. 336/PDT.G/2009/PN.JKT.PST, Apr. 12, 2010, at 77.

100. *Id.* at 4.

101. *Id*. at 36.

102. *Id*. at 36–37.

103. Indonesian Civil Code art. 1320

104. PT Star Abadi Ratu Indonesia v. Subandi, Dist. Ct. of Central Jakarta, Case No. 336/PDT.G/2009/PN.JKT.PST, Apr. 12, 2010, at 38.

III. Conclusion

Indonesia remains a prime market for foreign investment, especially franchising. However, while the intent of the recent amendments to the Franchise Regulations was to simplify the requirements for franchising in Indonesia, a number of questions remain and clarification over time must be sought.

Franchising in the Netherlands—A Primer

*Martine de Koning**

I. Introduction

This article provides an overview of the legal landscape to consider when expanding a franchise business in the Netherlands. It primarily focuses on contract law and European Union (EU) and Dutch competition law and addresses both the current legal framework and important legislative developments.

Ms. de Koning

II. The Dutch Market and Market Entry

The Netherlands is an attractive market for franchisors because franchise businesses are present in almost every sector of the market. With the number of franchise networks having increased to 921 in 2019, and more than 34,000 franchised stores employing approximately 375,000 people, franchised businesses generate a turnover of over €38.1 billion in the Netherlands.[1]

The Netherlands Franchise Association (NFV) acts as the umbrella branch organization for franchised businesses and is responsible for the

1. Dutch Franchise Ass'n, Growth in the Franchise Sector Continues, https://www.nfv.nl/Franchise%20statistiek%202018 (last visited Dec. 2, 2020).

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healthy development of franchising in the Netherlands.[2] The NFV has more than 200 franchisor members and is affiliated with the European Franchise Federation and the World Franchise Council.[3]

Under Dutch law, there are no restrictions on either a foreign entity granting a master franchise or on foreign franchisors owning equity in a local business or owning real property. However, companies incorporated under foreign law that are not located in a country that is a member of the European Economic Area can be subject to the Companies Formally Registered Abroad Act if they want to operate on the Dutch market.[4] On the basis of this act, companies have to comply with statutory and registration requirements that are applicable to Dutch companies, such as registration in the Business Register.[5] No specific tax rules apply for a foreign franchisor who wants to set up a franchise chain in the Netherlands. Foreign franchisors or franchisees qualify as a Dutch resident for tax purposes if they are established in the Netherlands as a Dutch liability company (for example, a private or a public limited liability company (*BV* or *NV* respectively)) or operate from the Netherlands through a permanent establishment.[6] In that event, foreign franchisors and franchisees are treated similarly to Dutch residents for tax purposes.

III. The Dutch Franchise Act

In the Netherlands, historically there was no statutory law on franchising. Franchising disputes, thus, have relied on a wide range of case law and statutory contract law, intellectual property laws, competition laws, and other civil laws.[7] In addition, the franchisors that are members of the NFV by virtue of their membership must comply with the European Franchise Federation's European Code of Ethics for Franchising, which includes for example the obligation to have operated the franchise system with success in the relevant market for at least one year in at least one pilot unit before starting its franchise network in that market.[8] The European Code of Ethics is not a part of Dutch law, and courts will apply it only if the parties incorporated it

2. Dutch Franchise Ass'n, *Nederlandse Franchise Vereniging* (NFV), www.nfv.nl (last visited Dec. 2, 2020).

3. *Id.*

4. Overheid.nl Law Bench, *Wet op de formeel buitenlandse vennootschappen*, https://wetten.overheid.nl/BWBR0009191/2020-02-01 (last visited Dec. 2, 2020).

5. The Dutch Chamber of Commerce (KVK) operates the registry. *See generally* www.kvk.nl (last visited Dec. 2, 2020); C. Assers, M.P. Nieuwe Weme, R.G.J. Nowak, T. Salemink, *Rechtspersonenrecht*, *Asser 2-IIb NV en BV - Corporate Governance*, July 4, 2019, 4.

6. Dutch Tax Collector, *Belastingdienst*, www.belastingdienst.nl (last visited Dec. 2, 2020).

7. *See*, *e.g.*, Paalman v. Lampenier, ECLI:NL:HR:2002:AD7329, 3.1–3.4 (Sup. Ct. Jan. 25, 2002); Albert Heijn v. Albert Heijn Franchising B.V., ECLI:HR:2018:1696 (Sup. Ct. Sept. 21, 2018).

8. NFV, *European Code of Ethics for Franchising*, www.nfv.nl/juridisch-franchisegevers (last visited Dec. 2, 2020), Eur. Franchise Fed'n, *Self-Regulation/European Code of Ethics/Guidelines on Precontractual Information*, www.eff-franchise.com/77/regulation.html (last visited Dec. 2, 2020).

into their franchise agreement.[9] In 2019 and early 2020, steps were taken to finally adopt a franchise law in the Netherlands.

A. *Dutch Franchise Act: Background*

In recent years, Dutch lawmakers faced pressure from franchisees in the Netherlands to adopt mandatory rules on franchising that would better protect the rights of the franchisees. In 2017, a controversial legislative proposal was published to provide a statutory basis for the Dutch Franchise Code (DFC), a self-regulation guidance.[10] This legislative proposal was heavily criticized by the franchisors and academics as poorly drafted, inconsistent, and contrary to the proper democratic law-making procedures in Parliament, particularly for such an impactful set of rules.[11] In February 2018, the government announced that the DFC would not form the basis of a new statutory regime.

In December 2018, a new preliminary draft bill on franchising, commonly referred to as the Franchise Act, was published.[12] The proposed Franchise Act introduced a new title on franchise agreements in Book 7 of the Dutch Civil Code (DCC)[13] and, if enacted, would become a mandatory law.[14] After the draft bill was published, a public consultation was held in January 2019.[15] There were 362 public responses, including responses from franchisees, the franchisors, law firms, franchise associations, and multinationals.[16]

In December 2019, the Dutch Council of State (Council of State) advised on the proposed—and in the meantime amended—draft bill on franchising.[17] The Council of State reviewed the proposal positively, making some recommendations regarding (a) pre-contractual exchange of information, (b) interim changes of an existing franchise agreement, (c) termination of

9. Albert Heijn v. Albert Heijn Franchising B.V., ECLI:HR:2018:1696, 3.3.3 (Sup. Ct. Sept. 21, 2018). In this case, the court ruled that the obligations included in the European Code of Ethics, such as providing information in the pre-contractual phase, are not "prevalent Dutch legal views" pursuant to Article 3:12 of the DCC.

10. *Coalition agreement*, 'Vertrouwen in de toekomst,' VVD, CDA, D66 en ChristenUnie, 35 (Oct. 10, 2017), https://www.kabinetsformatie2017.nl/documenten/publicaties/2017/10/10/regeerakkoord-vertrouwen-in-de-toekomst.

11. Martine de Koning, *Het wetsvoorstel Franchise, handig (aan)gehaakt of toch liever zelf iets breiden?*, NJB May 5, 2017, at 967, 1252–58; Martine de Koning, *Het wetsvoorstel Franchise*, *Bezint eer ge begint*, NJB, Feb. 1, 2019, at 201, 262–64.

12. Wijziging van Boek 7 van het Burgerlijk Wetboek in verband met de invoering van regels omtrent de franchiseovereenkomst (Wet franchise), Tweede Kamer, vergaderjaar 2019–2020, 35 392, nr. 2, https://www.eerstekamer.nl/behandeling/20200210/voorstel_van_wet/document3/f=/vl63itouugro.pdf.

13. Wet Franchise, *Franchise Act*, Memorandum of Explanation, 1, TK nr 3 (Feb. 10, 2020), https://www.eerstekamer.nl/behandeling/20200210/memorie_van_toelichting/document3/f=/vl63itouucq0.pdf (last visited Dec. 2, 2020).

14. Dutch Franchise Act 2020, Art. 922.

15. Letter from the Dutch State Secretary for Economic Affairs and Climate Policy to the Dutch Parliament (May 23, 2018).

16. Wet Franchise, *uw mening wordt gevraagd*, Dec. 12, 2018, https://www.internetconsultatie.nl/wet_franchise.

17. Wet Franchise, *Advies Afdeling Advisering Raad Van State en Nader Rapport*, https://www.eerstekamer.nl/behandeling/20200210/advies_afdeling_advisering_raad/document3/f=/vl63itouvawy.pdf (last visited Dec. 2, 2020).

the franchise agreement, and (d) consultation between the parties as important for balanced relationships between parties in franchising.[18] The preliminary draft bill was amended on the advice of the Council of State and presented to the House of Representatives (House) for parliamentary review in mid-February 2020.[19] The House amended provisions on pre-contractual disclosure obligations, goodwill, and the obligation to request prior consent from franchisees to certain franchise system changes; and new provisions were included.[20] The House did not act on the Council of State's recommendation to take out the possibility to lay down further mandatory rules, such as for information obligations in a royal decree. A royal decree is a decision of the government, often used to provide further detailed rules to a statute. A royal decree, unlike an act, does not have to pass through the parliamentary process.[21] The Council of state stated that a royal decree was neither necessary nor desirable for the Franchise Act, because the government's prerogative to issue royal decrees should be exercised with restraint and it is up to the courts to apply the Franchise Act in individual cases.[22]

The House of Representatives adopted the bill in a rather swift parliamentary process, which included one important amendment, declaring the Franchise Act a mandatory law for all franchisees established in the Netherlands, regardless of the law applicable to the agreement.[23] On June 16, 2020, the Dutch House of Representatives approved the bill with two amendments and some motions, (such as a scheduled evaluation of the Franchise Act after five years)[24], and on June 30, 2020, the Dutch Senate voted in favour of the Franchise Act.[25]

B. *Dutch Franchise Act: Content*

The Franchise Act includes the following topics:

1. Introduction of definitions such as "franchisor," "franchisee," "franchise agreement," and "franchise system."[26] The definition of a "fran-

18. Wet Franchise, *Franchise Act*, https://www.eerstekamer.nl/wetsvoorstel/35392_wet_franchise (last visited Dec. 2, 2020).

19. *Id.*

20. *Id.*, Arts. 913, 920, 921.

21. Although parliament can exercise control after the royal decree is issued and parliament can indicate upfront that the government needs to prior accounce its intention to issue a royal decree. The latter did no take place in the parliamentary process of the Franchise Act.

22. Wet Franchise, *Advies Afdeling Advisering Raad Van State en Nader Rapport* 3–4, https://www.eerstekamer.nl/behandeling/20200210/advies_afdeling_advisering_raad/document3/f=/vl63itouvawy.pdf (last visited Dec. 2, 2020).

23. Wet Franchise, *Franchise Act*, https://www.eerstekamer.nl/wetsvoorstel/35392_wet_franchise (last visited Dec. 2, 2020), Stemmingsoverzicht, https://www.eerstekamer.nl/behandeling/20200616/stemmingsoverzicht_tweede_kamer_2/document3/f=/vl9mf6sgpw7j.pdf (last visited Dec. 2, 2020).

24. Dutch Franchise Act 2020, Art. IIa.

25. Wet Franchise, *Franchise Act*, https://www.eerstekamer.nl/wetsvoorstel/35392_wet_franchise (last visited Dec. 2, 2020), Stemming hamerstuk, https://www.eerstekamer.nl/id/vl9yw1r89jxl/verslagdeel/stemming_hamerstuk (last visited Dec. 2, 2020), Wet Franchise, *Franchise Act*, https://www.eerstekamer.nl/behandeling/20200715/publicatie_wet/document3/f=/vlacfjxldkz7.pdf (last visited Dec. 2, 2020).

26. In Dutch, a franchise system is a "franchise formula."

chise system" is broad and comprises the operational, commercial, and organizational system for the production or sale of goods or services that is determinant for the uniform identity and reputation of the franchise businesses in the network where this system is applied, including trademarks, intellectual property rights, and know-how.[27] It is relevant that the definition of "franchise agreement" includes a reference to the licensing by the franchisor of the franchise system to a franchisee for a direct or indirect monetary remuneration.[28]

2. The concept of a "good franchisor" and a "good franchisee." The parties must behave as a good franchisor and a good franchisee respectively.[29] This means that the parties must be "reasonable and fair towards each other."[30] It applies to the pre-contractual phase—e.g. the selection of the candidate franchisee and the negotiation of the franchise agreement—as well as to the franchise relationship. What is expected and required from both parties depends on several factors, such as the type of franchise system, the industry, and the size of the franchise chain.[31]
3. Disclosure in the pre-contractual phase. The franchisee must, in any case, be informed in a timely and specific manner about a number of subjects.[32] The franchisor must provide all information that can reasonably be expected to be of importance for the franchisee in relation to entering into the franchise agreement, including the franchise agreement itself, the information regarding the required financial contributions and investments by the franchisee, the way and frequency in which parties consult each other, financial data regarding the franchise location that is to be operated by the franchisee, and the extent to which the franchisor, whether or not through a derived franchise system, may compete with the franchisee.[33] The obligation to provide financial data does not require that the franchisor provide a forecast of turnover at that location, merely that the franchisor share historical financial data available to the franchisor regarding the location (or a comparable location).

27. Dutch Franchise Act 2020, Art. 911. The definition is unfortunately not only broad but also not entirely clear. The Act also includes a definition of a "derivative franchise system," which is outside the scope of this article.

28. Wet Franchise, *Franchise* Act, Memorandom of Explanation, art. 911, 22–26, TK nr 3 (Feb. 10, 2020), https://www.eerstekamer.nl/behandeling/20200210/memorie_van_toelichting/document3/f=/vl63itouucq0.pdf (last visited Dec. 2, 2020).

29. Dutch Franchise Act 2020, Art. 912.

30. Wet Franchise, *Franchise Act*, Memorandum of Explanation, 26, https://www.eerstekamer.nl/behandeling/20200210/memorie_van_toelichting/document3/f=/vl63itouucq0.pdf (last visited Dec. 2, 2020).

31. *Id.* at 26–27.

32. Dutch Franchise Act 2020, Arts. 913–14, at 917.

33. *Id.*, Art. 913.

4. The franchisee's obligation to investigate. The franchisee must, within the bounds of reasonableness and fairness, take the necessary precautions to avoid entering into the franchise agreement under the influence of misinterpretations.[34] This means, for example, that the franchisee must properly study the information it received from the franchisor and, if necessary, timely consult expert support. For example, franchisees should request information from other franchisees in the network. Nonetheless, neither the Franchise Act nor its parliamentary history specify what is meant by "expert support." This is a term that is used in Dutch law to refer to advice by for example lawyers, financial consultants, IT consultants, or accountants. What it ultimately means in a given situation will depend on the area of the law and the precise circumstances of the case.[35]
5. Cooling off period. To prevent a prospective franchisee from agreeing to a franchise agreement, of which the content, obligations, and risks cannot be properly reviewed, a period of four weeks applies between the time of receipt of all relevant information and the intended time of execution of the franchise agreement.[36] During this period, the draft franchise agreement, and agreements inextricably linked to it, may not be changed to the detriment of the franchisee.[37] The franchisor also may not require the prospective franchisee to make any investments or payments during this period.[38]
6. Content of the franchise agreement. The act contains substantive regulations on the content of the franchise agreement.[39] In principle, the franchisor has ongoing information disclosure obligations, and must annually report on spending of contributions or fees paid by the franchisee to the franchisor for a specific purpose, such as contributions to a marketing fund.[40]
7. Technical and commercial support. The franchisor must provide the franchisee with the technical and commercial support that can reasonably be expected from it given the nature and scope of the franchise system.[41]
8. Non-compete clause. The scope of non-compete clauses will be limited to one year after the end of the franchise agreement and

34. *Id.*, Art. 914.
35. Gemeente Weerd, ECLI:NL:PHR:2014:2115, 3.1–4 (Sup. Ct. Feb. 6, 2015).
36. Dutch Franchise Act 2020, Art. 914.
37. *Id.*
38. *Id.*
39. Dutch Franchise Act 2020, Arts. 916–17, 919–20.
40. *Id.*, Arts. 916–17.
41. *Id.*, Art. 919.

to the geographic area within which the franchisee was allowed to operate a business under the licensed franchise concept.[42]

9. Goodwill. The franchise agreement must include a provision indicating if any goodwill is accrued in the franchise business of the franchisee and, if so, whether any such goodwill is attributable to the franchisor.[43] Where the franchisor takes over the franchise business after termination of the franchise agreement, or assigns it to a new franchisee with whom it concludes a franchise agreement, the franchise agreement must stipulate to what extent the franchisor will compensate the franchisee for accrued goodwill that is reasonably attributed to the franchisee.[44]
10. Consent to franchise system changes. The franchisor requires the prior consent of a majority of the franchisees established in the Netherlands, or each of the franchisees that are established in the Netherlands that are affected by the change, in order to make changes to the franchise system or to exploit directly (or via third parties) a "derived franchise system."[45] This consent requirement applies if: (1) the franchisor requires investments from the franchisee in connection with the proposed changes; (2) the amendment of the franchise agreement involves an obligation to pay, store, or other financial contribution to the detriment of the franchisee; or (3) the franchisor requires the franchisee to bear other types of costs, or if it can reasonably be expected that the intended change will lead to a loss of turnover of the business of the franchisee.[46] The franchise agreement may contain a set threshold, below which there is no need for prior consent, but the threshold may not be set too high.[47] In practice, unless franchisors negotiate and successfully introduce thresholds in their existing franchise agreements, amendments to a franchise system will generally require franchisee consent. The act aims to restrict the enforcement of clauses in the franchise agreement that allow the franchisor to make unilateral changes to the franchise system or agreement.[48]

42. *Id.*, Art. 920. The article does not clarify whether 'end of a franchise agreement' only refers to its scheduled expiry date or also an early termination (for cause) of a franchise agreement.
43. *Id.*
44. *Id.*, Art. 920.
45. *Id.*, Art. 921.
46. *Id.* The Franchise Act does not include a definition of the word "turnover" in the context of a franchise agreement. Presumably, it means any kind of negative financial impact of the change or derivative formula proposed by the franchisor on the turnover of the franchisee's unit.
47. Wet Franchise, *Franchise Act*, Memorandum of Explanation, 47–50, TK nr 3, https://www.eerstekamer.nl/behandeling/20200210/memorie_van_toelichting/document3/f=/vl63itouucq0.pdf (last visited Dec. 2, 2020).
48. *Id.*

In addition, franchise agreements cannot deviate from the provisions in the Franchise Act to the detriment of any franchisee that is established in the Netherlands, regardless of the law that governs the franchise agreement.[49] However, deviation by contract from the statute is enforceable against franchisees established outside the Netherlands, even when Dutch law is applicable to the franchise agreement.[50] Foreign franchisors therefore must amend their franchise agreements with franchisees that are established in the Netherlands to ensure compliance with the overriding mandatory provisions of the Franchise Act.

C. *Effective Date for the Franchise Act*

The Franchise Act went into effect January 1, 2021.[51] Franchise agreements executed after that date must comply with the statute's requirements. For agreements that were executed before the act's effective date, there is a limited transition period for compliance with articles 920 and 921 only, the statutory provisions on goodwill, non-compete, and prior consent.[52] In such cases, the transition period is two years, unless the agreement expires or is terminated earlier, in which case the transition period ends on the end date of the agreement.

IV. The Impact of General Contract Law

This section sets out relevant rules of general contract law that applies to franchise agreements in the Netherlands. It also provides relevant interpretations of these rules on franchising by Dutch courts.

A. *The Principle of Reasonableness and Fairness*

Legal principles and 'open norms' play a prominent role in Dutch contract law. There are several regularly invoked legal principles: the principle of freedom of contract, the principle of *pacta sunt servanda*,[53] and the principle of reasonableness and fairness.[54]

The principle of freedom of contract is fairly self-explanatory. It constitutes the freedom of every person to enter into an agreement or not, and

49. Dutch Franchise Act 2020, Art. 922.
50. *Id.*
51. Wet franchise, *Wet van 1 juli 2020 tot wijziging van Boek 7 van het Burgerlijk Wetboek in verband met de invoering van regels omtrent de franchiseovereenkomst*, https://www.eerstekamer.nl/behandeling/20200715/publicatie_wet/document3/f=/vlacfjxldkz7.pdf (last visited Dec. 2, 2020); The Franchise Act will come into force on January 1, 2021, *Besluit van 25 november 2020 tot vaststelling van het tijdstip van inwerkingtreding van de Wet franchise* Royal Decree, Staatsblad 3 Dec. 3, 2020, 493, https://zoek.officielebekendmakingen.nl/stb-2020-493.html (last visited Dec. 3, 2020.
52. Existing agreements have to comply with the rest of the statutory requirements as of January 1, 2021.
53. This phrase is in latin, and means that contracts are binding.
54. DCC, Art. 6:248(1).

once agreed, the parties are bound by it.[55] According to the principle of reasonableness and fairness, a contractual provision in a franchise agreement can be complemented, or even set aside if its effect, in light of all the facts and circumstances of the case, is unacceptable.[56] Courts adopt a reticent approach to deviating from a written contract based on this principle, and make an assessment on a case-by-case basis.[57]

Regarding termination of distribution or franchise agreements, courts consider a long duration and a high degree of dependency as relevant indicators to set aside a contractual notice period based on the principle of reasonableness and fairness if it is deemed too short in light of all circumstances of the case.[58] A limitation of liability, for example, cannot be invoked based on the principle of reasonableness and fairness, if damages arise as a consequence of willful misconduct or gross negligence of the debtor itself.[59]

The principle of reasonableness and fairness plays a role in the precontractual phase, as well as during the performance of an agreement. The contracting parties have a duty of care towards each other.[60] For example, and this now also codified in the Franchise Act, the franchisor and franchisee have a duty of care towards each other.[61] Since the franchisor is often the more powerful player in the relationship, his duties are more pronounced. The franchisor has a duty of care towards its franchisees, the presence and level of which depends on a variety of circumstances, such as the type of franchise and the experience of the franchisor.[62] For example, the following factors can be relevant: the extent to which the franchise concept covers the total business; whether the franchise concept is to be followed strictly (hard franchise); how much the franchisee can influence the operation of his own business; and how dependent the franchisee is in the relationship. The less influence the franchisee has over its own business decisions and the more the balance of power in the relationship is with the franchisor, the higher the level of the duty of care the franchisor will owe to the franchisee. And the higher the level of duty of care, the more quickly the franchisor will need to offer assistance and advice—including, where necessary, to innovate the franchise system to overcome any problems the franchisees may face—to avoid liability for negative results and damages.

55. H.B. Krans, C.J.J.M. Stolker, W.L. Valk, *Burgerlijk Wetboek*, Tekst & Commentaar (Aug. 8., 2019).

56. DCC, Art. 6:248(2).

57. *Id.*; Apeldoorn v. Duisterhof, ECLI:NL:HR:1998:ZC2540, JB 1998/27, NJ 1998, 363, RvdW 1998, 17 (Sup. Ct. Jan. 9, 1998).

58. De Ronde Venen v. Stedin, ECLI:NL:HR:2011:BQ9854 (Sup. Ct. Oct. 28, 2011), Auping v. Beverslaap, ECLI:HR:2013:BZ4163 (Sup. Ct. June 14, 2013). If the payment of a compensation is offered, this is a relevant circumstance that may render an otherwise too short notice period, enforceable.

59. DCC, Arts. 6:248(2), 3:40; Kuunders v. Swinkels ECLI:NL:HR:2004:AO6913, 3.6 (Sup. Ct. June 18, 2004); *Conclusion Attorney General* D.W.F. Verkade, n.14.

60. DCC, Art. 6:248.

61. Dutch Franchise Act 2020, Art. 912.

62. *Id.*, Art. 912.

B. *Pre-Contractual Disclosure*

Prior to the adoption of the Franchise Act, there were no statutory pre-contractual disclosure obligations for franchisors. Nonetheless, based on error, a franchisee could annul a franchise agreement if the franchisor provided erroneous statements or information, or omitted relevant information and the franchisee would not have entered into the agreement without that information.[63] It follows from general principles of contract law, as set forth in the DCC, that the franchisor has an obligation to provide relevant information to the franchisee and the franchisee also has a duty to investigate to obtain the information it needs (and vice-versa).[64] The scope of these duties, and how the agreement will be interpreted, will not only depend on the literal meaning of the agreement, but also on how the parties may have reasonably understood the agreement, and what they could reasonably expect from each other, given all facts and circumstances of the case, including the power and specific position and knowledge of each party.[65]

Nevertheless, the duty to inform the other party of relevant information generally outweighs the duty to investigate. In *Paalman v. Lampenier*, the Dutch Supreme Court determined that the doctrine of reasonableness and fairness does not, in principle, place an obligation on franchisors to provide a financial forecast (prognosis or projection) to a prospective franchisee, except in special circumstances.[66] If the franchisor provides the franchisee with a financial prognosis and is aware that the prognosis contains serious flaws, but does not notify the franchisee of those flaws, the franchisor may be found to have acted wrongfully and be held liable for damages, in addition to nullification of the franchise agreement.[67] Accordingly, in the *StreetOne* case, the Dutch Supreme Court clarified that if the franchisor prepared a financial forecast (or a party for which the franchisor is liable pursuant to Article 6:170–6:172 of the DCC), the franchisor is responsible if the forecast was not diligently prepared.[68] In other words, if the franchisee relies on incorrect information (regardless of whether the franchisor knew it was flawed), and proves that it would not have entered into the agreement without that information, it may nullify the agreement afterwards and the behaviour may be unlawful. Consequently, the franchisee must be placed in the same position as if the agreement had not been executed.[69] The court confirmed this ruling in *Albert Heijn v. Albert Heijn Franchising B.V.*[70]

63. DCC, Art. 6:228.
64. *Id.*, Arts. 6:216–217, 6:228–230, 6:248.
65. Haviltex, ECLI:NL:HR:1981:AG4158, IV sub 2 (Sup. Ct. Mar. 13, 1981).
66. Paalman v. Lampenier, ECLI:NL:HR:2002:AD7329, 3.1–3.4 (Sup. Ct. Jan. 25, 2002).
67. Aviti v. Kinderparadijs, Prg 1998/4967, (D.C. Breda Apr. 14, 1998); Brown Fashion, Prg. 1999/5211, (D. C. Arnhem June 18, 1999); Paalman v. Lampenier, ECLI:NL:HR:2002:AD7329, 3.1–3.4 (Sup. Ct. Jan. 25, 2002), ToFuel v. Tofuel B.V., ECLI:NL:GHSHE:2015:3583 (Hertogenbosch App. Ct. Sept. 15, 2015).
68. StreetOne, ECLI:NL:HR:2017:311, 5.3. (Sup. Ct. Feb. 24, 2017).
69. DCC, Art. 6:228.
70. Albert Heijn v. Albert Heijn Franchising B.V., ECLI:HR:2018:1696, 3.1–3.6 (Sup. Ct. Sept. 21, 2018).

However, if the revenues of the franchisee turn out lower than the financial forecast of the franchisor, this does not automatically mean that the financial forecast was not of the required quality. Disappointing results may result from unexpected circumstances (e.g., an economic recession) or behavior of the franchisee.[71] The franchisee must also independently investigate the franchise proposition.[72] Case law confirms that a candidate franchisee must have a critical attitude towards information provided by the franchisor regarding future revenues of a new franchise system.[73] However, there is no duty on the franchisee to investigate the correctness of the forecast in the event that the franchisor is a big professional party, who ensured that the forecast was conducted with "great care," and where the franchisor put the franchisee under time pressure to sign the agreement.[74]

If a franchisor elects to provide a forecast, which is not an obligation, it should describe how it prepared the financial forecast, including a clear substantiation of the figures, and it should clearly state whether or not the franchisee may rely on the projection, or whether it should do its own research (which still does not mean that waivers of the franchisor's liability are always enforceable). The franchisor should allow sufficient time for this research. In addition, the forecast should be based on a careful and thorough location survey and market investigation. This will make it easier, in case of a dispute, to ascertain the root cause of the error. If the error was relevant for the conclusion and performance of the agreement, the court must determine whether the error was attributable to the franchisor or the franchisee, and what the consequences should be for the parties.

C. *Termination for Convenience*

Franchise agreements can be for a definite or indefinite term, and are often a longer term. Termination for cause follows the rules of general contract law as set forth in the DCC.[75] Long-term franchise agreements for a definite term end on their expiration date and can only be terminated earlier if mutually agreed to. If an agreement is for an indefinite term, and the parties have not provided for a contractual right to terminate, the agreement can be terminated by either party for convenience. However, taking the nature and content of the agreement into consideration, the principle of reasonableness and fairness may provide that such a termination requires

71. Speeleiland Tholen v. Otto Simon, ECLI:NL RBOVE:2016:2172, 7.1–7.26 (D.C. Overijssel June 8, 2016).

72. X v. Otto Simon, ECLI:NL:RBOVE:2014:1985, 4.1–4.37 (D.C. Overijssel Mar. 9, 2014) and ECLI:NL:RBOVE:2015:2907, 2.1–2.31 (D.C. Overijssel June 6, 2015); K.S. Consulting, LJN CA1429, 4.1–5.7 (D.C. Den Bosch May 29, 2013); The Read Shop, LJN BR0232, 4.1–5 (D.C. Arnhem June 15, 2011).

73. X v. Tot Straks, ECLI:NL:GHAMS:2017:455, 3.1–3.15 (Amsterdam App. Ct. Feb. 14, 2017).

74. X v. Albert Heijn Franchising B.V., ECLI:NL:RBNHO:2014:11564, 4.1–4.36 (D.C. Noord-Holland Dec. 3, 2014).

75. DCC, Arts. 6:265–279.

sufficiently compelling grounds, a certain notice period, or an offer of compensation.[76] The fact that the termination has a negative impact on the other party plays a role, but on its own does not constitute compelling grounds.[77]

If the agreement provides a process for termination, in some cases, principles of reasonableness and fairness may still play a role. For example, they may require compelling grounds to terminate or may prevent termination at a certain moment or without an offer of compensation.[78] The Dutch Supreme Court clarified that even if the law or agreement provides a process for termination, reasonableness and fairness principles can impose further termination requirements, provided that the law or the agreement (or both) allow for application of this principle. Further, the Dutch Supreme Court stated that it could be unacceptable for a party to terminate an agreement pursuant to the terms of a contract if doing so would, for example, be unacceptable based on the principle of reasonableness and fairness.[79]

With respect to compensation upon termination, a goodwill or severance payment is normally not required in the event of the termination of a long-term agreement (except for commercial agency). When a franchisor terminates a franchise agreement, like a distributor, it may be liable to the franchisee for the amount of its investment in the franchise made at the time when the termination was not foreseeable, provided the investments could not be recouped before the end date of the agreement.[80]

In the event that a franchise agreement also contains provisions regarding the lease of premises, Dutch semi-mandatory provisions on rental law provide further protections for the franchisee.[81] For example, a landlord may only terminate a lease agreement for commercial premises (such as restaurants) through a dissolution by the sub district court.[82] It is therefore crucial that the franchisor be entitled to terminate the lease when the franchise agreement has ended and vice versa.[83] Any divergence from the semi-mandatory provisions on rental law requires the prior approval of the sub district court.[84] The sub district court will only grant permission if the rights of the tenant will be respected and it does not weaken the tenant's position.[85] But a clause in which a breach of the franchise agreement also qualifies as a breach of the lease agreement (and on the basis of which the lease agreement

76. De Ronde Venen v. Stedin, ECLI:NL:HR:2011:BQ9854, 3.1–3.7 (Sup. Ct. Oct. 28, 2011); Auping v. Beverslaap, ECLI:HR:2013:BZ4163, 3.1–3.8 (Sup. Ct. June 14, 2013).

77. Auping v. Beverslaap, ECLI:HR:2013:BZ4163, 3.1–3.8 (Sup. Ct. June 14, 2013).

78. Alcatel, ECLI:NL:HR:2016:1134, 3.1–5.2 (Sup. Ct. June 10, 2016), Goglio v. SMQ, ECLI:NL:HR:2018:141, 3.1–3.11 (Sup. Ct. Feb. 2, 2018).

79. *Goglio*, ECLI:NL:HR:2018:141, 3.1–3.11.

80. Mattel v. Borka, ECLI:NL:HR:1991:ZC0291, NJ 1991, 742, RvdW 1991, 169 (Sup. Ct. June 21, 1991).

81. DCC, Arts. 7:290–310.

82. *Id.*

83. C. Assers, I.S.J. Houben, *Onbenoemde overeenkomsten*, *Asser* 7-*X*, Mar. 1, 2015, 176.

84. Assers, *supra* note 77, at 178; DCC, Art. 7:291(2).

85. Assers, *supra* note 77, at 178; DCC, Art. 7:291(3), VBER, Art. 5(2).

may be terminated) is not a divergence that requires the prior approval of the sub district court.[86]

D. *Agency and Distributor Models*

Dutch rules regarding commercial agency are governed by statutory law.[87] Dutch law on commercial agency includes mandatory provisions, which are in line with the EU Directive of December 18, 1986 on the coordination of the laws of the Member States relating to self-employed commercial agents (86/653/EEC). Although franchisees and distributors are generally not entitled to compensation for goodwill upon termination, an agent may claim compensation for goodwill under the statute if the following conditions are met: (1) the agent has brought the principal new clients or has significantly increased the volume of business with existing clients; (2) the principal continues to derive substantial benefits from the business with those clients; and (3) the payment of this compensation is equitable.[88] The amount of compensation can never exceed the equivalent of one year's compensation based on the average of the previous five years because this provides an indication of the maximum, foreseeable exposure.[89]

The commercial and financial risks rest largely with the principal under an agency agreement. If, in reality, the franchisee acts not for his own account and risk, but for the franchisor's account and risk, such as contracting with customers in the name of the principal, the agreement may in fact be an agency relationship, which would trigger the applicability of agency law's mandatory provisions on termination, commission, and goodwill.[90] If the agent operates in the EU, this applies regardless of a choice for a non-EU member state's law.[91] Under Dutch law, this risk is reduced if the franchisee clearly indicates on or in its premises both the franchisee's identity (legal entity name) and that the franchisee operates the franchised business in its own name and for its own account and risk.[92] Usually, a sign in the store and a clear indication on the receipts that the customer receives upon payment are sufficient.

V. The Impact of EU and Dutch Competition Law on Franchise Agreements

Franchise agreements in the Netherlands are subject to EU and Dutch competition law. Article 6 of the Dutch Competition Act (DCA) is the

86. Kippersluis v. Jumbo, ECLI:NL:HR:2017:752, 2–4 (Sup. Ct. Apr. 21, 2017) and ECLI:NL:GHARL:2015:6591, (D.C. Arnhem Leeuwarden Sept 8, 2015).

87. DCC, Arts. 7:428–445.

88. DCC, Art. 7:442.

89. *Id.*

90. DCC, Arts. 7:431, 7:432, 7:442.

91. Ingmar GB Ltd v. Eaton Leonard Techs. Inc., Case C-381/98, 26 (E.C.J. Nov. 9, 2000).

92. Please note that the rules of EU member states vary and some states, not the Netherlands, may apply the goodwill compensation rule by analogy outside the context of commercial agency agreements.

national equivalent of Article 101 of the Treaty on the Functioning of the European Union (TFEU), which prohibits anti-competitive agreements and, more specifically, bans cartels.[93] If an agreement appreciably restricts trade between member states of the EU, an exemption may apply. Exemptions are an exception (e.g. a 'free pass' to application of the rule), and apply by virtue of the law (no notification or registration is required). Article 101(3) states the cumulative criteria for a so-called 'individual exemption.' To facilitate the applicable of EU competition law, certain groups of restrictions are block exempted under the Vertical Restraints Block Exemption (VBER). The VBER exempts certain groups of restraints (while qualifying others as "hard core" or "black listed") in vertical agreements provided that certain conditions are met, such as that both parties' market share on the relevant market does not exceed thirty percent and that the agreement does not contain hard core restrictions.[94] The European Commission's Guidelines on Vertical Restraints give further explanations on franchising and the Commission's policy.[95] The VBER applies to agreements with an appreciable effect on trade between member states of the EU and, through a clause in the DCA, also to trade in the Netherlands that has no cross-border effect.[96]

Certain contractual restraints common in franchise agreements, such as purchase obligations and non-competition clauses on the franchisee, fall outside the cartel prohibition, provided that these are necessary to protect the know-how of the franchise system.[97] Outside of the franchising context, these restraints should be evaluated under EU and Dutch competition law, and in some situations may be impermissible. Therefore, VBER and Article 101 of the TFEU are relevant to assess the enforceability of certain vertical restraints in franchise agreements.[98] The VBER will expire in 2022, and a consultation and law making process is currently ongoing regarding its renewal.[99]

93. The European Court of Justice (ECJ) has decided in the *Eco Swiss v. Bennetton* case, Case C-126/97 (E.C.J. June 1, 1999), that Article 101 TFEU is a rule of European public policy. By contrast, the Supreme Court stated that Article 6 of the Dutch Competition Act cannot be qualified as a rule of Dutch public policy. Gemeente Heerlen v. Whizz Croissanterie, *Conclusion Attorney General* Mr. Keus LJN BG3582, NJ 2009 (Sup. Ct. Jan. 16, 2009) and ECLI:NL:PHR:2009:BG3582, 3.1–3.7.

94. Commission Regulation (EU) No. 330/2010 of Apr. 20, 2010 on the application of Article 101 (3) on the TFEU to categories of vertical agreements and concerted practices, VBER 2010/330, examples of hard-core restrictions are resale price maintenance and internet sales restrictions.

95. European Commission, *Guidelines on vertical restraints*, 2010/C 130/01.

96. Mededingingswet, *The Dutch Competition Act* (DCA), Art. 12.

97. Pronuptia, NJ 1988, 163, par. 16 (E.C. J. Jan. 28, 1986).

98. Commission Regulation (EU) No. 330/2010 of Apr. 20, 2010 on the application of Article 101 (3) on the TFEU to categories of vertical agreements and concerted practices, VBER 2010/330.

99. European Commission, *EU Competition Rules - Revision of the Vertical Block Exemption Regulation*, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12636-Revision-of-the-Vertical-Block-Exemption-Regulation (last visited Dec. 2, 2020); European Commission, *Review of the Vertical Block Exemption Regulation*, https://ec.europa.eu/competition/consultations/2018_vber/index_en.html (last revised Oct. 23, 2020).

A. *Vertical Price Fixing*

A franchisee must always be free to set its own resale price because vertical price-fixing is a hard-core restriction under EU competition law.[100] This means that a franchisor may not require or incentivize its franchisees to sell goods for a certain minimum or fixed price. However, recommended resale prices and maximum resale prices are permitted, so long as they, in practice, do not amount to a fixed or minimum price level.[101]

In 2018, a Dutch appellate court ruled that a contractual obligation requiring the franchisees to apply fixed prices has the "object" of preventing, restricting, or distorting competition on the market.[102] The court ruled that in such a case, there is no need to perform a separate investigation into the appreciability of the restriction.[103] Because the obligation that the franchisees apply fixed prices violated Article 6(1) of the DCA, the court voided the obligation, regardless of the actual effect of the obligation, but not the entire franchise agreement.[104]

Franchisors also cannot impose a minimum resale price through indirect means. Thus, for example, franchisors may not fix distribution margins; fix the maximum level of discount the franchisee can grant from a prescribed price level; make rebates or reimbursements of promotional costs subject to the observance of a given price level; restrict the application of rebates or discounts by the franchisee; link the prescribed resale price to the resale prices of competitors; or otherwise make threats, warnings, or penalties, or use intimidation or delay or suspension of deliveries, or tie contract termination to the observance of a given price level.[105] Further, franchisors should not implement price-monitoring systems to achieve price-fixing. Practitioners should pay attention to practices such as the franchisor printing a recommended resale price on the product or the franchisor requiring the franchisee to apply a most-favored customer clause.[106]

However, resale price maintenance can, depending on the precise circumstances and purpose, be allowed in the context of launching and promoting a new product. The European Commission states that a coordinated, short-term, low-price campaign of two to six weeks can be justified to achieve a successful introduction of a new product.[107] Further, in the case of complex products, the extra margin provided by resale price maintenance may allow the franchisees to provide additional pre-and after sales services and prevent

100. Commission Regulation (EU) No. 330/2010 of Apr. 20, 2010 on the application of Article 101 (3) on the TFEU to categories of vertical agreements and concerted practices, VBER 2010/330.

101. European Commission, *Guidelines on Vertical Restraints*, 2010/C 130/01.

102. X v. X, ECLI:NL:GHSHE:2018:2370, 3.9.1–3.9.8 (Hertogenbosch App. Ct. July 5, 2018).

103. *Id.*

104. *Id.*

105. European Commission, *Guidelines on Vertical Restraints*, 2010/C 130/01, para 48.

106. *Id.*

107. *Id.* para 225.

free riding (this is where the buyer purchases from a discount vendor after having extensively consulted another seller that heavily invested in customer services and quality presentation of products).[108] In practice, companies rarely make use of these exceptions because they have the burden of proof to show the pro-competitive effects.

The European Commission seems to be enforcing more vertical price-fixing and market partitioning practices than in the past, but national competition authorities of EU Member States have also increased their focus on vertical price-fixing, and many have adopted specific guidelines for the enforcement of such practices.[109]

B. *Selective and Exclusive Distribution*

Selective distribution is the appointment of distributors and/or retailers based on specified criteria ('authorized resellers'). In a selective distribution system, these authorized resellers must be permitted to sell to end users and to each other, but they may be restricted to engage in sales outside this network of authorized resellers (in the territory where the seller operates the selective distribution system).[110] Selective distribution does not appreciably restrict trade and thus falls outside article 101 TFEU if objective, transparent, and non-discriminatory qualitative criteria are applied, and if the nature of the products justifies the operation of this system.[111] In addition, selective distribution, including qualitative as well as quantitative criteria, is permissible even where the nature of the products do not justify selective distribution, provided that the conditions for applicability of the VBER are met.[112] In *Coty v. Akzente*, the European Court of Justice ruled that under Article 101 of the TFEU, it is permissible for a franchisor—presuming the franchise network constitutes selective distribution—to prohibit its franchisees from using online third-party platforms.[113] In *Coty*, the objective of maintaining the luxury image of the products in a selective distribution network was relevant for the decision.[114] Although the judgment was subject to varying interpretations across the EU, it is clear that in any case, such Internet third-party platform bans would not constitute hard-core restrictions and

108. *Id.*

109. *See, e.g.*, Dutch Competition Authority, *Arrangements between suppliers and buyers*, Feb. 26, 2019, https://www.acm.nl/sites/default/files/documents/2019-07/guidelines-regarding-arrangements-between-suppliers-and-buyers.pdf (ENG); German Competition Authority, *Guidance note on the prohibition of vertical price fixing In the brick-and-mortar food retail sector*, July 2017, https://www.bundeskartellamt.de/SharedDocs/Publikation/EN/Others/Guidance_note_prohibition_vertical_price_fixing_LEH.pdf?__blob=publicationFile&v=2.

110. European Commission, VBER 2010/330, Arts. 1(1)e, 4(b)iii.

111. Metro I, Metro SB-Großmärkte v. Commission, 26/76, EU:C:1977:167, 39–51 (E.C.J. Oct. 25, 1977).

112. European Commission, *Guidelines on Vertical Restraints*, para 176 2010/C 130/01, European Commission, *Policy Brief re: ECJ Coty/Akzente*, at 4, https://ec.europa.eu/competition/publications/cpb/2018/kdak18001enn.pdf (last visited Dec. 2, 2020).

113. Coty v. Akzente, ECLI:EU:C:2017:941, 21–70 (E.C.J. Dec. 6, 2017).

114. *Id.*

could, regardless of the nature of the products and whether the system can be considered selective distribution, benefit from the VBER.[115]

Exclusive distribution—that is the allocation of a certain territory or consumer group exclusively to a distributor (which also can be a franchisee)—is permissible under EU and Dutch competition law.[116] Franchise agreements may prohibit franchisees from actively selling[117] to the exclusive territory or to an exclusive customer group that is allocated to another franchisee, or that the franchisor reserved to itself.[118] Passive selling,[119] including online sales, may not be restricted.[120] These arrangements are exempted by the VBER if the market share of both the franchisor and the franchisee does not exceed thirty percent of the relevant market and the agreement does not contain any hard-core restrictions.[121]

C. *Non-competes*

Non-compete provisions during the term of a franchise agreement generally fall outside the scope of Dutch and European competition law[122] if they are necessary to protect the franchisor's know-how and goodwill licensed to the franchisee, and to maintain the common identity and reputation of the franchised network.[123] Post termination non competes are block exempted if limited to the premises of the franchisee and they do not exceed one year in duration (where the agreement has a—non tacitly renewable—five-year term or is linked to a lease agreement where the franchisor is the lessor).[124]

Franchisees often try to escape from non-compete obligations by arguing that the provision constitutes a restriction on competition and is therefore null and void. Dutch courts, however, appear reluctant to set aside non compete clauses for reasons of competition law. In *ANVR cs v. IATA-NL*, the Dutch Supreme Court ruled that a contracting party trying to escape

115. European Commission, *Policy Brief re: ECJ Coty/Akzente*, 4. https://ec.europa.eu/competition/publications/cpb/2018/kdak18001enn.pdf (last visited Dec. 2, 2020).

116. Commission Regulation (EU) No. 330/2010 of Apr. 20, 2010 on the application of Article 101 (3) on the TFEU to categories of vertical agreements and concerted practices, VBER 2010/330.

117. "Active sales" are, in short, sales made at the initiative of the seller, for example as a result of his marketing or advertising activities.

118. Commission Regulation (EU) No. 330/2010 of Apr. 20, 2010 on the application of Article 101 (3) on the TFEU to categories of vertical agreements and concerted practices, VBER 2010/330.

119. "Passive sales" are, in short, sales made at the initiative of the buyer.

120. Commission Regulation (EU) No. 330/2010 of Apr. 20, 2010 on the application of Article 101 (3) on the TFEU to categories of vertical agreements and concerted practices, VBER 2010/330.

121. *Id.*

122. VBER 2010/330, Art. 5(1); European Commission, *Guidelines on vertical restraints*, 2010/C 130/01, para 190(b); *ACM Guidelines on vertical restraints*, www.acm.nl (last visited Dec. 2, 2020).

123. Pronuptia, NJ 1988, 163, para. 16 (E.C. J. Jan. 28, 1986); X v. FBD Franchise, ECLI:NL:RBOVE:2016:2914, par. 5.4. (D.C. Overijssel June 22, 2016); Multicopy, ECLI:NL:GHSHE:2005:AU8610, 4.3.2-5 (Hertogenbosch App. Ct. Dec. 28, 2005).

124. VBER 2010/330, Art. 5(2)(3).

a binding agreement by invoking competition law, has a high burden of proof.[125] Civil franchise cases such as *Yarden franchise v. X1*[126] and *Top 1 Toys v. Vedes*[127] show that a plaintiff invoking competition law must support its arguments with a thorough market definition of the relevant product and geographic market and an in-depth analysis of the market shares of the parties to fulfill the burden of proof; otherwise, the plaintiff will not succeed with the claims.[128]

A franchisee can also argue that a non-compete provision is unenforceable based on the principle of reasonableness and fairness. Relevant factors to the enforceability of a post-term, non-compete provision are the duration of the franchise relationship; the duration and the territorial scope of the non-compete provision; and the specific situation (i.e. knowledge, transfer of know-how),[129] background, and bargaining power of the franchisee.[130] The consequences of the non-compete provision to the franchisee may be taken into account when assessing the enforceability. The mere fact that the franchisee will not be able to generate revenues for some time is not sufficient to render the provision unenforceable.[131]

Moreover, if the franchisee terminated the franchise agreement, it is less likely to be protected against a non-compete provision than where the franchisor terminates or causes the termination of the franchise agreement.[132] For example, a claimant did not have a legitimate interest in enforcing the non-compete clause where he did not transfer any know-how to the franchisee.[133]

In general, and particularly if the clause does not violate competition law (for example, if the clause is block exempted), courts have been reluctant to

125. ANVR c.s. v. IATA-NL, NJ 2013, 155, ECLI:NL:HR:2012:BX0345, 3.5–3.10 (Sup. Ct. Dec. 21, 2012).

126. Yarden franchise v. X, ECLI:NL:RBMNE:2014:7395, 4.1–4.20 (D.C. Midden-Nederland June 11, 2014).

127. Top 1 Toys v. Vedes, ECLI:NL:GHARL:2013:7702, 4.1–5.4 (Arnhem-Leeuwarden App. Ct. Oct. 15, 2013).

128. ANVR c.s. v. IATA-NL, NJ 2013, 155, ECLI:NL:HR:2012:BX0345, 3.5–3.10 (Sup. Ct. Dec. 21, 2012).

129. X v. FBD Franchise, ECLI:NL:RBOVE:2016:2914, at 5.5 (D.C. Overijssel June 22, 2016).

130. Note that a post-term non-compete that applies for the entire territory of the Netherlands is not by definition invalid or unenforceable. Civil law merely requires interpretation of the agreement, review of the principle of reasonableness and fairness and the balancing of interests of the franchisor and the franchisee against each other. However, competition law may set boundaries. For example, see *FietsNed*, ECLI:NL:RBBRE:2012:BW4396 (D.C. Breda Apr. 18, 2012) confirmed by *FietsNed II*, ECLI:NL:GHSHE:2012:BX5661, (Den Bosch App. Ct. Aug. 21, 2012) and ECLI:NL:RBARN:2009:BK1781 (D.C. Arnhem Oct. 5, 2009), where the non-compete was held enforceable because the franchisee was aware of the non-compete clause when entering into the agreement, even though the franchisor had lifted that same non-compete obligation for certain other franchisees.

131. *Id*.

132. Ergotherapiepraktijk Zuid-Limburg, ECLI:NL:RBMAA:2011:BU5153, 5.3–5.3.5 (D.C. Maastricht Nov. 17, 2011).

133. X v. FBD Franchise, ECLI:NL:RBOVE:2016:2914, at 5.1–5.14 (D.C. Overijssel June 22, 2016).

set aside a non-compete provision that does not exceed one year or the geographic scope of the activities covered by the agreement.[134] This is unless the franchisor has no reasonable interest in enforcing the clause, such as where the validity of the franchisor's termination of the franchise agreement is in dispute.[135]

Under the newly-adopted Franchise Act, a post-term non-compete provision will only be valid if: (1) it is in writing, (2) it is necessary for the protection of the know how licensed by the franchisor to the franchisee under the franchise agreement, (3) it does not exceed the term of one year; and (4) the geographical scope is not larger than the territory or area within which the franchisee could commercialize the franchise system under the franchise agreement.[136] These criteria are largely in line with existing competition law.[137] However, the VBER is just a block exemption, not a hard and fast rule of what is, and what is not permitted. The parties may argue that their market shares are below fifteen percent and thus within the De Minimis threshold,[138] or that their market shares are above the VBER threshold of thirty percent but that an individual exemption applies.[139] Therefore, in such cases the Franchise Act does provide a stricter set of rules, because these 'free passes' do not apply under the Franchise Act.

D. *Evaluation of the EU Vertical Block Exemption Regulation and Guidelines on Vertical Restraints*

As indicated earlier, the VBER is set to expire on May 31, 2022. The European Commission is currently reviewing the VBER and its Guidelines[140] to determine whether they should let the VBER and the accompanying Guidelines lapse, prolong their duration, or revise them to take proper account of new market developments and participants, such as the growth of e-commerce. In the first quarter of 2019, the Commission held a public consultation aimed at gathering information from the experiences of competition authorities and domestic courts of the EU Member States in applying the VBER.[141] The evaluation also entailed an analysis of new market devel-

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134. *E.g.*, Yarden franchise v. X, ECLI:NL:RBMNE:2014:7395, 2.5–5 (D.C. Midden-Nederland June 11, 2014).

135. Super de Boer, ECLI:NL:RBUTR:2011:BV3058, 4.2–4.7 (D.C. Utrecht Dec. 23, 2011).

136. Dutch Franchise Act 2020, Art. 920.

137. VBER 2010/330, art 5(2)(3).

138. Communication from the Commission—Notice on agreements of minor importance which do not appreciably restrict competition under Article 101(1) of the Treaty on the Functioning of the European Union (De Minimis Notice), 2014/C 291/01, II, 8(b), or—if there is no appreciable effect on the trade between members state of the EU but there is an effect on trade in the Netherlands, that an exception under art. 7 DCA ("bagatel," e.g. an event of minor significance) would apply.

139. *Id.*, Art. 101(3).

140. European Commission, *Guidelines on vertical restraints*, 2010/C 130/01.

141. European Commission, *EU Competition Rules—Revision of the Vertical Block Exemption Regulation*, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12636-Revision-of-the-Vertical-Block-Exemption-Regulation, https://ec.europa.eu/competition/consultations/2018_vber/index_en.html (last visited Dec. 2, 2020).

opments and their impact on the supply and distribution of goods and services in the EU. The Commission asked stakeholders to submit their views on the need for changes, and the public consultation was held from February until May 2019. Thereafter, the Commission published an impact assessment in November 2020. It references topics such as price restrictions (e.g., retail price maintenance), selective distribution, exclusive distribution, agency, data sharing, dual distribution (where the supplier is also active at retail level) and price parity clauses.[142] It is likely that some legislative changes will be proposed one or more of these topics. A draft VBER is likely in 2021.

Based on the European Commission's factual summary of the public consultation, and the evaluation support study and impact assessment on the EU competition rules that apply to vertical agreements, it is generally expected that the VBER will be revised regarding the abovementioned topics and in particular to clarify what vertical restraints are block exempted (see section V), blacklisted, or hard core in the context of e-commerce, online platforms, and other technological developments.[143]

For franchisors, compliance with these increasingly complex competition laws on vertical restraints is essential. Should the European Commission renew the VBER and its Guidelines in an amended form, this will most likely impact foreign franchisors trading in the EU. Among other things, they will need to review and potentially revise their franchise agreements with their franchisees.

VI. The European and Dutch Legal Landscape for Franchising is Changing

The EU and Dutch legal frameworks have recently introduced and revised a number of relevant regulations that are relevant for franchising. Important legislative developments are prominent in general civil, competition, consumer, and data protection laws, and will have an impact on franchise systems across Europe and in the Netherlands. Many of the EU's new legislative initiatives or reforms are linked to the European Commission's Digital Single Market Strategy, a policy aimed to enhance digital transformation in the EU.[144] The following legislative developments are worth calling out:

142. European Commission, *EU Competition Rules—Revision of the Vertical Block Exemption Regulation*, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12636-Revision-of-the-Vertical-Block-Exemption-Regulation (last visited Dec. 2, 2020).

143. European Commission, *VBER Inception Impact Assessment*, https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12636-Revision-of-the-Vertical-Block-Exemption-Regulation (last visited Dec. 2, 2020); European Commission, *Review of the Vertical Block Exemption Regulation*, https://ec.europa.eu/competition/consultations/2018_vber/index_en.html (last visited Dec. 2, 2020).

144. The European Digital Strategy, https://ec.europa.eu/digital-single-market/en/content/european-digital-strategy.

- the EU Geo-blocking Regulation, which prohibits rerouting or blocking (e.g. making access via their website dependent on the origin or nationality of the user) services to consumers and end users acting in a professional capacity from another member state;[145]
- the EU Platform-to-Business Regulation, which contains transparency requirements (such as methods used for ranking of search results and conditions for termination) for business users of online intermediation services (e.g. search engines, social media and internet platforms acting as intermediaries between buyers and sellers on line);[146] and
- the privacy and data protection of data under the EU General Data Protection Regulation (GDPR) and draft e-Privacy Regulation.[147]
- the public consultation on the proposal for a Digital Services Act and Digital Markets Act that aims to upgrade liability and safety rules for digital platforms, services, and products.[148]
- The New Deal for Consumers, which contains a package of new and updated EU e-commerce and consumer protection law directives.[149] The New Deal further increases the level of consumer protection through such things as modernization and enforcement, additional information obligations to be provided in distance selling, the right of withdrawal of consumers when purchasing on line, and the unenforceability of unfair trading terms. For franchisors also the price indication directive is relevant, which aims to ensure that the selling price and the price per unit of measurement (unit price) are indicated for all products offered by traders to consumers. This facilitates the comparison of prices by consumers.The selling price must be unambiguous, easily identifiable and clearly legible. The increased consumer protection is coupled with the implementation

145. Regulation (EU) 2018/302 (Feb. 28, 2018) addressing unjustified geo-blocking and other forms of discrimination based on customers' nationality, place of residence, or place of establishment within the internal market.

146. Regulation (EU) 2019/1150 (June 20, 2019) promoting fairness and transparency for business users of online intermediation services (OJ L 186/57).

147. H.H. de Vries & Martine de Koning, *The impact of GDPR on Franchise Systems*, ABA Newsletter Int'l Franchise Forum; Martine de Koning and H.H. De Vries, *ABA Franchise: EU General Data Protection Regulation*, ABA Annual Update, Fall 2017 (an edited version for 2018 will be published soon); Martine de Koning and H.H. de Vries, '*Wat is de impact van de Algemene Verordening Gegevensbescherming van de EU op internationale franchiseovereenkomsten?*' [What is the impact of the EU General Data Protection Regulation on international franchise agreements?] Contracteren 2018, no. 1, 19 (presented at the NFV and International Division of the ABA International Franchise Forum in 2018).

148. Digital Services Act, https://ec.europa.eu/digital-single-market/en/digital-services-act-package.

149. The "**New Deal for Consumers**" initiative aimed at strengthening enforcement of EU consumer law in light of a growing risk of EU-wide infringements and at modernizing EU consumer protection rules in view of market developments. The Commission adopted it on April 11, 2018, https://ec.europa.eu/info/law/law-topic/consumers/review-eu-consumer-law-new-deal-consumers_en.

of the EU Trade Secrets Directive to harmonize and enhance the level of protection of know-how in the European Union.[150]

The ongoing reform of various competition and consumer protection laws will continue to impact franchisors and franchisees. This includes the evaluation of the EU Market Definition Notice, which is used to define the "relevant market" and, thus, the "market shares" of market players to assess abuse of dominance and cartel cases or mergers and acquisitions under EU competition law.[151] Also of great importance is the pending public consultation on the introduction of a new competition tool for the European Commission, which will affect the enforcement of competition law.[152]

In particular, with an eye to digital transformation and e-commerce which has been on the Commission's agenda for over a decade now, the European Commission's competition inquiry into the Consumer Internet of Things is crucial.[153] This inquiry comprises consumer products and services that are connected to a network and can be controlled at a distance, for example via a voice assistant or mobile device. The Commission believes that there is behaviour in the market that may structurally distort competition. Therefore, the Commission will gather market information to better understand the nature, prevalence and effects of these potential competition issues, and to assess them in light of EU competition rules. The Sector Inquiry will cover products such as wearable devices (e.g. smart watches or fitness trackers) and connected consumer devices used in the smart home context, such as fridges, washing machines, smart TVs, smart speakers and lighting systems. The sector inquiry will also collect information about the services available via smart devices, such as music and video streaming services and about the voice assistants used to access them.[154] The European Commission is also already actively enforcing compliance with the current EU competition laws, particularly in the field of e-commerce, internet platforms, and data. To this end, it has initiated several investigations into companies such as

150. Directive (EU) 2016/943 of the European Parliament and of the Council (June 8, 2016) on the protection of undisclosed know-how and business information (trade secrets) against their unlawful acquisition, use and disclosure, http://data.europa.eu/eli/dir/2016/943/oj.

151. This is crucial for how the relevant market is defined and, thus, the market shares of the parties to an agreement are determined. EU Market Definition Notice (evaluation), https://ec.europa.eu/info/law/better-regulation/have-your-say/initiatives/12325-Evaluation-of-the-Commission-Notice-on-market-definition-in-EU-competition-lawpublic-consultation.

152. Impact Assessment for a Possible New Competition Tool, https://ec.europa.eu/competition/consultations/2020_new_comp_tool/index_en.html.

153. EC Sector Inquiry into Consumer Internet of Things, (July 16, 2020) https://ec.europa.eu/competition/antitrust/sector_inquiries_internet_of_things.html; Press Release, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1326.

154. *Id.* As part of the sector inquiry, the Commission will send requests for information to a range of players active in the Internet of Things for consumer-related products and services throughout the EU. The Commission expects to publish a Preliminary Report on the replies for public consultation in the spring of 2021. The final report is expected in the summer of 2022.

Amazon,[155] concerning its collection and use of data to compete with retailers on its marketplace, and Apple concerning certain clauses in its licensing agreements and the limiting of access to certain technologies or functionalities for competitors in its terms and conditions and other measures.[156] Since e-commerce strategies, loyalty programs, data collection and use, and use of online platforms increasingly become important for the success of franchise networks, these developments should be top of mind when expanding a franchise system into the European market.

VII. Conclusion

Franchisors and franchisees doing business in the Netherlands need to stay abreast of emerging laws and regulations impacting franchising. Many legislative developments that impact the legal landscape for franchising in the Netherlands are driven by legislative activity at the EU level and in particular, competition, consumer protection, and data protection laws. One key development is the Dutch Franchise Act, which went into effect on January 1, 2021.

Although the Franchise Act codifies important points of existing Dutch case law, it aims to bring more balance in the relationship between franchisors and franchisees by introducing new rules that protect the interests of the franchisee. The act will introduce pre-contractual obligations and restrictions on how to shape the relationship with franchisees.[157] Most noteworthy are the information obligations before and during the franchise relationship,[158] the obligation to be a good franchisor and a good franchisee,[159] the franchisor's obligation to support and advise its franchisees,[160] and the requirement that the franchisor provide annual reports on certain financial aspects to the franchisee.[161] Some of these purportedly new obligations, such as more general disclosure obligations and a duty of care on both sides, already existed under case law. The scope and frequency stated in the Franchise Act intensifies these obligations, and thus places an administrative and financial burden on the franchisor.

The Franchise Act has more controversial provisions as well, such as franchisor's obligations to obtain franchisee consent before making changes

155. European Commission, *Antitrust: Commission opens investigation into possible anti-competitive conduct of Amazon*, https://ec.europa.eu/commission/presscorner/detail/en/IP_19_4291 (last visited Dec. 2, 2020).

156. European Commission, *Antitrust: Commission opens investigation into Apple practices regarding Apple Pay*, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1075 (last visited Dec. 2, 2020), European Commission, *Antitrust: Commission opens investigation into Apple's App Store rules*, https://ec.europa.eu/commission/presscorner/detail/en/ip_20_1073 (last visited Dec. 2, 2020).

157. Dutch Franchise Act 2020 Arts. 911–922.

158. *Id.* Arts. 913–14, 916–17.

159. *Id.* Art. 912.

160. *Id.* Art. 919.

161. *Id.* Art. 916.

to the franchise system[162] and the obligation to determine if any goodwill exists and is attributable to the franchisee, and, if so, how it will be calculated and paid out if the franchisor takes over the franchise.[163] These obligations attracted the most attention and criticism in the parliamentary process. Franchisors also objected to the mandatory nature of the statute in combination with "open norms." But the use of general descriptions or mere obligations to lay down in an agreement certain points that must be "reasonable," are common in Dutch contract law. However, mandatory provisions, and in particular those "priority rules" that are applied even if the agreement is not governed by Dutch law, may bring about uncertainty for franchisors because their agreements, or clauses therein, may be nullified (or void) even when they thought they complied with the "open norms" in the Franchise Act.[164]

Whether the Franchise Act will have a positive or a negative effect on franchising in the Netherlands will largely depend on how the courts apply these open norms to concrete facts and circumstances in franchise disputes. In particular, the right of consent and the obligations regarding goodwill seem to deviate from what is customary in international franchising networks and agreements.[165] These provisions place a burden on international franchise networks. They may risk losing uniformity across jurisdictions because these provisions may limit a franchise network's ability to respond quickly to market developments—such as COVID-19—if consent of franchisees has to be requested. And at the same time, buying out franchisees that are unwilling to accept changes to the franchise system may require compensating them for goodwill. Courts need to consider that it is in the interest of the franchise network, as well as the other franchisees therein, to not let the interests of one or a small group of franchisees prevail too quickly. Looking at Dutch case law to date, in light of the duty to be a "good franchisee," the general expectation should be that courts will balance the interests of the parties wisely and apply the law, unless explicitly overruled by the Franchise Act, in line with existing case law that weighs in the interests of the entire network.[166]

162. *Id.* at Art. 921.

163. *Id.* at Art. 920.

164. Martine de Koning, *Het wetsvoorstel Franchise, Bezint eer ge begint*, NJB, Feb. 1, 2019, 201, 262–264.

165. Martine de Koning, *Het wetsvoorstel Franchise, handig (aan)gehaakt of toch liever zelf iets breiden?*, NJB May 5, 2017, 967, 252–1258, Martine de Koning, *Het wetsvoorstel Franchise, Bezint eer ge begint*, NJB, Feb. 1, 2019, 201, 262–264.

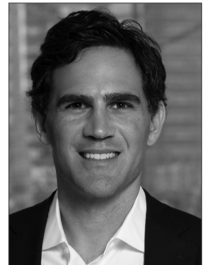
166. Albert Heijn v. Pollemans, ECLI:NL:RBNHO:2014:9474, 4.23 (D.C. Noord–Holland Sept. 11, 2014).

Franchising & Distribution Currents

Marlén Cortez Morris, Matthew Gruenberg & Laura Kupish

ADVERTISING AND MARKETING

Ms. Cortez Morris


Mr. Gruenberg

Ms. Kupish

***Maaco Franchisor SPV, LLC v. Sadwick*, Bus. Franchise Guide (CCH) ¶ 16,702, 2020 WL 4468727 (W.D.N.C. Aug. 4, 2020)**

The U.S. District Court for the Western District of North Carolina denied Maaco Franchisor SPV, LLC's (Maaco) motion to dismiss defendants Gregg Sadwick (Sadwick) and Greba Corporation's (Greba) counterclaim for breach of contract and the implied covenant of good faith and fair dealing.

In July 2016, Sadwick entered into a franchise agreement to operate a Maaco auto repair center in Rochester, New York. Although Sadwick later assigned the franchise agreement to Greba, he personally guaranteed Greba's obligations. A few years later, Maaco terminated the defendants' franchise agreement. Shortly thereafter, Maaco filed a lawsuit alleging claims for breach of contract and trademark infringement, along with a motion for preliminary injunction alleging that the defendants had violated their post-termination restrictive covenants. After the court granted a preliminary injunction in favor of Maaco, the defendants filed an answer to the complaint and an amended counterclaim alleging that Maaco's misuse of the franchisees' weekly advertising contributions constituted a breach of the franchise agreement, a breach of the covenant of good faith and fair dealing, and caused the franchisee to suffer significant losses in business volume and revenues. Specifically, the defendants alleged that Maaco breached the franchise agreement by redirecting thirty percent of the franchisee's weekly

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advertising contributions to a program called "Project Restore," which funded store maintenance, capital improvements, and equipment purchases, even though the defendants were responsible for such expenditures under the franchise agreement. The defendants also alleged that Maaco breached the franchise agreement when it redirected weekly advertising contributions to cover digital marketing costs, including a "pay-per-click" marketing methodology, even though the franchise agreement required payment of an additional fee for digital marketing.

Maaco moved to dismiss the counterclaim for failure to state a claim. It argued that (1) it had the sole discretion to use advertising contributions "in the manner determined to be most effective by MAACO"; (2) it had discretion under the franchise agreement to use advertising contributions to update and refurbish franchise locations; and (3) the franchise agreement did not limit the amount Maaco could spend on digital marketing.

The defendants responded that, under the franchise agreement, Maaco had "sole discretion" to spend the defendants' advertising contributions on local marketing only during the first six months after the franchise opened. Otherwise, Maaco could use advertising contributions only for "the creation and placement of advertising and promotion programs . . . for the benefit of the System, including website development, telemarketing, and Maaco Center locator numbers." Moreover, the franchise agreement also stated that "advertising and promotion conducted by MAACO [was] intended to maximize general public recognition and patronage of the System in the manner determined to be most of effective by MAACO."

Based on this information, the court found that the franchise agreement was ambiguous about whether Maaco could redirect advertising contributions and, therefore, held that the defendants stated a plausible claim for breach of contract. In accordance with North Carolina law, the court treated the claim for breach of the covenant of good faith and fair dealing as "part and parcel" of the breach of contract claim, as the two claims were based on the same set of facts. Accordingly, court held that the defendants also stated a plausible claim for breach of the covenant of good faith and fair dealing, and denied Maaco's motion to dismiss the defendants' counterclaim.

ARBITRATION

***Blanton v. Domino's Pizza Franchising LLC*, Bus. Franchise Guide (CCH) ¶ 16,671, 962 F.3d 842 (6th Cir. 2020)**

The Sixth Circuit affirmed the district court's decision to compel the named plaintiffs to arbitrate their claims against Domino's Pizza, Inc. (Domino's) for violations of federal antitrust law and state law.

In 2014, Derek Piersing (Piersing) began working at a Domino's franchise in Washington state. Four years later, he was hired by a second Domino's franchise in the area. When he was hired by the second franchise, Piersing signed an arbitration agreement, which required him to arbitrate a wide

array of issues related to his employment pursuant to the American Arbitration Association National Rules for the Resolution of Employment Disputes (AAA Rules). The first Domino's franchise fired Piersing, allegedly because the franchise agreement with Domino's required the franchisee to do so for Piersing to be able to work at the second franchise.

Piersing and another plaintiff then filed a putative class action against Domino's, alleging that the franchise agreement violated federal antitrust and state law. Pursuant to the arbitration clause in the franchise agreement, Domino's moved to compel arbitration under the Federal Arbitration Act (FAA). The plaintiffs opposed, arguing that Domino's could not enforce the arbitration agreements because Domino's did not sign them (only the franchisees had). Still, the district court ordered the plaintiffs to go to arbitration to determine the threshold question of arbitrability and the merits of the claims. Plaintiffs appealed.

On appeal, the Sixth Circuit first addressed the question of arbitrability, which generally requires "clear and unmistakable" evidence that the parties agreed to have an arbitrator decide such issues. Following its own prior precedent, the Sixth Circuit held that incorporation of the AAA Rules in an arbitration agreement provides such "clear and unmistakable" evidence. The court explained that because Piersing agreed that the AAA Rules applied to any arbitration, and those rules provided that "the 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," the parties clearly and unmistakably agreed to arbitrate arbitrability.

The court then addressed several arguments made by both sides. Domino's had argued that the arbitrability question was one of state law, not federal law. The Sixth Circuit observed that an argument that arbitrability was a question of state law conflated the questions of contract formation and interpretation (which generally involve state law) with the question of whether a particular agreement satisfies the "clear and unmistakable" standard, which is an issue of federal law under the FAA. Further, the Sixth Circuit stated that none of the precedent cited by the parties suggested that state law governed this analysis. Even if they did, Washington courts have also found the incorporation of AAA Rules to satisfy the "clear and unmistakable" standard for arbitrability. The choice of law, thus, made no difference here.

Piersing argued that his arbitration agreement incorporated the AAA Rules only as to claims that fell within the scope of the agreement. In other words, a court should first determine whether the agreement covered a particular claim before the arbitrator had any authority to address its jurisdiction. The court rejected this argument, explaining that it was contrary to the plain language of the arbitration provision.

Piersing next argued that the AAA Rules did not address whether a non-signatory like Domino's may enforce the arbitration agreement under state contract law. The Sixth Circuit found this question went to the arbitrator's jurisdiction, which the AAA Rules allow the arbitrator to resolve, and

thus this argument was for the arbitrator. The court also distinguished this case from one where the non-signatory opposed arbitration. In such a case, the Sixth Circuit noted, the question would challenge the "existence" of a valid arbitration agreement and the court would have to resolve the question, even with the incorporation of the AAA Rules.

Second, Piersing took the position that a court can decide arbitrability because the AAA Rules do not give arbitrators the "exclusive" power to decide such questions. Although the term "exclusive" is not in the relevant AAA Rule, the Sixth Circuit concluded that allowing courts to determine arbitrability under the circumstances would result in chaos. It would lead to a race to the courthouse or arbitrator's forum to have each party's preferred decision maker rule first—in the case of a court, the ruling would have res judicata effect on the arbitrator, or in the case of the arbitrator, the ruling would be subject to an extremely narrow form of judicial review.

The court also rejected a variety of other arguments that Piersing asserted. For example, it declined Piersing's invitation to draw a sophisticated versus unsophisticated party distinction in enforcing arbitration agreements. It also rejected Piersing's policy argument that a ruling for Domino's would expose him to frivolous motions to compel from anyone because the U.S. Supreme Court rejected a nearly identical argument just last term and an arbitrator can quickly resolve a frivolous motion (and even impose sanctions).

Finally, Piersing raised two procedural arguments. First, Piersing claimed that the district court erred when it refused him leave to amend his complaint, but this argument was without merit because he never filed a motion for leave to amend. Second, Piersing sought to vacate certain portions of the district court's opinion—where it purportedly decided whether Domino's could enforce the arbitration agreement under state contract law (specifically, equitable estoppel)—because that should have been decided by the arbitrator, not the district court. The Sixth Circuit noted that it is not the job of an appellate court to revise opinions; it corrects wrong judgments. Its own opinion made clear that the arbitrator should decide whether Domino's can enforce the arbitration agreement. As a result, the court affirmed the district court's decision in favor of compelling arbitration.

BANKRUPTCY

In re Jonesboro Tractor Sales, Inc., Bus. Franchise Guide (CCH) ¶ 16,698, 619 B.R. 223 (Bankr. E.D. Ark. 2020)

The U.S. Bankruptcy Court for the Eastern District of Arkansas determined that a dealer sales and service agreement and a dealer terms and discount schedule (collectively, the dealership agreement) between tractor manufacturer Kubota Tractor Corporation (Kubota) and bankrupt dealer Jonesboro Tractor Sales, Inc. (Jonesboro) was an assumable executory contract where the extension of credit was incidental to, and not required under, the dealership agreement. Therefore, the dealership agreement was not a mere

contract to make a loan or extend other debt financing or financial conditions that is not assumable under the Bankruptcy Code.

Wilma Grissom (Grissom) and her husband founded Jonesboro in 1969, and later became a Kubota dealership in 1992. Under its dealership agreement with Kubota, Jonesboro had the nonexclusive right to purchase certain products for resale from Kubota via cash, collect on delivery (COD), or the extension of credit, as Kubota required. Since 1992, up to its bankruptcy filing in 2020, Jonesboro purchased products financed through Kubota and, to secure Jonesboro's performance, Kubota retained a security interest in those products. The dealership agreement covered more than just payment arrangements, addressing, among other things, the local market area, shipping and transportation specifications, insurance requirements, and dealer performance standards. Jonesboro had been a successful dealership with over eighty percent of its revenue coming from the sale of Kubota products, and for years it earned "elite" status during Kubota's annual performance assessments.

Despite its success, Jonesboro filed for bankruptcy after a creditor removed several thousand dollars from its checking account in March 2020. Under the dealership agreement, filing for bankruptcy constituted an event of default. Grissom informed Kubota of the bankruptcy because, as Grissom testified, "doing business with Kubota as usual was important to the continuing operations of [Jonesboro]." According to Grissom's testimony, Kubota representatives implied that the bankruptcy would not impact the parties' relationship. However, Kubota subsequently stopped extending credit to Jonesboro and required that all new product orders be paid by cash or COD. Thereafter, Jonesboro filed a motion for determination that the dealership agreement was assumable. Kubota opposed the motion and filed a motion for relief from stay.

The court first analyzed whether the dealership agreement was an assumable executory contract or a non-assumable "financial accommodation" within the meaning of Section 365(c)(2) of the Bankruptcy Code (11 U.S.C. § 365(c)(2)). As an initial matter, the court adopted a narrow interpretation of "financial accommodation," defining it as "the extension of money or credit to accommodate another." Jonesboro argued that the dealership agreement was not a financial accommodation because financing was only one aspect of the robust dealership agreement. Relying on *In re Cole Brothers, Inc.*, 137 B.R. 647 (Bankr. W.D. Mich. 1992) (*Cole I*), which held that financing terms were incidental to the agreement where the "primary purpose of the agreements was to establish the debtor as a dealer of John Deere products," Jonesboro contended that the primary purpose of the dealership agreement was to sell Kubota products, not extend credit and, therefore, financing was incidental to the dealership agreement. Jonesboro argued that the fact that Kubota stopped financing purchases after Jonesboro filed for bankruptcy proved that financing was only incidental to the dealership agreement.

However, *Cole I* was reversed in *John Deere Company vs. Cole Brothers, Inc.* 154 B.R. 689 (W.D. Mich. 1992) (*Cole II*). In *Cole II*, the court disagreed with

the bankruptcy court's decision in *Cole I* and ruled that that the extension of credit was not merely incidental, but rather "an integral component of the dealership arrangement" because financing was "vital to the debtor's continued operation as a seller of farming and industrial equipment and . . . [was] the central purpose of the group of contracts." Unsurprisingly, Kubota relied on *Cole II* to support its position that the dealership agreement was a non-assumable financial accommodation under § 365(c)(2). Kubota highlighted that financing was an integral component of the dealership agreement because, before filing for bankruptcy, Jonesboro always used the financing option to acquire Kubota products and, as admitted by Grissom, financing was critical to Jonesboro's continued business.

The court found that the dealership agreement was an assumable executory contract and fell outside of the exception of §365(c)(2). The court distinguished the facts of this case from *Cole I* and *Cole II* because Kubota was not required to extend credit to Jonesboro under the dealership agreement. Rather, the court relied on the fact that Kubota, in its sole discretion, could and did require the payments in cash or COD. Further, because Kubota was not required to advance additional funds to Jonesboro, the court reasoned that Kubota did not need the protections of § 365(c)(2), which was intended to prevent a trustee from requiring new post-petition advances of money from a creditor.

The court next analyzed whether Kubota should be granted relief from the automatic stay to terminate the dealership agreement, repossess its collateral, and de-brand Jonesboro as a Kubota dealer. Kubota argued that if the dealership agreement was a financial accommodation, the bankruptcy default provision would be enforceable under § 365(e)(2)(B). However, because the dealership agreement was an assumable executory contract, the court rejected this argument. Kubota alternatively argued the court should grant it relief from the stay because the evidence proved that Jonesboro could not maintain required inventory levels without financing. In its defense, Jonesboro asserted that any default based on inventory levels was speculative because Jonesboro, in fact, was not in default under any other provision of the dealership agreement. The court agreed with Jonesboro, finding Kubota's arguments speculative. Because Jonesboro was not otherwise in default of its dealership agreement, the court found the bankruptcy default provision unenforceable. Consequently, the court denied Kubota's motion for relief from the automatic stay.

CHOICE OF FORUM

***Halcyon Syndicate Ltd. v. Graham Beck Enterprises (PTY), Ltd.*, Bus. Franchise Guide (CCH) ¶ 16,687, 2020 WL 4051865 (N.D. Cal. July 20, 2020)**

This case is discussed under the topic heading "Jurisdiction."

***Interim Healthcare, Inc. v. Interim Healthcare of Se. La.*, Bus. Franchise Guide (CCH) ¶ 16,666, 2020 WL 3078531 (S.D. Fla. June 10, 2020)**
This case is discussed under the topic heading “Jurisdiction.”

CHOICE OF LAW

***Blanton v. Domino’s Pizza Franchising LLC*, Bus. Franchise Guide (CCH) ¶ 16,671, 962 F.3d 842 (6th Cir. 2020)**
This case is discussed under the topic heading “Arbitration.”

***Interim Healthcare, Inc. v. Interim Healthcare of Southeast Louisiana*, Bus. Franchise Guide (CCH) ¶ 16,666, 2020 WL 3078531 (S.D. Fla. June 10, 2020)**
This case is discussed under the topic heading “Jurisdiction.”

CLASS ACTIONS

***In re Sonic Corp. Customer Data Security Breach Litigation (Financial Institutions)*, Bus. Franchise Guide (CCH) ¶ 16,680, 2020 WL 3577341 (N.D. Ohio July 1, 2020)**
The U.S. District Court for the Northern District of Ohio granted in part and denied in part a motion to dismiss negligence claims brought by several banks against Sonic Corporation and its subsidiaries and affiliates, Sonic Industries Services, Inc., Sonic Capital LLC, Sonic Franchising LLC, Sonic Industries LLC, and Sonic Restaurants, Inc. (collectively, Sonic), stemming from a 2017 data breach at more than 300 franchised Sonic Drive-Ins. The court dismissed the plaintiffs’ claims for negligence per se and declaratory and injunctive relief against Sonic, but their negligence claim survived.

In 2015, Sonic’s corporate-owned restaurants were hacked and login credentials were stolen. The hackers attempted to install malware that would allow them to skim credit card data from Sonic’s customers. Sonic hired a third-party data breach reviewer to investigate and remediate the threat. After the investigation, the third-party reviewer warned Sonic that similar future attacks could occur. The complaint alleges that despite this warning, Sonic did not address the vulnerabilities.

Sonic largely controlled its franchisees’ data security. In its franchise agreements, Sonic required franchisees to pay into a cybersecurity and technology fund that Sonic used to fund and control franchisees’ security technology. In addition, the franchise agreements required franchisees to conform to Sonic’s security policies, and Sonic and Sonic-approved vendors set up the technology that franchisees used. Sonic also required franchisees to choose one of three Sonic-approved point-of-sale (POS) technology vendors; use of other vendors required Sonic’s express permission. One of the three approved POS vendors was the card processing firm Infor.

In 2017, hackers breached Sonic's POS systems at the 762 Sonic franchises that used the Infor system. Although Sonic had begun updating its POS technology in 2013, it allegedly selected the implementation timeline for each store and at the time of the 2017 breach, twenty-three percent of Sonic locations still used "end of life" technology with no anti-virus or anti-malware protection. Beyond the outdated hardware, Sonic required franchisees to enable permanent remote access for Sonic, and weak passwords were used. Given these weak configuration settings, the hackers were able to access and steal customer credit card data in all Sonic restaurants using the Infor platform because the data was not encrypted. Moreover, because Sonic had an invalid email address set up to receive security alerts, this breach went unabated for nearly six months before Sonic notified the public about the data breach, resulting in stolen funds from customers and costly reimbursement by banks of those funds.

On behalf of its customers, various payment card issuing banks (plaintiffs) filed a class action lawsuit against Sonic alleging that Sonic owed plaintiffs and the proposed class a duty to secure the data and that Sonic's failure to do so was negligent and resulted in damages to the plaintiffs. The plaintiffs also alleged that Sonic was negligent per se based on Section 5 of the Federal Trade Commission Act (FTC Act), the Oklahoma Consumer Protection Act, and the Oklahoma Breach Notification Act. Sonic moved to dismiss all claims against it.

The court first addressed the negligence count. Sonic argued that under Oklahoma law, plaintiffs had not pleaded sufficient facts to show that Sonic owed any duty. Generally, no duty is owed to another person to protect from third party criminal acts under Oklahoma law. However, Oklahoma courts have recognized three special circumstances that can create a duty to anticipate and prevent a third party's foreseeable criminal acts: (1) where the defendant is under a special responsibility toward the person harmed; (2) where the defendant's own affirmative act has created or exposed the other to a recognizable high degree of risk of harm through such misconduct, which a reasonable person would have taken into account; and (3) where the defendant has a special relationship to the person causing the injury. Here, the first and third circumstances did not apply because Sonic had no contractual or other relationship to either the banks or the criminal hackers.

For the second circumstance, the court found that the plaintiffs sufficiently plead that Sonic's affirmative acts exposed the plaintiffs to harm based on the various controls indicated earlier. Sonic argued that it might have failed to act, but that it did not affirmatively create a risk. In making this argument, Sonic relied heavily on *BancFirst v. Dixie Restaurants, Inc.*, 2012 WL 12879 (W.D. Okla. Jan. 4, 2012), which had dismissed a similar data breach case alleging that the restaurants' failure to put in place adequate security measures was negligent. The court rejected Sonic's argument, noting that *BancFirst* involved a failure to act, unlike here where the plaintiffs pleaded that Sonic affirmatively created the vulnerabilities that the hackers easily

exploited, including requiring franchisees to enable remote access, weak passwords, and setting up security email alerts to a defunct email account. All of these steps, which the plaintiffs alleged violated industry security standards, were affirmative steps that put the plaintiffs at greater risk for suffering a data breach. This was enough to allege an actionable duty.

The court also found that sufficient facts were plead to show that a reasonable person would have foreseen the data breach risk and its effects on the plaintiffs as the banks of Sonic franchisees' customers who were impacted by the data breach. Among other things, Sonic had already suffered a similar data breach before this one. The plaintiffs also pointed to other high-profile data breaches within the fast food industry and warnings from data experts for prevention. Oklahoma law incorporates foreseeability into the duty analysis and given these facts, Sonic "had reason to assume, even anticipate, that many hackers would violate the law," and the hackers' criminal acts were "sufficiently foreseeable." Accordingly, the court denied Sonic's motion to dismiss the negligence count.

Second, for the negligence per se count, the court held that the plaintiffs waived any argument that Oklahoma statutes supported the claim because plaintiffs had only asserted arguments based on the FTC Act when opposing Sonic's motion to dismiss. As to the FTC Act, the plaintiffs alleged that Sonic breached a duty to engage in unfair or deceptive practices affecting commerce in violation of Section 5 of the FTC Act. Under Oklahoma law, however, the underlying statute of a negligence per se claim must "impose positive objective standards" to support liability. Although the court recognized that Section 5 applies to data security requirements, it found that the act does "not lay out positive, objective standards" that could create liability. Section 5 therefore cannot support a negligence per se claim, and the court granted Sonic's motion to dismiss this count.

Third, Sonic argued that Oklahoma's economic loss rule barred the plaintiffs' claim. The court rejected this argument because Oklahoma limited the economic loss rule to product liability claims and had never applied it outside that context.

Finally, the court dismissed the plaintiffs' count for declaratory and injunctive relief because neither basis provides an independent cause of action.

CONTRACT ISSUES

***Halcyon Syndicate Ltd. v. Graham Beck Enterprises (PTY), Ltd.*, Bus. Franchise Guide (CCH) ¶ 16,687, 2020 WL 4051865 (N.D. Cal. July 20, 2020)**

This case is discussed under the topic heading "Jurisdiction."

***In re Jonesboro Tractor Sales, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,698, 619 B.R. 223 (Bankr. E.D. Ark. 2020)**

This case is discussed under the topic heading "Bankruptcy."

***Keen Edge Co. v. Wright Manufacturing, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,712, 2020 WL 4926664 (E.D. Wis. Aug. 21, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

***Maaco Franchisor SPV, LLC v. Sadwick*, Bus. Franchise Guide (CCH) ¶ 16,702, 2020 WL 4468727 (W.D.N.C. Aug. 4, 2020)**
This case is discussed under the topic heading "Advertising and Marketing."

***OsteoStrong Franchising, LLC v. Richter*, Bus. Franchise Guide (CCH) ¶ 16,706, 2020 WL 4584007 (D.N.M. Aug. 10. 2020)**
This case is discussed under the topic heading "Trade Secrets."

***Smash Franchise Partners, LLC v. Kanda Holdings, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,709, 2020 WL 4692287 (Del. Ch. Aug. 13, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

COVID-19

***Massey v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 16,679, 2020 WL 5700874 (Ill. Cir. Ct. June 24, 2020)**
An Illinois state court entered a preliminary injunction requiring the owners of several franchised and corporately owned McDonald's restaurants to change their social distance training and strictly enforce mask wearing policies where the training and policy enforcement was inconsistent with the Illinois governor's executive order.

On March 9, 2020, the Illinois governor declared Illinois a disaster area in response to the outbreak of the COVID-19 virus. The governor issued various other orders in response to the virus, including, on May 29, 2020, an executive order requiring all Illinoisans to maintain social distancing of at least six feet from others and to wear a face covering in public places when unable to social distance for six feet, whether indoors or outdoors (Executive Order). The Executive Order required all businesses to: ensure that employees practiced social distancing or wore face coverings when social distancing was not possible; ensure that all visitors (customers, vendors, etc.) to the workplace practiced social distancing, or if not possible, were encouraged to wear face coverings; and follow guidance provided by the Illinois Department of Commerce and Economic Opportunity (IDCEO), the Illinois Department of Public Health (IDPH), and local public health departments regarding safety measures and social distancing requirements. The IDPH provided specific guidance on how face coverings applied in the restaurant setting, advising that all Illinoisans should wear a face covering when picking up food from the drive-thru or curbside pickup.

On May 19, 2020, five employees of several McDonald's franchised and corporate restaurants filed a three-count complaint for: negligence against McDonald's Corporation and McDonald's USA, LLC (collectively,

McDonald's Corporate); negligence against the restaurant owners and operators, Lexi Management LLC (Lexi), DAK4, LLC (DAK4), and McDonald's Restaurants of Illinois, Inc. (MRI), a subsidiary of McDonald's USA, LLC; and public nuisance against all defendants. The plaintiffs sought injunctive relief requiring the defendants to take five measures they allegedly failed to take after the COVID-19 outbreak (the Five Measures): (1) provide workers with an adequate supply of face coverings and gloves; (2) supply hand sanitizer for workers and customers entering the restaurant; (3) enforce policies requiring employees to wear face coverings during their shifts and requiring customers entering a store to wear face coverings; (4) monitor infections among workers and, if an employee experiences COVID-19 symptoms or is confirmed to be infected with COVID-19, inform fellow employees immediately of their possible exposure; and (5) provide employees with accurate information about COVID-19, how it spreads, and risk of exposure, as well as train employees on proper hand washing and other preventative measures established by the Center for Disease Control (CDC).

Addressing the plaintiffs' motion for a preliminary injunction, the court denied the motion as to the Lexi location because that restaurant underwent a change in ownership and there was no evidence of noncompliance by the new owner.

Turning to the public nuisance claim against all of the other defendants, the plaintiffs had to show a likelihood of success on the merits and prove: (1) the existence of a public right; (2) a substantial and unreasonable interference with that right by the defendants; (3) proximate cause; and (4) injury. The court found there was a clear public right to be free from an environment that may endanger public health, including monitoring the spread of infectious diseases. The court decided that the plaintiffs did not have to show that the defendants' conduct affirmatively caused a COVID-19 case; rather, they merely had to show that the defendants' actions made a positive case "highly probable." The plaintiffs met this burden by introducing testimony that there were positive COVID-19 tests at two of the restaurants at issue and that employees showed all the symptoms of the virus, but tested negative at the third restaurant.

The court then analyzed each restaurant's actions with respect the Five Measures to determine if a substantial and unreasonable interference with the plaintiffs' rights had occurred. One of the five plaintiffs worked at a franchised McDonald's restaurant owned and operated by DAK4. The court found that DAK4 supplied the necessary masks, gloves, and sanitizer based on testimony from employees that these items were available at the restaurant. Nothing about the way DAK4 monitored and informed employees of COVID-19 positive cases was improper either. The evidence showed no positive COVID-19 cases and, if there were, a policy was in place to examine the infected worker's shifts, identify any close contacts and instruct those individuals to self-quarantine, and notify all workers.

However, the court found that DAK4 failed to train employees on social distancing properly. For one, McDonald's Corporate provided franchisees

with a social distancing policy and manager talking points stating that it was "okay pursuant to CDC guidance" for individuals to be closer to each other than six feet, as they passed each other, "[a]s long as it's not for a period of 10 cumulative minutes or more." This ten-minute addendum to the social distancing definition was in neither the Executive Order nor the IDPH guidelines. Further, the plaintiffs provided photographic evidence of employees and managers standing within six feet of each other without wearing masks properly. The training with respect to social distancing was, therefore, inadequate.

The court next determined that DAK4 had not adequately enforced the policy requiring employees to wear masks, resulting in violation of the Executive Order and Illinois public safety guidelines. Although the McDonald's franchisor issued a policy requiring employees and customers entering a restaurant to wear masks, and franchisees were required to follow the policy, DAK4 did not enforce the policy with employees.

Conversely, the court found that prior issues with customers existed, but were cured and did not warrant an injunction because customers now had to wear a mask before entering the building, signage was posted at the drive-thru, and plexiglass was installed at the counter and drive-thru.

The court thus concluded that two key failures remained at DAK4's franchised restaurant. The incorrect social distancing training with the ten-minute addendum and the failure to enforce the mask wearing policy, although each insufficient on its own, combined resulted in the failure of employees to either remain six feet part or wear a mask. Both sides' medical experts agreed that social distancing and mask wearing were key to reducing exposure to the virus. The plaintiffs' expert also testified that short repeated exposures could result in transmission of the virus. Accordingly, the court found that this "potentially hazardous combination" the McDonald's franchisor and franchisee created contradicted the Executive Order and IDPH guidelines and endangered the employees, their families, and the public as a whole.

Next, the court analyzed how MRI, the McDonald's subsidiary operating two corporate locations, acted with respect to the alleged Five Measures. At its first location, the court found that MRI supplied the necessary masks, gloves, and sanitizer. MRI also did not improperly monitor and inform employees of COVID-19 positive cases. Temperature checks of all employees were taken at the beginning of their shift and if the temperature was higher than 99.5 degrees, they were sent home. There was one positive COVID-19 case and the manager informed all workers, including the plaintiff, and closed the restaurant for cleaning. The manager later learned, after video review, that no one in fact came in close contact with the employee. However, the court found that MRI, like DAK4, failed to train employees on social distancing properly because it too followed the McDonald's Corporate ten-minute addendum to the social distancing training. MRI also failed to enforce policies requiring employees to wear masks at work as employees and managers "frequent[ly]" failed to wear masks. Conversely, customer mask-wearing issues had been remedied by requiring they wear masks before

entering the building, installing signs at the drive-thru, and installing plexiglass at the counter and drive-thru. As with DAK4, the court found the two failures created a substantial and unreasonable interference with the plaintiffs' or the public's health.

At the second MRI location, the court rejected the plaintiff-employee's claim that cloth masks originally given to employees were too thin and inadequate. The court further found that like the first MRI location and the DAK4 locations, this location also failed to adequately train employees on social distancing, relying on the McDonald's Corporate ten-minute addendum to the social distancing training, and did not properly enforce the policy requiring employees to wear masks at work.

Importantly, the court noted for "all three restaurants that the Defendants' policies, in theory, are not unreasonable, rather, as stated above, it is how they are failing to be properly implemented" that created a public health hazard to the plaintiffs. As a result, the court held that the plaintiffs established a likelihood of success on the merits of their public nuisance claim against all of the defendants, excepting the dismissed Lexi defendant.

Conversely, the court held that the plaintiffs were unlikely to succeed on the merits of their negligence claim for a number of reasons. First, the McDonald's Corporate defendants owed no duty of care to the plaintiffs because McDonald's Corporate did not own any of the restaurants. Although McDonald's Corporate took steps to promulgate guidance to the franchisees during the COVID-19 pandemic, these steps were not likely to create a duty of care. MRI and DAK4 did owe a duty of care to their employees. However, the plaintiffs' injuries—potentially contracting the virus—were too speculative. Since none of the plaintiffs had been exposed to or infected by the virus, causation and injury were "purely speculative."

Moving to the other injunction factors, the court held that the irreparable injury and inadequate remedy at law elements were met. The court specifically found that COVID-19 presents an immediate harm and that the harm of being infected is not compensable with money. In so doing, the court rejected defendants' contrary argument based on a Missouri case, *Rural Cmty. Workers Alliance v. Smithfield Foods*, 2020 U.S. Dist. LEXIS 78793 (W.D. Mo. May 5, 2020), which had found that there was no actual, imminent threat of harm "as no one's health is guaranteed in the raddle of a pandemic," and the employer had already taken measures to minimize the risk of its workers contracting the virus, as here. The court rejected *Smithfield* because it was not binding authority and Illinois law specifically allows for injunctive relief for a prospective nuisance.

Finally, the court ruled that the balance of equities and hardships weighed in favor of granting an injunction. The benefit of strictly enforcing mask policies and retraining employees on proper social distancing procedures protected not only employees, but also their families and the public. Such benefit outweighed the slight hardship of requiring the defendants to change improper policies and strictly enforce policies that were consistent with the Executive Order.

In summary, the court denied the preliminary injunction as to McDonald's Corporate and Lexi (or that restaurant's current owner) and as to the negligence claim. Regarding the public nuisance claim, the court denied the injunction with respect to DAK4 and MRI on three of the Five Measures, as indicated earlier. However, the court enjoined DAK4 and MRI and ordered them to train employees on social distancing and to enforce the mask wearing policies when employees are not six feet apart, in compliance with the Executive Order. The preliminary injunction will remain in effect until a decision on the merits is made or the Executive Order changes its guidance on masks and/or social distancing.

North American Securities Administrators Association, *Disclosing Financial Performance Representations in the Time of COVID-19*, Bus. Franchise Guide (CCH) ¶ 16,670 (June 17, 2020)
This guidance is discussed under the topic heading "FTC Franchising Rule."

DAMAGES

***Midway Labs USA, LLC, v. South Service Trading, S.A.*, Bus. Franchise Guide (CCH) ¶ 16,660, 2020 WL 2494608 (S.D. Fla. May 14, 2020)**
In a contract dispute involving the sale and importation of nutritional supplements, South Service Trading S.A. and Codime Comercio e Distribucao de Mercadorias Ltda. (Exicon), an importer, distributor and reseller of various consumer products in Brazil, alleged that Midway Labs USA, LLC (Midway), a producer and seller of nutritional supplements, and two related parties, Midway Labs Bio, LLC (Midway Bio) and Wilton B. Colle (Colle) (collectively, the Midway Parties), engaged in deceptive conduct and breached a distribution agreement between the parties. Specifically, Exicon alleged that Midway violated the Florida Deceptive and Unfair Trade Practices Act (FDUTPA) and that the controlling member and manager of Midway tortiously interfered with the distribution agreement. The Midway Parties filed a motion to dismiss with prejudice and the U.S. District Court for the Southern District of Florida granted the motion without prejudice.

In May 2018, Midway and Exicon entered into a distribution agreement under which Midway appointed Exicon as an importer, distributor, and reseller of Midway products in Brazil. In November 2019, Midway filed a complaint against Exicon for breach of the distribution agreement and a subsequent June 2019 agreement reached by the parties after the distribution agreement was terminated. In January 2020, Exicon filed its answer and counterclaim against the Midway Parties for alleged misconduct and repeated breaches of the distribution agreement. Exicon alleged that the Midway Parties violated the FDUTPA and that Colle tortiously interfered with a contract between Midway and Exicon. The Midway Parties moved to dismiss the counterclaims with prejudice.

The court began by analyzing Exicon's claim that Midway violated the FDUTPA. Under the FDUTPA, a claimant must satisfy three elements: (1) a deceptive act or unfair trade practice; (2) causation; and (3) actual damages. To be eligible for relief under the FDUTPA, claimants must show a consumer injury. Here, the court concluded that Exicon failed to state a claim under the FDUTPA because it did not allege *any* facts showing "consumer injury or detriment" caused by the Midway Parties. Although Florida courts liberally construe the word "consumer," plaintiffs must still allege facts demonstrating a consumer injury in order to state a claim. For purposes of the "consumer injury" prong of the FDUTPA, Florida courts have determined that a "consumer" is someone who "has engaged in the purchase of goods or services." Exicon, however, did not allege in its counterclaim that it engaged in the purchase of Midway's goods. Rather, Exicon described its responsibilities as "largely logistical" for the distribution of Midway's products to customers in Brazil. The court found that Exicon did not explain how its logistical role made it a "consumer" for purposes of the FDUTPA. As such, the court found that Exicon failed to allege a consumer injury.

Even though this determination resolved the matter, the court nonetheless addressed the damage claim. In order to satisfy a claim under the FDUTPA, there must be actual damages, as opposed to consequential damages. Exicon alleged that its damages included lost past and future profits because it had suffered and would continue to suffer those damages as a direct and proximate result of the Midway Parties' allegedly deceptive and unfair trade practices. Exicon specified that it was seeking lost profits as its primary form of damages under the FDUTPA. The court explained that Florida law bars consequential damages under the FDUTPA and that courts consistently consider future lost profits to be consequential damages that cannot be recovered under the FDUTPA. Consequently, the court held that Exicon could not recover future lost profits because such damages are consequential and, therefore, not recoverable under the FDUPTA.

The court went on to analyze whether past lost profits are permissible under the FDUTPA. Courts in the Eleventh Circuit are split on this issue. For example, some district courts find that past lost profits are actual damages and are recoverable, whereas others find that past lost profits constitute consequential damages and may not be recovered under the FDUTPA. Neither the Eleventh Circuit nor the Florida Supreme Court has resolved the issue.

Rather than "kick the legal can down the road," the court held that past profits are not actual damages under the FDUTPA; instead they are unrecoverable consequential damages. The court reasoned that "there is no substantive distinction between past lost profits and future lost profits for the purposes of determining whether past lost profits are actual damages" and that both involve consequential-type damages, which are barred under the FDUTPA. The court explained that the fact that a lost profit occurred in the past does not necessarily change the nature of the damage from

consequential to actual. Instead, the court found that "a past lost profit is simply a consequential damage which has happened." The court found that the only significant difference between past lost profits and future lost profits is that past lost profits are no longer speculative; however, being speculative is not what makes a future lost profit unavailable in a FDUTPA claim. The question is whether the damage is consequential, and the court held that a lost profit damage "is no less consequential merely because it is a past profit." As such, Exicon could not properly state a claim under the FDUTPA because it did not satisfy the "actual damages" element.

Finally, the court turned to Exicon's allegation that Colle tortiously interfered with Midway's performance under the distribution agreement with Exicon. Exicon alleged that Colle intentionally interfered with the agreement by directing one of Midway Bio's subsidiaries, Perseus, to purchase Midway products from Brazilian manufacturers and sell them directly to customers, in direct competition with Exicon and in breach of its exclusive distribution rights. The court explained that a tortious interference claim can only succeed if the interfering defendant is a third party and a "stranger" to the business relationship. Because Colle executed the distribution agreement on behalf of Midway and was a managing member of Midway, he could not tortiously interfere with a contract to which Midway was a party because he was not a stranger to the business relationship. Thus, the court held that Exicon's argument failed as a matter of law. For these reasons, the court granted the Midway Parties' motion to dismiss, although without prejudice.

DEFINITION OF FRANCHISE

***Keen Edge Co. v. Wright Manufacturing, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,712, 2020 WL 4926664 (E.D. Wis. Aug. 21, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

DISCRIMINATION

***Elsayed v. Family Fare LLC*, Bus. Franchise Guide (CCH) ¶ 16,707, 2020 WL 4586788 (M.D.N.C. Aug. 10, 2020)**
This case is discussed under topic heading "Labor and Employment."

***Griffith v. Coney Food Corp.*, Bus. Franchise Guide (CCH) ¶ 16,711, 2020 WL 4748452 (E.D.N.Y Aug. 17, 2020)**
This case is discussed under the topic heading "Labor and Employment."

EARNINGS CLAIMS

North American Securities Administrators Association, *Disclosing Financial Performance Representations in the Time of COVID-19*, Bus. Franchise Guide (CCH) ¶ 16,670 (June 17, 2020)
This guidance is discussed under the topic heading "FTC Franchising Rule."

FRAUD

***Arruda v. Curves International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,692, 2020 WL 4289380 (W.D. Tex. July 27, 2020)**
This case is discussed under the topic heading “Statutory Claims.”

***Kiddie Academy Domestic Franchising, LLC v. Wonder World Learning, LLC*, Bus. Franchise Guide (CCH) ¶ 16,694, 2020 WL 4338891 (D. Md. July 27, 2020)**
The U.S. District Court for the District of Maryland granted summary judgment in favor of the franchisor of Kiddie Academy childcare centers and two of its officers on counterclaims for negligent misrepresentation brought by the franchisee and its owners. The court found that the alleged promotional statements and financial projections in pro formas were mere puffery and the defendants could not justifiably rely on them. As to the alleged misrepresentations about construction costs, there were no allegations that the franchisor provided incomplete information or prevented the defendants from understanding the full costs of constructing a childcare center. Nor were the defendants misled by two franchisor officers regarding a bank analysis and pro formas the defendants used to secure a loan for their franchise. The defendants conducted their own independent analysis and were intimately involved in revising the pro formas.

On March 14, 2014, Kiddie Academy Domestic Franchising, LLC (Kiddie) and Wonder World Learning, LLC (Wonder World or franchisee) entered into a franchise agreement by which Wonder World agreed to operate a franchised Kiddie Academy childcare center located in Cedar Park, Texas. The owners of Wonder World, a married couple, Sumanth Nandagopal and Supriya Sumanth (the Sumanths or owners), personally guaranteed Wonder World’s obligations under the franchise agreement. Ms. Sumanth had a Masters of Business Administration (MBA) and was familiar with generally accepted accounting principles.

The Sumanths first began researching childcare franchise companies in January 2011. They chose Kiddie Academy because the Kiddie marketing department allegedly told them that owners did not need any training or experience to run a Kiddie Academy franchise. They applied to become franchisees in February 2011. The Sumanths wanted to search for a franchise location in San Jose, California, where they lived, but allegedly were told by Kiddie that they should consider the Texas market. Beginning in September 2013, the Sumanths worked with Lene Steelman (Steelman), Kiddie’s Vice President of Accounting, to complete a pro forma financial statement of projected revenues and expenses associated with developing and operating a franchise in order to obtain financing. Steelman provided Ms. Sumanth a blank pro forma template in late September 2013. The Sumanths then drafted and revised the pro forma several times with respect to enrollment, building cost, and tuition rates and asked Steelman to provide feedback on their projections. Steelman did.

In October and November 2013, Kiddie, with the help of Kiddie's Vice President of Real Estate, Joshua Frick (Frick), also generated site analysis reports (SARs) assessing the viability of three potential locations for the Sumanths in Austin, Texas. The SARs contained demographic information, such as total potential customers, population growth rates, median household income, median home values, and other relevant information (e.g., traffic counts and a list of competitors in the vicinity). In December 2013, the Sumanths, accompanied by Frick, visited three potential sites for their franchise in Austin and chose the Cedar Park location.

Throughout January and February 2014, the Sumanths continued to revise their pro forma and sought feedback from Steelman. To obtain capital for their franchise, the Sumanths applied to several banks for a $2.7 million loan using the same pro forma they submitted to Steelman on February 6, 2014. On March 14, 2014, without loan approval, Kiddie executed a franchise agreement with Wonder World and a personal guaranty with the Sumanths.

Thereafter, one of the banks emailed the Sumanths expressing concerns with the profitability of the Cedar Park location because of significant competition near the site. The Sumanths shared the email with Steelman and Frick and asked for their help with the bank approving the location. Frick contacted the bank and defended the viability of the site. Ms. Sumanth performed her own research and disputed directly with the bank its singular focus on the toddler group since there were other groups. The bank still denied the loan.

In April 2014, another bank, Square 1 Bank, approved a loan for $2,677,000. Months later, the Sumanths submitted four new pro formas to Square 1 Bank, seeking to increase the loan amount to cover construction overruns and staffing. Lisa Conley (Conley), Kiddie's Finance Manager, assisted the Sumanths in preparing these pro formas. The first page of each pro forma contained a disclaimer that Kiddie was not warranting or guaranteeing that the amounts included on the report were correct; all such amounts were estimates only; and the franchisee's figures "will" vary from the estimates. Defendants closed on their loan with Square 1 Bank in November 2014.

In August 2015, Wonder World began operating its Kiddie Academy franchise. Pursuant to the franchise agreement, Wonder World was required to report all financial records at the end of the week and submit the data to Kiddie to, in turn, determine the royalties owed to Kiddie. In September 2017, Wonder World stopped submitting these weekly reports and instructed its bank to withhold the royalty payments to Kiddie. On October 10, 2017, Kiddie informed Wonder World and the Sumanths that they had thirty days to cure their breach of the franchise agreement for nonpayment. On November 13, 2017, after receiving no payment, Kiddie issued a notice of termination and disabled Wonder World's access to servers and online systems. Kiddie also attempted to coordinate the defendants' return of its

intellectual property and removal of signage. The Sumanths did not cooperate and Kiddie sent a letter to defendants' staff and customers notifying them that Kiddie had terminated its relationship with the defendants. Wonder World ceased operation of its franchised childcare center in November 2017.

On November 16, 2017, Kiddie filed this lawsuit against Wonder World and the Sumanths for breach of contract and trademark and copyright infringement. After several extensions, Wonder World answered the complaint, asserted several affirmative defenses, and asserted ten counterclaims against Kiddie and its officers: (1) intentional misrepresentation, (2) fraud in the inducement, (3) fraudulent concealment, (4) negligent misrepresentation, (5) defamation, (6) detrimental reliance, (7–9) several RICO violations, and (10) conspiracy. Kiddie moved to dismiss the counterclaims against it. With the exception of count four, the court dismissed all counterclaims against Kiddie. With respect to counts one, two, and three (the fraud claims), the court found that the defendants failed to allege that Kiddie intended to deceive them. As for count four for negligent misrepresentation, the court did not dismiss it because the promises allegedly made by Kiddie and its officers were not entirely limited to promises about future performance and conduct. The court also dismissed all counterclaims as to the Kiddie officers because the defendants failed to effect service on them.

In June 2019, the defendants moved to reinstate the fraud claims and to amend count four of their counterclaim. In October 2019 Kiddie filed a motion for summary judgment on defendants' claim for negligent misrepresentation and a motion for judgment on the pleadings (Rule 12(c) motion) as to defendants' affirmative defenses. While Kiddie's motions were pending, the court denied the defendants' request to revive their fraud claims because they were based on the same conduct previously alleged, which lacked the requisite intent to deceive. However, the court allowed the defendants to "bolster" their negligent misrepresentation claim by "clarify[ing] the effect" of Kiddie's alleged false statements and to pursue this claim against Frick and Steelman as well. According to the court, the claims were not futile given the role these individuals played in the events leading to the defendants' purchase of the franchise.

Frick and Steelman were served in January 2020, and they moved to dismiss the counterclaim under Federal Rule of Civil Procedure Rule 12(b)(6) or, in the alternative, for summary judgment in February 2020. After briefing on the dispositive motions concluded, the defendants moved to supplement the record with thirty-nine exhibits to sufficiently plead fraud, and for the court to reconsider its prior dismissal of the fraud counts. Kiddie opposed both motions.

First, the court addressed Kiddie's Rule 12(c) motion as to the defendants' affirmative defenses for failure to state a claim, fraud, unclean hands, inequitable conduct, prior breach, and statute of limitations. The court noted that although neither the U.S. Supreme Court nor the Fourth Circuit has

addressed whether the *Iqbal/Twombly* pleading standard applies to affirmative defenses, courts in the district, including this particular court, had concluded that it applied. Against this backdrop, the court granted Kiddie judgment as to some, but not all, of the defendants' affirmative defenses. Specifically, the court granted the motion on the failure to state a claim and fraud affirmative defenses, but denied it as to the rest. The defendants had to raise the failure to state a claim defense before answering the complaint but filed an answer instead. The fraud defense failed for the same reasons the fraud counterclaims failed twice before. The remaining affirmative defenses survived because the defendants persistently claimed that Kiddie did not abide by its promises and acted with unclean hands and inequitably.

Next, the court denied the defendants' motion to reconsider as both untimely and without merit. The deadline to seek reconsideration had long passed—six months earlier. Moreover, the defendants' argument that they had newly acquired evidence of Kiddie's intent to deceive to support their fraud claims contravened the law of the case doctrine as to the court's earlier rulings rejecting the fraud claims. Even so, the Fourth Circuit has instructed that a court may revise an interlocutory order in "extraordinary circumstances," such as where a subsequent trial produces substantially different evidence, there is a change in applicable law, or the court commits a clear error causing "manifest injustice." The defendants did not show any extraordinary circumstances here. The purported "new" evidence of fraud was a supplemental affidavit from Conley and a 2016 employment decision related to a claim Conley brought following her termination against Kiddie's parent company. This evidence, however, was not new. Defendants had earlier access to Conley—in fact, their second amended counterclaim for fraud attached an affidavit from her, and the court still dismissed the claim—and the employment decision existed before this suit began. Thus, the court denied reconsideration.

Similarly, the motion to supplement largely failed because the briefs were surreplies not filed in accordance with the local rules and untimely, in any event. Further, the submissions raised nothing new and only reiterated the defendants' belief that they had viable fraud claims against Kiddie—a contention repeatedly rejected by this court. However, given the discovery extensions, the court did allow the later depositions of Frick and Steelman to assess the various motions for summary judgment.

The court then addressed the dispositive motions filed by Kiddie and its two officers. First, the court exercised its discretion to look at matters outside the pleadings with respect to the individuals' motions to dismiss or, in the alternative, for summary judgment, thus treating them as motions for summary judgment. The defendants opposed, arguing that additional discovery was needed, namely depositions from Frick and Steelman. Because the defendants delayed for months in pursuing this discovery, ultimately deposed both Frick and Steelman during an extension of discovery, and the

court allowed supplementation of the record with these two depositions, it was appropriate to address the motions as ones for summary judgment.

On the merits, the court held that there were no genuine issues of material fact on the defendants' negligent misrepresentation claim. The evidence did not support the defendants' assertion that Kiddie made misrepresentations on which defendants could reasonably rely. According to the court, Kiddie's promotional statements that "owner operations of its franchises did not need any training or experience as Kiddie provided all training," its curriculum "was as good or better than its best competitor," and Kiddie had a platform which would guide franchisees to success, were mere puffery and not concrete facts that could be verified. No reasonable person could believe that Kiddie would provide "all" of the training necessary to successfully operate a childcare center and that inexperience in the childcare industry would have no bearing on the likelihood of success in operating a childcare franchise. Because these statements were not ones of fact, they could not be false.

Moreover, the court found that the Sumanths were not justified in relying on "this kind of sales talk." Ms. Sumanth held an MBA, six years of work experience as a financial analyst, and was familiar with business and accounting principles. Kiddie's statements were also so vague and patently puffery that the defendants were not justified in relying on them.

The court also determined that the defendants' claimed reliance on the SARs was unjustified. The SARs provided by Kiddie on three potential franchise locations contained the very data that the defendants alleged was lacking. Regarding competition, the SARs listed potential competitors within a five-mile radius of the proposed franchise site. As for demographics, the SARs contained a rich data set, including number of businesses by industry, population growth, median household income, and median home values.

Similarly, the court found the defendants' claimed reliance on Kiddie's pro formas unpersuasive. A pro forma is simply a financial projection and reliance on it was unjustified. In addition, the Sumanths were actively involved in revising and generating the pro formas in collaboration with Kiddie, and particularly Steelman, over the course of a year. Indeed, Ms. Sumanth exercised editorial control over the pro formas and did not simply accept the changes Steelman provided. To the contrary, Ms. Sumanth told Steelman that some changes "do not look good." Such frequent changes should have put the Sumanths on notice that the pro formas were malleable and trended optimistic. The Sumanths were also on notice that the market was "oversaturated," based on the first bank's rejection of their loan application, which included a pro forma.

Finally, the defendants' contentions surrounding the construction process did not create a genuine issue of material fact on the negligent misrepresentation claim. The only evidence presented was affidavits from the defendants' and Conley that construction cost overruns were Kiddie's fault for approving walls that were built incorrectly, failing to budget for a splash

pad, or overlooking certain permitting requirements. However, there was no basis to conclude that the defendants were competent to opine about the construction of a childcare center. And there were no allegations that Kiddie provided incomplete information or prevented the defendants from understanding the full costs of constructing a childcare center. Thus, there were no facts to support the defendants' claim that Kiddie made a false statement that could have, and did in fact, trigger justifiable reliance. Accordingly, the court granted Kiddie's motion for summary judgment on the negligent misrepresentation claim.

The court also granted summary judgment in favor of the two Kiddie officers, Frick and Steelman. The defendants contended that Frick misled them regarding the quality of the analysis performed by the first bank, which led them to continue pursuing a loan to start their franchise, and that Steelman provided inaccurate pro formas that the defendants used to obtain the loan for their franchise. However, the evidence showed that the defendants independently adopted their own view of the bank analysis—Ms. Sumanth did her own research and asked Frick to reach out to the bank because the bank's analysis focused only on the toddler age group and there were other age groups to consider. Nor was any reliance on the pro formas reasonable in light of the first bank's analysis and the defendants' active role in preparing the pro formas. Accordingly, the two Kiddie officers were entitled to summary judgment on the defendants' negligent misrepresentation claim as well.

***Smash Franchise Partners, LLC v. Kanda Holdings, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,709, 2020 WL 4692287 (Del. Ch. Aug. 13, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

FTC FRANCHISING RULE

***Arruda v. Curves International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,692, 2020 WL 4289380 (W.D. Tex. July 27, 2020)**
This case is discussed under the topic heading "Statutory Claims."

***In re Sonic Corp. Customer Data Security Breach Litigation (Financial Institutions)*, Bus. Franchise Guide (CCH) ¶ 16,680, 2020 WL 3577341 (N.D. Ohio July 1, 2020)**
This case is discussed under the topic heading "Class Actions."

North American Securities Administrators Association, *Disclosing Financial Performance Representations in the Time of COVID-19*, Bus. Franchise Guide (CCH) ¶ 16,670 (June 17, 2020)
At the request of several state examiners, the North American Securities Administrators Association (NASAA) released guidance for reviewing historical financial performance representations (FPRs) based on data from 2019.

The examiners sought this guidance because of the significant impact the COVID-19 pandemic has had on many franchise businesses.

NASAA began by recapping the existing guidance for FPRs based on historical data (Historical FPRs). Under federal and state franchise disclosure laws, a franchisor is permitted to make a Historical FPR if the franchisor has a reasonable basis and written substantiation for the representation, and the franchisor discloses the material bases for the representation. If there are any material changes to the information contained in a registered franchise disclosure document (FDD), including changes to the FPR, the franchisor is obligated to amend the disclosure. Franchisors must also comply with anti-fraud provisions in state franchise registration and disclosure laws. These provisions generally make it unlawful for a franchisor to make an untrue statement of material fact or to omit a material fact in connection with the offer or sale of a franchise.

Under some circumstances, an FPR that discloses historically accurate data may nonetheless contain an omission of a material fact, or an untrue statement of material fact, if material changes have occurred to performance before the FPR is provided to a prospective franchisee. Whether a franchisor can make and continue to use a Historical FPR in 2020 without amending the disclosure is a fact-intensive endeavor and depends on a number of factors, including: (1) whether the franchise business has been significantly impacted by the pandemic; (2) the type of data the franchisor includes in the FPR; (3) the reasonable inferences a prospective franchisee can draw from the FPR; (4) when the franchisor estimates a prospective franchisee can expect to open for business; and (5) whether and how the franchisor plans to adapt the franchise business to account for current and future market conditions resulting from the pandemic.

According to NASAA, if outlets whose data is represented in an FPR have experienced material changes in financial performance such that the historical data is no longer reflective of the current situation, the franchisor may no longer make a Historical FPR without updating it to reflect those changes. As a result, franchise systems that have been significantly impacted by the pandemic must carefully consider whether they can continue to make a Historical FPR in 2020 or whether they must amend to include updated data reflecting the impact of the pandemic on the franchise business. NASAA reminded franchisors that they cannot get around this complex issue by simply including additional disclaimers regarding the Historical FPR data. Such disclaimers are not permitted, and franchisors should not include them in their FDDs.

NASAA also noted that some franchise systems have implemented changes to adapt to shifting consumer attitudes and government regulations during the pandemic (e.g., expanded take-out and delivery services in food service establishments). While some adaptations may be temporary, others may be permanent. If a franchisor concludes that it will make long-term changes to its system or business model to adapt to consumer demands in

a post-COVID world, the franchisor must consider whether those changes would materially impact a historical FPR. If so, the franchisor may no longer include a Historical FPR unless it is updated to reflect such changes and their impact on financial performance.

NASAA acknowledged that it could not issue specific guidance regarding the use of Historical FPRs in 2020 and beyond, as some franchise businesses have experienced tremendous growth during the pandemic while others suffered unprecedented losses. Because each franchise system is unique, NASAA found it was impossible to craft a one-size-fits-all solution. Some franchisors may have a reasonable basis to include Historical FPRs in their FDDs, while others must amend to show the impact of the pandemic on the franchise business. NASAA warned all franchisors who make Historical FPRs to be prepared to respond to comments from state examiners asking them how to explain how the FPR complies with federal and state requirements.

GOOD FAITH AND FAIR DEALING

***Halcyon Syndicate Ltd. v. Graham Beck Enterprises (PTY), Ltd.*, Bus. Franchise Guide (CCH) ¶ 16,687, 2020 WL 4051865 (N.D. Cal. July 20, 2020)**

This case is discussed under the topic heading "Jurisdiction."

***Maaco Franchisor SPV, LLC v. Sadwick*, Bus. Franchise Guide (CCH) ¶ 16,702, 2020 WL 4468727 (W.D.N.C. Aug. 4, 2020)**

This case is discussed under the topic heading "Advertising and Marketing."

INJUNCTIVE RELIEF

***AmeriSpec, LLC v. Sutko Real Estate Services, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,683, 2020 WL 3913584 (W.D. Tenn. July 10, 2020)**

The U.S. District Court for the Western District of Tennessee granted AmeriSpec, LLC (AmeriSpec), a national franchisor of property inspection services, a preliminary injunction enforcing a post-termination noncompete agreement against a Nebraska franchisee.

In 2010, AmeriSpec and Thomas Sutko entered into two franchise agreements to operate two franchised residential and commercial inspection locations in Lincoln and Omaha, Nebraska under the corporate name Sutko Real Estate Services, Inc. (SRESI). Five years later, Thomas Sutko and SRESI renewed those agreements with Amerispec. The franchise agreements contained a one-year noncompete from any direct or indirect involvement in any type of residential and commercial building inspections business within a ten-mile radius of their designated territories or any other Amerispec location. John Sutko, the son of Thomas Sutko, joined SRESI in 2016 in the role of vice president in charge of daily operations. On May 4, 2020, Thomas Sutko and AmeriSpec signed a mutual termination and release agreement

(MTRA) requiring Thomas Sutko to comply with all post-termination obligations in the franchise agreements, including the noncompete. The MTRA specified that the noncompetition obligations continued "in full force and effect," and included an integration clause incorporating the noncompete provision.

Two days after the signing of the MTRA, John Sutko announced that he had created a new property inspection company, SRE Home Inspections, Inc. (SREI), with many of the same management employees and inspectors from SRESI. John Sutko was able to register SREI—with a similar corporate name to Thomas Sutko's testing and mitigation businesses called SRE Homeservices, LLC—only after Thomas Sutko executed a document consenting to the use of this name. When AmeriSpec learned of SREI continuing SRESI's operations, AmeriSpec sent a cease and desist letter demanding prompt compliance with the franchise agreements. Although Thomas Sutko offered to return manuals, assign phone numbers, and stop using AmeriSpec's trademarks, he disclaimed any ownership of SREI.

AmeriSpec then sued Thomas Sutko and John Sutko individually, as well as SREI and SRESI (together, the defendants), for breach of the MTRA, and moved for a temporary restraining order (TRO) and preliminary injunction enjoining them from competing with AmeriSpec and its new franchisee in the designated territories for one year. The court granted the TRO and enjoined the defendants from unlawfully competing with Amerispec for a fourteen-day period, ordering them to comply with their confidentiality and post-termination obligations. One day before the TRO expired, the court held a hearing on Amerispec's request for a preliminary injunction. At the end of the hearing, the court extended the TRO for another fourteen-day period while it determined the merits of the preliminary injunction.

In granting the franchisor's motion for preliminary injunction, the court first found that Amerispec was likely to succeed on the merits of its claim. Although noncompete agreements are disfavored in Tennessee, Tennessee courts will uphold a noncompete that protects a legitimate business interest and is reasonable under the particular circumstances. The defendants here did not dispute that the noncompete was enforceable as to SRESI and Thomas Sutko. Nor did the defendants dispute that Amerispec had several legitimate business interests to enforce the noncompete, including preserving customer goodwill, preventing unfair competition by former franchisees, and preserving the integrity of the franchise system. Instead, the defendants argued that enforcing the noncompete would be unreasonable for three reasons. First, Thomas Sutko had not violated the noncompete agreement. Second, the noncompete could not be applied to John Sutko and SREI because they were not parties to the agreements containing the noncompete provision. Third, the noncompete was overbroad and unreasonable when applied to John Sutko, SREI, or employees of SREI.

Focusing its analysis on these three arguments, the court found that the noncompete provision was reasonable and extended to all of the defendants,

including John Sutko and SREI, as well as TruHome Inspections Services, Inc. (TruHome), the business John Sutko used to continue to operate the same business as the franchised businesses after SREI was discovered.

The court began its analysis with the reasonableness of the noncompete provision and concluded that it was reasonable. Under Tennessee law, courts consider four factors in ascertaining reasonableness: (1) the consideration supporting the agreement; (2) the threatened danger in the absence of such agreement; (3) the economic hardship imposed by such a covenant; and (4) whether or not such a covenant should be inimical to public interest. Taking these factors in turn, the court first found that sufficient consideration supported the franchise agreements given the ten-year franchise relationship and Thomas Sutko's leadership role for the franchises. Second, the court found that Amerispec had protectable business interests in preserving customer relationships, preventing unfair competition, and conserving the integrity of its franchise system. Thomas Sutko's admission during the hearing that he continued to service clients of the franchised business despite entering into the MTRA made this fact even clearer. Third, although the court found that the defendants would suffer some economic hardship from enforcement of the noncompete, Thomas Sutka voluntarily agreed not to compete with Amerispec as a condition of entering into the franchise agreements and the territorial restriction was reasonable. Fourth, the covenant was not contrary to the public interest.

Moving on to whether the noncompete provision should apply to John Sutko and SREI, the court concluded that it did. Although John Sutko and SREI were not signatories to the agreements containing the noncompete obligations, they were in "active concert or participation" with Thomas Sutko when he acted to counter his contractual obligation not to compete. Their active participation could be found in many emails sent by SREI to customers during the transition from SRESI to SREI stating that SRESI was terminating its relationship with AmeriSpec in name only. The emails made it clear that SRESI would continue doing the same business, with the same staff, under SREI. And John Sutko knew SREI had identified itself to customers as SRESI's replacement, as reflected in emails. In addition, Thomas Sutko orchestrated the creation of SREI with his son by signing the document consenting to the use of the name. Moreover, Thomas Sutko was behind and personally approved much of the logistics related to creating SREI. For example, he led the charge in designing the new business cards for SREI and directed the employee benefits for SREI. He also attempted to access SRESI's proprietary information within minutes of signing the MTRA, which was further proof of his intent to continue SRESI's operations in competition with AmeriSpec. Because the evidence showed that Thomas Sutko was in active concert or participation with his son and SREI when he acted to violate his obligation not to compete, the court found that it was reasonable to enforce the noncompete against John Sutko and SREI (and TruHome). The court thus held that AmeriSpec was likely to succeed on the merits.

Next, the court held that AmeriSpec would suffer irreparable harm without the injunction. Thomas Sutko admitted that he continued to service the same clients as its AmeriSpec franchise after entering into the MTRA. Through his active participation, SREI continued to operate as if it was SRESI, and SREI attempted to benefit from some of AmeriSpec's proprietary information to advance its own business interests. These are the kinds of behaviors that the Sixth Circuit has found cause irreparable harm. Additionally, the balance of equities tipped in favor of AmeriSpec because AmeriSpec would suffer irreparable harm to its business reputation and customer goodwill, while defendants need only comply with their contractual obligations. Finally, it would be in the public's interest to grant the preliminary injunction because AmeriSpec had a clear interest to protect its franchise system.

The court therefore granted AmeriSpec a preliminary injunction to enforce the noncompete provision in the franchise agreements for a period of one year from the MTRA against not only Thomas Sutko and SRESI, but also John Sutko and SREI, and any of their "officers, agents, servants, employees, attorneys and all those in active concert or participation with them, including TruHome."

***Interim Healthcare, Inc. v. Interim Healthcare of Southeast Louisiana*, Bus. Franchise Guide (CCH) ¶ 16,666, WL 3078531 (S.D. Fla. June 10, 2020)**

This case is discussed under the topic heading "Jurisdiction."

***Keen Edge Co. v. Wright Manufacturing, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,712, 2020 WL 4926664 (E.D. Wis. Aug. 21, 2020)**

The U.S. District Court for the Eastern District of Wisconsin granted Keen Edge Company, Inc.'s (Keen Edge) motion for preliminary injunction and temporary restraining order against Wright Manufacturing, Inc. (Wright Manufacturing), enjoining and temporarily restraining Wright Manufacturing from terminating the distributorship relationship.

Upon its founding in the 1980s, Wright Manufacturing, a Maryland-based corporation, partnered with Keen Edge, a supplier of engines and parts, to distribute Wright Manufacturing products, including Wright Manufacturing's state of the art "Strander" line lawnmowers, throughout the Midwest. As part of this partnership, Keen Edge educated retailers and their customers about the features and benefits of the Strander line, which created a market that accounts for a substantial portion of Wright Manufacturing's business. Due to Keen Edge's efforts, Wright Manufacturing granted Keen Edge the exclusive right to sell Wright Manufacturing products in Wisconsin, Minnesota, and North Dakota, and parts of Illinois, Indiana, Missouri and Kansas. Although the parties never entered into a written contract, Wright required Keen Edge to fulfill certain obligations in exchange for certain privileges (e.g., minimum sales growth requirements and restrictions on trademark use).

Wright Manufacturing product sales constituted a significant portion of Keen Edge's business. For example, in 2019, the sale of Wright Manufacturing products accounted for nearly ninety-five percent of Keen Edge's sales. Keen Edge operated out of a primary facility in Illinois and a distribution facility in Wisconsin. Robert Burke (Burke), Keen Edge's president, operated out of the Wisconsin facility. Keen Edge distributed more than two-thirds of Wright Manufacturing products from Wisconsin, sold approximately twenty percent of Wright Manufacturing products to in-state purchasers, spent $1.2 million to lease the Wisconsin facility, and spent a substantial amount of money advertising in the state.

After undergoing a leadership change, Wright Manufacturing sent Keen Edge a letter dated May 30, 2019, claiming that Keen Edge was underperforming and in default of its obligations. According to the letter, if Keen Edge failed the resolve the deficiencies, Wright Manufacturing could terminate the distributorship. In June 2019, Keen Edge and Wright Manufacturing personnel met to address the alleged deficiencies. During this meeting, Keen Edge expressed concern over some of the recommended solutions and noted that other distributors were not subject to the same requirements. In response, Wright Manufacturing suggested that Keen Edge could sell its business, an option in which Keen Edge had no interest. After the initial meeting, Wright Manufacturing did not conduct a follow-up visit or otherwise assess whether Keen Edge had resolved the alleged deficiencies. Keen Edge continued to distribute Wright Manufacturing products, attended the annual general meeting and territory manager meetings, drafted a sales and marketing budget for 2020, and proposed dealer program terms that Wright Manufacturing approved in August 2020.

On October 11, 2019, Wright Manufacturing sent notice to Keen Edge that it intended to terminate Keen Edge's distributorship agreement effective November 10, 2019. Instead of providing a clear reason for termination, Wright Manufacturing referenced the deficiency notice sent earlier in the year. Approximately a month after receiving this notice, Keen Edge filed a lawsuit alleging that Wright Manufacturing had wrongfully terminated its oral distributorship agreement and filed a motion for a temporary restraining order and a preliminary injunction.

The court first analyzed whether Keen Edge adequately demonstrated that it would suffer irreparable harm and was without an adequate remedy at law without the entry of a preliminary injunction. The court found that it would. Keen Edge contended that it would lose approximately ninety-five percent of its business if the injunction were not granted. Wright Manufacturing did not dispute that Keen Edge would suffer irreparable harm, rather it focused its arguments on Keen Edge's likelihood of success of the merits.

The court then analyzed whether the plaintiff adequately established a substantial likelihood of success on the merits of its claims. To do this, the court had to determine whether Keen Edge's business was situated in Wisconsin and whether the parties had a "community of interest," triggering the

application of the Wisconsin Fair Dealership Law (WFDL). Wright Manufacturing argued that Keen Edge was not situated in Wisconsin and no "community of interests" existed.

In determining whether Keen Edge was "situated in Wisconsin," the court considered a variety of factors, including those set out by the Wisconsin Supreme Court in *Baldewein Co. v. Tri-Clover, Inc.*, 606 N.W.2d 150 (Wis. 2000). The court found that Keen Edge conducted a substantial portion of its business in Wisconsin, was partially located in Wisconsin, and had spent a considerable amount of time, money, and other resources in building its business in Wisconsin. More specifically, for approximately two decades, Keen Edge distributed Wright Manufacturing products exclusively in the Midwest from the Wisconsin facility. Keen Edge directed twenty to twenty-five percent of its sales efforts to Wisconsin, devoted approximately twenty percent of its resources to advertising and promoting in Wisconsin, and spent nearly twenty percent of its time servicing and providing consultations to customers in Wisconsin. Finally, Keen Edge's President, "perhaps the most visible and consequential employee," worked out of the Wisconsin facility. Unlike prior cases, the court highlighted, "Wisconsin constituted a large enough portion of sales such that any concern about directing the efforts within Wisconsin [was] mitigated." Thus, the business was located in Wisconsin, supporting the application of the WFDL.

The court next turned to whether a "community of interest" existed between the parties. The court considered a variety of factors, all of which weighed in favor of Keen Edge. The court found that a community of interest existed because Keen Edge was the exclusive distributor of Wright Manufacturing products in a large portion of the Midwest for approximately forty years; Keen Edge sold almost exclusively Wright Manufacturing products and provided training, repairs, and replacement parts and rebates to customers; and nearly all of Keen Edge's revenue came from the sale of Wright Manufacturing products. Accordingly, the WFDL applied.

Keen Edge argued that Wright Manufacturing failed to comply with the WFDL by failing to provide at least ninety days' written notice of termination and a sixty-day period in which Keen Edge could have cured any deficiencies. The court agreed. Although the letter sent on May 30, 2019 followed the termination procedures, Wright Manufacturing's subsequent behavior "demonstrated a willingness to continue the dealership." Thus, the May 30, 2019 letter could not satisfy WFDL's notice and cure requirements. Further, the October 11, 2019 letter, which attempted to terminate the dealership the following month, also failed to meet the notice and cure period requirements. Therefore, the termination was improper. Keen Edge also asserted that Wright Manufacturing did not have good cause for termination. The court again agreed, finding that the parties' actions were inconsistent with termination and "potentially pretextual" because Wright Manufacturing did not uniformly impose the same requirements on other dealers.

Finally, the court largely rejected Wright Manufacturing's argument that the injunction should be limited to Wisconsin. The court concluded because it was plausible that Keen Edge could succeed on the merits of its claims in Illinois, Indiana, North Dakota, Missouri, and Minnesota, which would support an injunction in the respective states. However, because Wright Manufacturing was not a retailer who served the "ultimate customer," as required under Kansas law, the court limited the injunction so that it did not apply to Kansas.

After determining that the equities weighed in favor of issuing the injunction, the court granted Keen Edge's motion for preliminary injunction and restrained Wright Manufacturing from proceeding with its planned termination of the dealership. Keen Edge could, thus, continue doing business as the exclusive distributor for Wright Manufacturing in all states at issue, except Kansas.

***Massey v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 16,679, 2020 WL 5700874 (Ill. Cir. Ct. June 24, 2020)**
This case is discussed under the topic heading "COVID-19."

***Nevada DeAnza Family Ltd. Partnership v. Tesoro Refining & Marketing LLC*, Bus. Franchise Guide (CCH) ¶ 16,697, 2020 WL 4284827 (N.D. Cal. Jul. 27, 2020)**
This case is discussed under the topic heading "Petroleum Marketing Practices Act."

***Smash Franchise Partners, LLC v. Kanda Holdings, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,709, 2020 WL 4692287 (Del. Ch. Aug. 13, 2020)**
A Delaware Chancery Court largely rejected a request from Smash Franchise Partners, LLC and Smash My Trash, LLC (together, the plaintiffs or Smash) for injunctive relief against Todd Perri (Perri), Kevin McLaren (McLaren), and their companies Kanda Holdings, Inc. and Dumpster Devil, LLC (together, the defendants), for allegedly feigning interest in buying a Smash franchise to learn all about the trash compactor business from Smash and then start a competing business using Smash's confidential and proprietary information and trademarks.

The plaintiffs operate a mobile trash compaction business and sell franchises to prospects interested in running a Smash-branded franchise in a protected territory. Perri expressed interest in purchasing a Smash franchise and concluded that he could create a similar business. Although he decided to form his own business outside of the Smash brand, Perri continued to express interest in the Smash franchise and gather related information. To do so, he signed a non-disclosure agreement (NDA). At the time, Perri was the sole owner of Kanda Holdings, Inc. (Kanda), a North Carolina company.

Perri and McLaren then formed Dumpster Devil, LLC (Dumpster Devil), a competing mobile compaction business. On the defendants' website, the

defendants compared certain components of the business to those of the Smash franchise business. The defendants also purchased the name "Smash My Trash" from Google AdWords, so that in certain areas, users searching "Smash My Trash" would see a paid advertisement for Dumpster Devil as the top result.

On April 20, 2020, the plaintiffs filed a lawsuit against the defendants asserting eight causes of action (which are detailed next) seeking a preliminary injunction to prevent the defendants from: "(1) using and/or disclosing the [c]onfidential [i]nformation; (2) using and/or disclosing [the plaintiffs'] confidential and proprietary information; (3) using and/or advertising using [Smash's] intellectual property, including its trademarks; and (4) competing with [the plaintiffs]." The court focused its analysis on the probability of success on the merits of the plaintiffs' various legal theories.

First, the plaintiffs alleged that Perri and Kanda breached their contractual obligations under their NDA by using or disclosing confidential information that Perri received in initial calls with Franchise Fastlane, Inc. (Fastlane), an independent contractor for Smash's franchise sales, Franchisee Forum Calls, and Founder Calls. The court analyzed each type of call and held that the plaintiffs failed to demonstrate a reasonable likelihood of success on the merits for breach of the NDA because the information shared was either publicly available or did not fall within the NDA's definition of "Confidential Information." The NDA defined "Confidential Information" as information disclosed by the "Company," which was defined as "SMT Holdings, LLC and its affiliates (including but not limited to Smash Franchise Partners, LLC and Smash My Trash, LLC)." The information shared on the Franchisee Forum Calls was provided by the franchisees, who were independent contractors and not affiliates or agents of the plaintiffs. The information shared by Fastlane in the initial also was not intended to be confidential because the information provided to the defendants resembled the information in the franchise disclosure document (FDD) and the recipients were not required to execute a NDA until after receiving the information. The other information released in the Founder Calls (e.g., information about current territories, expected expenses and profits for franchisees, fleet management, and Smash's general pricing model) was publicly available and non-proprietary. Most of the information was freely provided by franchisees on Franchisee Forum Calls or available on the plaintiffs' website or in its YouTube videos. The court concluded that although "Perri engaged in disingenuous and underhanded conduct" by participating in the calls under false pretenses, Smash failed to show that Perri acquired Confidential Information that was subject to protection.

Second, the court considered the plaintiffs' unjust enrichment claim based on its allegation that all of the defendants took the plaintiffs' confidential information and used it for their benefit. The court acknowledged that a claim for unjust enrichment "is not available if there is a contract that governs the relationship between parties that gives rise to the unjust enrichment

claim." According to the court, the plaintiffs' claim for unjust enrichment was based on the same facts as the breach of contract claim. Because the plaintiffs failed to establish a reasonable likelihood of success on the breach of the NDA claim, the unjust enrichment claim failed as well.

Third, the court turned to the plaintiffs' claim for misappropriation of trade secrets against all of the defendants and held that the plaintiffs were unlikely to prevail because the alleged trade secrets were not actually secret and were publicly available. To prevail on a trade secret misappropriation claim, the plaintiff must "show both the existence of a trade secret and its misappropriation." The court focused on the statutory definition of a "trade secret" under Delaware law, noting that "to qualify as a 'trade secret,' information must both derive independent economic value from not being generally known or readily ascertainable and be subject to reasonable efforts to maintain its secrecy." The plaintiffs detailed the information presented to Perri that they considered trade secrets, but the court disagreed. Much of the information the plaintiffs claimed as trade secrets was otherwise publicly available—for example, in the plaintiffs' FDD, pitch deck, and introductory call. Additionally, the court rejected the plaintiffs' argument that the identity of a few national accounts was akin to a true customer list worthy of trade secret protection. The court also stated that even if the plaintiffs' high-level plan to partner with waste management companies, which was shared with Perri, was protectable information, the plaintiffs did not offer "persuasive evidence of an independent economic advantage emanating from [the] plan's secrecy." As such, the plaintiffs' plan was no protectable trade secret. Continuing with its analysis, the court found that even if the plaintiffs had protectable trade secrets, they did not take reasonable steps to protect their secrecy. For example, the plaintiffs used the same Zoom meeting call for all of its meetings, without screening participants or taking roll.

Fourth, the court held that the plaintiffs also failed to establish a reasonable likelihood of success on the merits of their conversion claim. The plaintiffs alleged that the defendants "converted Smash's confidential information for its own benefit," but the Delaware Uniform Trade Secrets Act (DUTSA) preempted this claim.

Fifth, the plaintiffs' claim for unfair competition against Dumpster Devil depended on the plaintiffs establishing that the defendants used Smash's Confidential Information and misappropriated Smash's trade secrets. Because the plaintiffs failed to establish a reasonable likelihood of success on these predicate acts, they failed to show a likelihood of success on this claim as well.

Sixth, the court found that the plaintiffs were likely to succeed on the merits of their fraud claim against Perri and Kanda. The court noted that it was reasonably likely that Perri made false claims about his intention to become a franchisee. The record indicated that as of December 12, 2019, he decided against proceeding with a Smash franchise but continued to indicate to Smash that he was interested in becoming a franchisee. These indications included purchasing (and canceling) a plane ticket and signing up for discovery day,

participating in the Franchisee Forum Calls and Founder Calls, canceling his attendance at one discovery day and signing up for another, and expressing interest in buying territories in North Carolina. The court found it was also reasonably likely that Perri intended to induce the plaintiffs into relying on his misrepresentations so that he could continue to learn about the plaintiffs' business and that the plaintiffs reasonably relied on Perri's representations. The court then noted that the weakest element of the fraud claim case was damages because the plaintiffs had not attempted to prove causation given their focus on obtaining an injunction. According to the court, it would be difficult for the plaintiffs to prove a meaningful amount of damages because the key effect of the fraud was access to non-confidential information of Smash, but it was reasonable to infer some form of damages, even if only nominal. The court then rejected the defendants' contention that the plaintiffs were attempting to impermissibly bootstrap the breach of contract claim into a fraud claim because the plaintiffs asserted a freestanding claim for fraud based on Perri's misrepresentations of his interest in buying a Smash franchise.

Seventh, the court turned to the plaintiffs' claim against Dumpster Devil asserting that Dumpster Devil's website included false representations about Smash in violation of the Delaware Deceptive Trade Practices Act (DDTPA). Under the DDTPA, "[a] person engages in a deceptive trade practice" if he performs any one of the enumerated acts, including an act that "disparages the goods, services, or business of another by false or misleading representation of fact." To succeed, a plaintiff does not need to "prove competition between the parties or actual confusion or misunderstanding." The court evaluated the seven website statements that allegedly disparaged the plaintiffs and found that the plaintiffs established a reasonable likelihood of success as to three of them: (1) Smash's hydraulic drum lacks protective guards—the evidence showed this statement was incorrect because Smash's drum has guards; (2) the slides on Smash's trucks need daily greasing—although greasing was needed, it did not need to be daily; and (3) and Dumpster Devil's trucks weighing under 26,000 pounds and not needing a commercial license to operate, which was disputable (together, the Three Statements).

Eighth, the court addressed the plaintiffs' claim for trademark infringement against Dumpster Devil based on its purchase and use of "Smash My Trash" as part of its Google AdWords marketing campaign. To succeed on a trademark infringement claim, Smash had to prove that Dumpster Devil's use of the "Smash My Trash" mark was likely to create actual consumer confusion that it was affiliated with Smash's marks. The court found that the likelihood of actual confusion was "quite low." The court noted that the burden of proving actual confusion is much heavier if the consumers have expertise in the field or the goods are relatively expensive. Here, Smash sold expensive products to individuals interested in starting a business who, although not experts in the field, were likely to perform their own due diligence before making this type of investment. The court also noted that a claim of confusion based on a website advertisement would not succeed where the search engine results separated

sponsored links in a separately labeled section. Dumpster Devil's listing in the search results was clearly marked with the bolded word "Ad" and did not display Smash's mark. Accordingly, without actual confusion, this claim failed.

Next, the court addressed the second requirement for a preliminary injunction: a showing of irreparable harm if the injunction were not granted. The court reiterated that irreparable injury exists when damages involve speculation, such as harm to goodwill or customer relationships. The plaintiffs only established a reasonable probability of success on the merits for two of its eight claims—the fraud and DDTPA claims. The court held that the fraud claim alone did not support injunctive relief because it was unlikely that the plaintiffs suffered meaningful harm (much less irreparable harm), given the nature of the information the defendants obtained. However, the court did note that a person likely to be injured by a deceptive trade practice may also obtain injunctive relief under the principles of equity and on terms the court considers reasonable. The plaintiffs did not need to provide "[p]roof of monetary damage, loss of profits, or intent to deceive." Because the Three Statements on Dumpster Devil's website were inflicting harm on an ongoing basis, they gave rise to irreparable harm.

Finally, the court turned to balancing the hardships posed by an injunctive order. The court found that the "equities favor an injunction that addresses Dumpster Devil's deceptive marketing tactics. They do not support a broader injunction." As a result, the court enjoined Dumpster Devil from continuing to publish false and misleading statements—the Three Statements—on its website pending a final hearing on the merits. However, the court rejected the plaintiffs' request to enjoin the defendants from operating their competing business, noting that an injunction of that level would be the "equivalent of final relief" and "disproportionate on the facts of the case."

Editor's Note: After entry of the order, the parties submitted a joint stipulation to vacate a portion of the preliminary injunction. Specifically, the stipulation vacated the portion of the injunction that enjoined Dumpster Devil from posting a statement on its website about the weight of its vehicles and whether those vehicles needed a commercial license. The court granted the stipulation.

JURISDICTION

***Arruda v. Curves International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,692, 2020 WL 4289380 (W.D. Tex. July 27, 2020)**

This case is discussed under the topic heading "Statutory Claims."

***Halcyon Syndicate Ltd. v. Graham Beck Enterprises (PTY), Ltd.*, Bus. Franchise Guide (CCH) ¶ 16,687, 2020 WL 4051865 (N.D. Cal. July 20, 2020)**

The U.S. District Court for the Northern District of California held that it had personal jurisdiction over a winery in South Africa, venue was proper,

forum non conveniens dismissal was not warranted, and the plaintiff sufficiently pled its claims for breach of implied-in-fact contract and breach of implied covenant of good faith and fair dealing.

San Francisco-based Halcyon Syndicate Ltd., LLC d/b/a Maritime Wine Trading Collective (Maritime) asserted claims for breach of implied-in-fact contract and breach of implied covenant of good faith and fair dealing against a South African-based wine producer, Graham Beck Enterprises, Ltd. (Graham Beck). Maritime alleged that the parties established certain understandings and implied agreements based on their conduct over the course of a decade. Although the parties never executed a written contract, they allegedly had an understanding that Maritime would be the exclusive U.S. importer of Graham Beck's wines. Maritime alleged that the parties understood that this agreement could not be terminated without cause. As evidence of the implied agreement, Maritime pointed to a 2014 draft agreement that Graham Beck sent to Maritime via email. Although the parties never got around to signing the draft agreement, Maritime alleged that it accurately reflected the parties' implied agreement in several respects. For instance, the draft agreement provided that Maritime would be the exclusive importer of Graham Beck wines in the United States, the agreement could only be terminated for cause, and the parties would work together to develop a budget and marketing strategy—all of which were consistent with the parties' practices.

Maritime alleged that Graham Beck violated the parties' implied contract in June 2019, when Graham Beck sent a notice of termination to Maritime, ending the parties' relationship on three-months' notice. As a result, Maritime alleged that Graham Beck breached the implied covenant of good faith and fair dealing by abruptly terminating the implied agreement without cause on just three-months' notice.

Graham Beck filed a motion to dismiss, arguing that the court lacked personal jurisdiction, the venue was improper, the action should be dismissed under the doctrine of forum non conveniens, and that Maritime failed to adequately state a claim.

The court began by analyzing whether it had personal jurisdiction over Graham Beck. The court quickly concluded that it did not have general jurisdiction over Graham Beck because the forum for general jurisdiction is typically the defendant's domicile and Graham Beck was headquartered in South Africa.

The court turned to the issue of specific jurisdiction, which courts may exercise if (1) the non-resident defendant purposefully avails itself of the benefits and protections of the forum's laws; (2) the claim arises out of or relates to the defendant's forum-related activities; and (3) the exercise of jurisdiction is reasonable. The court found specific jurisdiction existed, and it focused primarily on the purposeful availment prong, which it identified as the "crux of the parties' dispute" with respect to personal jurisdiction. The court determined that Graham Beck's conduct satisfied the purposeful availment

requirement because Graham Beck had even more substantial contacts with the forum state than foreign winemakers in other similar cases in which California courts exercised specific jurisdiction. For instance, Graham Beck hired a California recruiting company to find someone to help it distribute its wines in the United States, hired a San Francisco resident to carry out this task, made numerous trips to California to set up a new company (i.e., Maritime) to distribute its wines in the United States, engaged in extensive oversight of Maritime's business, and sold hundreds of thousands of bottles of wine in California, for which it accepted payment in U.S. dollars.

Next, the court analyzed whether venue was proper. The court explained that under 28 U.S.C. § 1391(b). Here, the court found that venue was proper under subsection (b)(2) because a substantial part of the events giving rise to the claims occurred in the court's judicial district. In the alternative, the court found that venue was also proper under subsection (b)(3) given the fact that the court had personal jurisdiction over Graham Beck.

The court turned next to Graham Beck's argument that the action should be dismissed under the forum non conveniens doctrine. Although district courts have discretion to decline to exercise jurisdiction in a case where litigation in a foreign forum would be more convenient for the parties, the court noted that it is an "exceptional tool to be used sparingly." A party moving to dismiss based on forum non conveniens bears the burden of showing that there is an adequate alternative forum and that the balance of private and public interest factors favors dismissal. In addition, dismissal is only proper when, in light of the private and public interest factors, the defendant makes a clear showing that establishes the defendant's hardship is out of proportion to the plaintiff's convenience.

The court concluded that Graham Beck did not make a showing in favor of dismissal under the forum non conveniens doctrine, despite the existence of an alternative forum in South Africa. In terms of the private interest factors, the court was not persuaded by Graham Beck's argument that several of its witnesses and documents were in South Africa. The court noted that many of the witnesses in South Africa were not key witnesses, and the focus should be on the materiality and importance of the anticipated witnesses' testimony rather than the sheer number of witnesses in each locale. In addition, the court noted that many of the key documents in the case were in electronic format and could be easily accessed in either forum. The court also determined that Graham Beck failed to make a clear showing that litigating in California would be so inconvenient as to be oppressive. The evidence showed that Graham Beck had extensive contacts with the forum for over a decade and regularly traveled to the forum to oversee Maritime's business and promote its wines. As such, the court believed that it would not be an extreme hardship for Graham Beck to travel to California to litigate the case.

Graham Beck argued that the public interest factors weighed in its favor because there was no local interest in the lawsuit. The court found that this argument ignored the "well-established rule" that a state "generally has

a manifest interest in providing its residents with a convenient forum for redressing injuries inflicted by out-of-state actors." The court found that this rule was particularly relevant here, where Graham Beck essentially created the California company that filed the complaint (by having its North American Business Director start the exclusive import company that would later become known as Maritime) and where Graham Beck intentionally injected itself into the State of California to profit from sales of its wines. The court acknowledged that South African law may apply to the dispute but that fact alone did not warrant dismissal under the doctrine of forum non conveniens, particularly since Graham Beck did not identify any significant differences between California law and South African law regarding the claims at issue. Balancing the public and private factors, the court found that dismissal under forum non conveniens was not warranted.

Finally, the court analyzed whether Maritime adequately stated a claim. The court found that Maritime adequately stated a claim for breach of implied-in-fact contract and breach of the covenant of good faith and fair dealing. Graham Beck argued that Maritime could not allege the existence of an implied-in-fact contract given Maritime's reliance on the 2014 draft agreement in support of its claims. The court disagreed because the 2014 draft agreement was unsigned and therefore not enforceable as a written contract. In addition, the court found that Maritime properly alleged the existence of an implied-in-fact agreement based on the conduct and practices of the parties.

The court also held that Maritime properly stated a claim for breach of the covenant of good faith and fair dealing by alleging facts showing that Graham Beck abruptly ended the parties' decade-long exclusive relationship and began selling directly to Maritime's customers. Such actions demonstrated that Graham Beck's conduct was deliberate, unreasonable, and frustrated the terms of the implied-in-fact contract. As a result, the court held that Maritime satisfied the standard for breach of the covenant of good faith and fair dealing and denied Graham Beck's motion to dismiss.

***Interim Healthcare, Inc. v. Interim Healthcare of Southeast Louisiana*, Bus. Franchise Guide (CCH) ¶ 16,666, 2020 WL 3078531 (S.D. Fla. June 10, 2020)**

The U.S. District Court of the Southern District of Florida denied a terminated franchisee's motion to dismiss a home hospice care franchisor's breach of contract and trademark infringement suit, finding that the court had both personal and subject matter jurisdiction over the franchisee. The court also granted the franchisor's motion for preliminary injunction in part, enjoining the franchisee from continuing to use the franchisor's marks and allowing the franchisor to enforce the post-termination obligations and step-in rights under the franchise agreement. However, the court denied the franchisor's preliminary injunction motion to enforce the non-compete provision of the franchise agreement.

On May 11, 1970, Personnel Pool of America, Inc. and Personnel Pool of New Orleans, Inc. (PPNO) entered into a franchise agreement (NOFA) with the plaintiff, Interim Healthcare, Inc., whereby PPNO began operating an Interim Healthcare franchise in several parishes in and around New Orleans. PPNO assigned the NOFA to Interim Healthcare of New Orleans, Inc. (IHNO), who assigned it to Interim Healthcare of Southeast Louisiana, Inc. (IHSL) on May 1, 2012. Julia Burden (Burden), IHSL's sole shareholder, executed a personal guarantee (NO Guaranty) in connection with the NOFA.

On March 12, 2012, the plaintiff and IHNO entered into a franchise agreement (LFA) whereby PPNO began operating an Interim Healthcare franchise in several parishes in and around Livingston Parish, Louisiana. In 2013, IHNO's charter was revoked by the State of Louisiana. Since then, the LFA was operated by IHSL, Interim Healthcare Hospice, Inc. (IH Hospice), and Burden, with the consent of the plaintiff. Burden also executed a personal guarantee in connection with LFA as sole shareholder of IH Hospice.

On May 2, 2018, the plaintiff served IHSL with a notice of default for nonpayment with a ten-day cure period under both the NOFA and the LFA (together, the franchise agreements). IHSL failed to cure the defaults, and on May 17, 2018, the plaintiff served IHSL with a notice extending the cure period with the condition that IHSL make certain periodic payments until all amounts due were paid in full. IHSL made six payments, but failed to make subsequent payments, in material default of the franchise agreements. On August 20, 2019, the plaintiff sent IHSL a notice terminating the franchise agreements. Following termination, the plaintiff provided Burden and her entities a conditional right to continue operating the businesses while the parties negotiated a resolution, but these efforts failed.

On September 27, 2019, the plaintiff filed a complaint against IHSL and Burden. Nonetheless, Burden and her entities failed to cooperate as required by the post-termination provisions of their franchise agreements, continued to owe $425,112.43 in unpaid fees under the agreements, and continued to offer hospice services under the Interim Healthcare name and proprietary business system. The plaintiff moved for a preliminary injunction against IHSL and Burden on November 8, 2019, seeking to assume control and operations of its hospice business, obtain its hospice license, and obtain its Medicare provider number.

However, also in November 2019, IHSL filed a voluntary petition for Chapter 11 bankruptcy in the U.S. Bankruptcy Court for the Eastern District of Louisiana. The plaintiff notified this court of the bankruptcy filing and the court stayed the case against IHSL and Burden, pending the conclusion of the bankruptcy.

The plaintiff then initiated a case against IH Hospice and Burden (together, the defendants) for breach of contract, trademark infringement, and unfair competition. The plaintiff alleged that IH Hospice and Burden intended to sell the business and/or hospice license and refused to permit the plaintiff to step in and operate the business, including refusing to assign

to the plaintiff the hospice license and Medicare provider number, which were necessary for the continued operation of the Interim hospice business. On February 12, 2020, the two cases were consolidated. The defendants moved to dismiss and briefing ensued. Then, on March 3, 2020, the plaintiff filed a motion for preliminary injunction against IH Hospice and Burden.

At issue here were three motions in the consolidated proceedings against IH Hospice and Burden: (1) the defendants' motion to dismiss for lack of subject matter jurisdiction, lack of personal jurisdiction, and improper venue, and alternative request to transfer this case to the U.S. Bankruptcy Court for the Eastern District of Louisiana; (2) the plaintiff's motion for a preliminary injunction to assume operation and control of IH Hospice's hospice business and to obtain IH Hospice's hospice license and Medicare provider number; and (3) the defendants' motion to stay pending a ruling on their motion to dismiss.

First, the court denied the defendants' motion to dismiss for lack of subject matter jurisdiction because complete diversity existed and the amount in controversy exceeded the diversity jurisdiction threshold. In addition, the case raised claims under the Lanham Act, which gave rise to federal question jurisdiction.

The court then considered and denied the defendants' motion to dismiss for lack of personal jurisdiction under Federal Rule of Civil Procedure 12(b)(2). The defendants claimed that they lacked sufficient contacts within the state and that they were not subject to the forum selection clause of the LFA designating Florida as the applicable jurisdiction because they were not parties to the LFA, nor did they assume any obligations under the LFA. The plaintiff maintained that the defendants were bound by the terms of the LFA because they assumed the rights and obligations of the LFA as successors in interest. As such, according to the plaintiff, the defendants availed themselves to the benefits of the franchise agreements, used the plaintiff's proprietary information and business system granted solely to Interim Healthcare franchisees, and were bound to the obligations and conditions of the franchise agreements. The court agreed.

Florida courts have provided five characteristics a contract must have to satisfy the long-arm statute. A contract must: (1) include a choice of law provision designating Florida law as the governing law, in whole or in part; (2) include a provision whereby the non-resident agrees to submit to the jurisdiction of the courts of Florida; (3) involve consideration of not less than $250,000 or relate to an obligation arising out of a transaction involving in the aggregate not less than $250,000; (4) not violate the U.S. Constitution; and (5) either bear a substantial or reasonable relation to Florida or have at least one of the parties be a resident of Florida or incorporated under the laws of Florida. The court found that the plaintiff sufficiently alleged specific personal jurisdiction because the language of the LFA's forum selection clause satisfied the first two requirements—it designated Florida as the applicable law and jurisdiction. For the third prong, the amount in controversy implied

that the agreement generated more than $250,000. In connection with the fourth prong, where the parties freely negotiate a commercial agreement, including jurisdiction, the contract has not violated the U.S. Constitution. Because of the plaintiff's Florida residence, the last prong was also satisfied.

The court then evaluated and denied the defendants' motion to dismiss for improper venue. The defendants argued that venue was improper in Florida because the LFA was neither negotiated nor executed in Florida. The court noted that venue can be proper in a number of locations, including the location designated for litigation pursuant to a contractual agreement or the location where the harm or injury was suffered. The LFA designated Florida as the appropriate venue for litigation and the court "note[d] that, under the terms of the [LFA], a substantial portion of the events occurred in Florida." The court also noted that where a contract is silent about the place of payment, it is presumed to be the place of residence of the payee. Thus, the court concluded that venue was proper in Florida because of the venue provision in the LFA and because the plaintiff alleged that it sustained injuries in Florida for lack of payment.

The court next turned to the plaintiff's motion for preliminary injunction on its claims for trademark infringement and breach of contract with respect to the post-termination obligations and step-in rights in the LFA, including the non-compete.

Starting with trademark infringement, the court concluded that the plaintiff satisfied all four injunction factors and granted the motion. First, it was not disputed that the defendants continued to use the plaintiff's trademark post-termination. As such, the court found that the plaintiff had a "strong probability of proving at trial that consumers are likely to be confused by Defendants' improper use of its trademarks." Second, the court found that the plaintiff was likely to suffer immediate and irreparable injury because the plaintiff had lost the ability to control the quality of the hospice care provided under its brand and marks. Third, the court noted that granting the injunction would only prevent the defendants from using the plaintiff's marks without the plaintiff's consent, "which is illegal to begin with." Fourth, the court found that the "public interest favors granting the preliminary injunction to protect Plaintiff's trademark interests and to protect consumers from being misled."

Next, the court considered and granted the plaintiff's motion for a preliminary injunction as to its post-termination obligations and step-in rights under the LFA. However, the court found that the defendants' continued operation and use of the plaintiff's marks and system, and their refusal to comply with the post-termination obligations, supported an injunction enforcing the post-termination step-in rights. The court also found that the plaintiff established irreparable harm because: (1) the defendants continued to operate under the plaintiff's marks in violation of the LFA's post-termination provisions; (2) there was a "likelihood of consumer confusion and the potential loss of goodwill from Defendants' continued improper

operation of Plaintiff's hospice business"; and (3) the plaintiff submitted evidence establishing that Burden was poorly managing IHSL's hospice business during bankruptcy and was likely to do the same with IH Hospice, posing additional concerns of irreparable harm from the "potential threat to the safety and health of IH Hospice patients" and potential loss of employees due to IH Hospice's inability to continue operating.

In the court's view, the balance of harms also favored the plaintiff because any harm inflicted by the enforcement of post-termination obligations was self-inflicted and was outweighed by the fact the defendants agreed to such obligations when operating under the terms of the franchise agreements. Moreover, the public interest was served because the franchise system would be fortified by "supporting contractual enforcements." The court agreed to the plaintiff's proposed bond amount of $150,000 (the defendants failed to voice any opposition to such amount).

The court, however, declined to enforce the non-compete provision of the LFA. Under Florida law, a restrictive covenant cannot be enforced unless it is in writing and signed by the party against whom enforcement is sought. Because the defendants did not sign the LFA, the non-compete could not be enforced against them.

Last, the court rejected the defendants' motion to stay pending the resolution of their motion to dismiss and IHSL's ongoing Chapter 11 bankruptcy proceeding. Because the court resolved the motion to dismiss, the request for a stay on that basis was moot. As for the bankruptcy proceeding, IH Hospice was a separate entity and not party to the IHSL Chapter 11 bankruptcy, so the request for relief against IH Hospice and Burden would not frustrate the automatic stay in IHSL's bankruptcy. Accordingly, the court denied a stay here.

***Nevada DeAnza Family Ltd. Partnership v. Tesoro Refining & Marketing LLC*, Bus. Franchise Guide (CCH) ¶ 16,697, 2020 WL 4284827 (N.D. Cal. Jul. 27, 2020)**

This case is discussed under the topic heading "Petroleum Marketing Practices Act."

LABOR AND EMPLOYMENT

***Elsayed v. Family Fare LLC*, Bus. Franchise Guide (CCH) ¶ 16,707, 2020 WL 4586788 (M.D.N.C. Aug. 10, 2020)**

The U.S. District Court for the Middle District of North Carolina granted in part and denied in part a motion for summary judgment brought by the Family Fare franchisor of gas station convenient stores against the owners of a former franchise, Lola Salamah (Salamah) and Amro Elsayed (Elsayed). Specifically, the court granted summary judgment in favor of the franchisor on the plaintiffs' claims that they were misclassified as franchisees rather than employees in violation of the federal Fair Labor Standards Act (FLSA),

and their franchise agreement was terminated because of their Arab American background in violation of several anti-discrimination statutes. However, the court denied summary judgment on the plaintiffs' claims for violation of North Carolina common law and the North Carolina Unfair and Deceptive Trade Practices Act (NCUDTPA) because the franchisor wrongfully evicted them from their franchise upon termination.

In 2012, plaintiffs, a married couple, formed Almy, LLC (Almy) and entered into a contract with defendant M.M. Fowler, Inc. (Fowler) to operate a Family Fare store in Winston-Salem. In 2013, Almy and Family Fare, LLC (Family Fare) entered into a franchise agreement, with Almy as franchisee of the Winston-Salem store, Family Fare as franchisor, and Fowler as landlord, for a five-year term. Family Fare is an affiliate of Fowler that licenses the right to franchise the Family Fare brand. In May 2018, the parties renewed the agreement for a second five-year term. According to the terms of the franchise agreement, Almy was to "employ and provide personnel" to operate the store, "assume[ ] full responsibility for such employees," and neither Almy nor any other person associated with the franchise operations would be deemed an employee or agent of Family Fare. Under the agreement, Almy and Family Fare each received fifty percent of the store's gross profits.

Fowler employed defendant Donald Pilcher (Pilcher) as a business consultant and day-to-day liaison with the plaintiffs. In 2015, Pilcher and Salamah discovered that an employee was stealing lottery tickets from the store, resulting in the plaintiffs owing $22,800 for the theft to Family Fare. Pilcher advised the plaintiffs to fire the employee and worked with them on a plan to pay the amount owed to Family Fare. Generally, the franchisee must pay the full amount of an employee's theft by the end of the month. Here, Pitcher instructed Salamah to mark the stolen lottery tickets as sold as plaintiffs paid for the loss through monthly increments. After three years, the plaintiffs had not paid the debt in full. In October 2018, at Pilcher's suggestion, the plaintiffs contacted the president of Family Fare and Fowler and requested an advance to pay the remaining debt. This was the first time the plaintiffs had informed Family Fare of the theft. On November 30, 2018, the defendants terminated their franchise agreement and lease with the plaintiffs because of the lottery shortages. The same day, Pilcher confiscated the key to the store's safe, had a locksmith change the locks to the business, pushed a worker out of the way to take control of the cash register, and attempted to have Salamah removed from the store, with police on site.

Plaintiffs filed a complaint against Fowler, Family Fare, and Pilcher, alleging that they misclassified plaintiffs as franchisees rather than employees and owed them overtime wages under the FLSA. In addition, the plaintiffs asserted that the defendants terminated their franchise agreement because of Pilcher's animus toward Arab Americans, which constituted discrimination in violation of the Civil Rights Act of 1866, 42 U.S.C. § 1981, and Title VII of the Civil Rights Act of 1964 (Title VII). Plaintiffs also alleged that the self-help eviction to repossess their franchised store violated North Carolina

common law and the NCUDTPA. Defendants moved for summary judgment in their favor on these claims.

First, the court granted summary judgment on plaintiffs' FLSA claim in favor of the defendants. Plaintiffs asserted that defendants were their employer given the excessive controls defendants exercised over them, but the court disagreed. According to the court, there was no dispute that Almy employed the workers at the store. The question, thus, was whether a joint employment relationship existed between Almy and the defendants using the governing test articulated by the Fourth Circuit in *Salinas v. Commercial Interiors*, 848 F.3d 125 (4th Cir. 2017). Although the Fourth Circuit has not decided how the existence of a franchisor-franchisee relationship affects the *Salinas* analysis, district courts in the Fourth Circuit and beyond have recognized that joint employer relationships can exist between a franchisor and a franchisee with respect to a franchisee's employees. Nonetheless, plaintiffs faced a high burden to impose joint employer liability on their franchisor, as national case law showed.

Applying the six *Salinas* factors here, the court first found that defendants' power to "direct, control, or supervise" the plaintiffs was insufficient to create an employment relationship. Plaintiffs contended that defendants, through Pilcher, exercised excessive control over the plaintiffs, but Pilcher's efforts—including directing store employees to be in uniform or to clean the store's sink—were aimed at quality control and brand standards. This factor weighed against a joint employer finding.

Second, the court found that the defendants did not have any power to hire or fire the plaintiffs or their employees. Plaintiffs argued that Pilcher exercised "final approval" over new hires, but Pilcher merely gave new employees a name tag, tie, badge, and drug test—although defendants did require new hires to undergo a background check. The court found that defendants did not actually hire store employees and noted that franchisors may set minimum qualifications for franchisee hires without themselves deciding who to hire. Regarding firing, the court was unpersuaded by plaintiffs' contention that defendants fired four employees (the two plaintiffs, the lottery thief, and one more) by the mere fact of terminating the franchise agreement. Moreover, although Pilcher told the plaintiffs to fire one employee, they did not do so. As for the employee who stole lottery tickets, "franchisors have the right to require employees of their franchisee behave lawfully." The court refused to conclude as a matter of law that requiring a franchisee to terminate an employee who steals from the company weighs in favor of a joint employer finding against the franchisor. Nor did the defendants modify the terms or conditions of employment of workers at the franchised store. There was no evidence of defendants promoting, demoting, or disciplining employees, changing their job responsibilities, or determining their pay or work schedule.

Third, as to the "degree of permanency and duration of the relationship" between the plaintiffs and the defendants, the court held that little weight

should be given to this factor in the franchise context where franchise agreements are typically for a period of years.

Likewise, the court gave little weight to who owns or controls the location where the work is performed because the location was leased and primarily controlled by the franchisee, not the defendants.

Fifth, regarding which putative joint employer controls the other, this factor favored the defendants because Family Fare and Fowler did not own or formally manage Almy. However, given the plaintiffs' allegation that the franchise structure was a sham and that they were truly employees controlled by the defendants, the court assigned little weight to this factor and gave greater weight to the first two factors.

Sixth, the court examined whether the defendants jointly determined, shared, or allocated responsibility over functions normally carried out by an employer, such as handling payroll; providing workers' compensation insurance; paying payroll taxes; or providing the facilities, equipment, tools, or materials necessary to complete the work. It concluded that this factor weighed decidedly in the favor of defendants because Samalah handled payroll services, taxes, and business and workers insurance for the franchised store. The court was not persuaded by the argument that plaintiffs had to use the vendors the defendants designated to complete these tasks or that defendants had access to payroll records. It noted that franchisors may, consistent with the need to maintain uniform brand standards, require their franchisees to use payroll systems and have the ability to access a franchisee's payroll records without indicating a joint employment relationship. Nonetheless, this factor did not weigh as heavily in defendants' favor as other factors because the defendants did play some role in providing the equipment and materials needed for work at the franchise, a role normally played by an employer.

In conclusion, the court held that the franchisor defendants were not the joint employers of the franchise owners and were, thus, were entitled to summary judgment on the FLSA claim.

Although not necessary, the court in its discretion went on to address an additional flaw in the plantiffs' FLSA claim: Salamah was an independent contractor, not an employee. To determine if a worker is an employee or an independent contractor, the Fourth Circuit examines the six *Silk* factors announced in *United States v. Silk*, 331 U.S. 704 (1947).

Here, the weight of evidence established that Salamah was an independent contractor, not an employee because Salamah: (1) controlled important aspects of her own work, such as recruiting, processing, training, and setting work schedules for new employees; (2) had the power to increase the store's profitability; (3) retained hiring power; and (4) was required to have a good deal of skill in managing five to seven employees. The court noted that the permanence of the working relationship and degree to which services were an integral part of the putative employer's business (factors five and six) did not fit into the analysis because Salamah was a franchisee and played an integral role in Family Fare's business model precisely because she

controlled the operation of her franchise. Accordingly, the FLSA claim also failed because Salamah was not an employee of the defendants based on the *Silk* factors.

Next, the court analyzed whether summary judgment was appropriate on Elsayed's Title VII claim. Elsayed alleged that the defendants violated Title VII by firing him because of their racial animus and hatred of persons from Middle Eastern countries. Defendants countered that they were not liable under Title VII because they were not Elsayed's joint employers and that they had a legitimate, non-pretextual reason for terminating their franchise agreement with Almy, namely the lottery shortages. The court ruled that defendants were not Elsayed's joint employer under Title VII.

To arrive at its conclusion, the court applied a nine-factor test announced in *Butler v. Drive Automotive Industries of America, Inc.*, 793 F.3d 404 (4th Cir. 2015), to determine joint employment liability for purposes of Title VII. These factors are: (1) authority to hire and fire an individual; (2) day-to-day supervision and discipline of the employee; (3) whether the putative employer provides equipment and the place of work; (4) possession and responsibility over employment records; (5) length of time that the employee worked for the putative employer; (6) whether the putative employer provides informal or formal training; (7) whether the individual's duties are similar to a regular employee's duties; (8) the individual's exclusive assignment to the putative employer; and (9) whether the individual and putative employer intended to enter an employment relationship. The first three factors are the most important; courts may modify the factors to the specific industry context; and the ninth factor will be of minimal consequence.

Applying the first three *Butler* factors, the court found that: (1) defendants had no power to hire or fire employees, outside of the limited context where employees harmed the franchise brand by breaking the law; (2) defendants did not discipline employees and the control defendants exercised was only over brand standards; and (3) defendants provided some equipment to the franchised store and leased it to Almy. Thus, of the three most important factors, two favored the defendants and one favored Elsayed. The court also looked at three additional relevant factors. Factor six favored Elsayed because the defendants played some role in training the franchisee's employees. On the other hand, the fourth factor favored defendants because Salamah was responsible for Elsayed's employment records, payroll insurance, and taxes. Finally, regarding factor nine—the intent of the parties—there was ample evidence that Elsayed and Defendants did not intend to enter into an employment relationship, including the language in the franchise agreement disclaiming any employment relationship. Accordingly, just as the defendants were not joint employers under the FLSA, the court also held that they were not joint employers under Title VII and granted summary judgment in favor of the defendants.

Then, the court addressed the plaintiffs' Section 1981 claim. Plaintiffs argued that defendants terminated their franchise agreement because

defendants were prejudiced against Arab Americans. Defendants countered that the termination was justified based on the lottery shortfall and had nothing to do with the plaintiffs' race. To prove a § 1981 claim, the plaintiffs had to show both that the defendants intended to discriminate based on race, and that the discrimination interfered with a contractual interest. The court found that the plaintiffs provided no direct evidence of discrimination where their allegations that Pilcher made anti-Arab statements, even if true, were not linked to the termination of the franchise agreement because he was not a decision maker.

The § 1981 claim also failed under *McDonnell Douglas* framework applicable to discrimination claims because the defendants articulated a legitimate, non-discriminatory reason for terminating the franchise agreement, namely the lottery shortage. The burden then shifted to plaintiffs to establish that the articulated reason was pretextual, which the plaintiffs failed to do. According to the plaintiffs, the fact that they received a warning letter regarding the lottery shortages in March 2018, and the defendants subsequently renewed the franchise and lease agreements in May 2018, suggested that the reason for termination was pretextual. The court disagreed, noting that this sequence of events instead showed that the defendants had ongoing concerns with Almy's performance and that when those concerns intensified in the fall of 2018, the defendants terminated the agreement with Almy. Nor could pretext be inferred from the defendants allegedly providing a loan to a non-Arab franchisee who suffered a similar lottery shortage as Almy. Even if true, the arrangement Pilcher gave the plaintiffs—to pay off their debt quietly over an indefinite period that lasted years—was more favorable. In the end, Family Fare, not Pilcher, terminated the franchise agreement; and plaintiffs provided no evidence that Family Fare or any of the other defendants discriminated against them. The court therefore granted summary judgment on this claim in favor of the defendants.

Finally, the court analyzed whether summary judgment should be granted on plaintiffs' NCUDTPA and wrongful eviction claims under state law. Plaintiffs seemingly argued that the same facts that gave rise to their FLSA claim also supported an NCUDTPA claim. But the Supreme Court of North Carolina does not recognize an NCUDTPA claim in employment disputes over unpaid wages. Plaintiffs also argued that Family Fare violated the act by wrongfully evicting them and repossessing goods in the store. Because this claim overlapped with plaintiffs' claim for wrongful eviction under North Carolina law, the court analyzed the claims together.

The court held that the evidence established a violation of North Carolina eviction law because Pilcher locked the plaintiffs out of the store on the day defendants terminated their franchise agreement, as well as pushed a worker to take possession of the store's cash register. Further, North Carolina courts recognize NCUDTPA claims for self-help evictions in the residential and commercial context. Here, the court reasoned that locking and repossessing the property was an unfair practice affecting commerce where

North Carolina has a policy against forcible self-help evictions and operating a franchise affects commerce. Last, the court held that plaintiffs raised a genuine issue of material fact as to whether defendants' forcible self-eviction proximately caused them injury based on anxiety treatments Elsayed had to undergo since the eviction. The court noted that all the dangers of forcible self-help evictions were on display here—tempers flared, the police were summoned, and a minor physical altercation occurred. Accordingly, the court denied defendants' motion for summary judgment as to the NCUDTPA and wrongful-eviction claims.

***Griffith v. Coney Food Corp.*, Bus. Franchise Guide (CCH) ¶ 16,711, 2020 WL 4748452 (E.D.N.Y. Aug. 17, 2020)**

The U.S. District Court for the Eastern District of New York largely denied a motion to dismiss claims brought by Sadannie Griffith (Griffith), a pregnant employee of a Checkers franchisee, Coney Food Corp. (Coney Food), against the franchisee, its general manager, and the Checkers franchisor, Checkers Drive-In Restaurants, Inc. (Checkers), as a joint employer, for discrimination and wage violations under several federal and New York laws.

Griffith worked as a crew member for Coney Food from June 29, 2018 until sometime in July 2018. Defendant Javaid Abid (Abid), Coney Food's general manager and Griffith's direct supervisor, complained about Griffith being slow at work and inquired about whether she was pregnant. After learning from a coworker that Griffith was pregnant, Abid allegedly called and told Griffith "had I known you were pregnant, I wouldn't have hired you," and terminated her via text message. Griffith alleges that she was owed $42.40 in unpaid wages and that she was not given any notice of her wages or wage statements.

On March 20, 2019, Griffith filed a complaint against Coney Food and Abid, but not against Checkers. She later amended her complaint to add Checkers as a defendant. Griffith asserted discrimination claims under Title VII of the Civil Rights Act of 1964 (Title VII), the New York State Human Rights Law (NYSHRL), and the New York City Human Rights Law (NYCHRL). She also asserted claims under the New York Labor Law (NYLL) for failure to pay earned wages and failure to provide a pay rate notice and wage statements. A default was entered against Coney Food on September 4, 2019. On October 30, 2019, Checkers filed a motion to dismiss Griffith's complaint, and Griffith withdrew her Title VII claims against Checkers, leaving only her state and city discrimination and wage claims.

First, Checkers argued for dismissal of the NYSHRL and NYCHRL claims because Checkers was not Griffith's joint employer for purpose of these discrimination claims. The court disagreed because the complaint alleged "numerous facts" to support an inference of joint employer status. To ascertain joint employer status for discrimination claims, New York courts look to whether the defendant exercised "immediate control" over the employee, including hiring, firing, discipline, pay, insurance, records, and

supervision. The complaint included many examples of Checkers' control over Coney Food, such as the use of specific systems to track wages and hours, recordkeeping of payroll records, the appointment of management, and various operational and management standards. Further, the court noted that liberal construction "must" be given to city and state discrimination claims and that the existence of a joint employer relationship is a factual issue that cannot be disposed of on a motion to dismiss. Accordingly, the court denied Checkers' motion to dismiss the discrimination claims.

Likewise, the court rejected Checkers' argument that Griffith failed to allege an employment relationship between it and Griffith for purposes of her NYLL claims. Courts in the Second Circuit apply the same test applied under the Fair Labor Standards Act, which looks to the "economic realities" of the relationship between the entities to determine whether an employment relationship exists. Checkers argued against application of this test based on a 2012 state appellate decision, *Matter of Ovadia v. Office of Industrial Board of Appeals*, 19 N.Y.3d 138 (N.Y. 2012), where the court held the economic realities test ill-suited to general/subcontractor relationships. Finding that this case did not implicate general/subcontractor relationship concerns, the court went on to apply the economic realities test, and particularly focused on the amount of control exercised by Checkers.

The Second Circuit considers either formal control or functional control in determining whether there is sufficient control to qualify as an employer. In analyzing formal control, the court considers four factors: (1) the power to hire and fire employees; (2) supervision and control of work schedules or working conditions; (3) setting wages; and (4) maintenance of employment records. Even in absence of such factors, the economic realities test may be met when there is functional control over the worker. The Second Circuit recognizes six factors as indicative of functional control: (1) the employer's premises and equipment were used for the plaintiff's work; (2) the business' ability to shift as a unit from one putative joint employer to another; (3) whether the plaintiff performed a discrete line-job that was integral to the alleged employer's process of production; (4) the ability to pass responsibility from one subcontractor to another without material changes; (5) the employer's degree of supervision over the plaintiff's work; and (6) whether the plaintiff works exclusive or predominantly for the alleged employer.

The court held that the complaint sufficiently alleged that Checkers had an employment relationship with Griffith under either the formal or functional control test. Specifically, the complaint alleged that Checkers: (1) controlled or approved Coney Food's management-level employees; (2) maintained Coney Food's point-of-sale system; (3) supervised and imposed restrictions on Coney Food; (4) provided a team to support Coney Food's operations; (5) set and enforced employee performance requirements; and (6) had the ability to audit and inspect Coney Food's records and facilities. Additionally, the court held that, as a matter of law, there is no blanket rule that a franchisor is not an employer of its franchisee's workers. The court also disagreed

with Checkers that a contract for the payment of wages between Griffith and Checkers was necessary for the NYLL claim. The court explained that "NYLL does not require an enforceable contractual right where . . . straight wages are at issue."

Nor was the court persuaded by Checkers' argument that Griffith's claims still failed because Checkers had no knowledge that she was pregnant, terminated, or her wages were wrongly paid. Because the complaint alleged that Checkers controlled the appointment of Coney Food's management-level employees, the court found this sufficient to infer that Abid, Coney Food's general manager and direct supervisor of Griffith, was also an employee of Checkers for the purposes of Griffith's discrimination and NYLL claims. Checkers was therefore "in a position to control the activities of" Abid and potentially liable for his alleged misconduct.

For these reasons, the court granted Checkers' motion to dismiss Griffith's Title VII claim but denied the motion as to the remaining discrimination and wage claims.

***Martel v. Hearst Communications, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,678, 2020 WL 3470094 (N.D. Cal. June 25, 2020)**

The U.S. District Court for the Northern District of California granted Paul Martel's (the plaintiff) motion for summary judgment and denied Hearst Communications, Inc.'s (the defendant) motion for summary judgment in a wage and hour dispute brought by the plaintiff, a newspaper carrier, alleging misclassification as an independent contractor in violation of California's labor laws.

The plaintiff delivered newspapers for the *San Francisco Chronicle* (*Chronicle*) since the 1980s, and the defendant owns and manages the distribution of the *Chronicle*. In 2008, the plaintiff signed a new contract with the defendant, transitioning from newspaper "carrier" to newspaper "dealer." In this role, the plaintiff's responsibilities increased, and he has signed each subsequent contract with the defendant since then. The contract signed by the plaintiff required him "to 'deliver a complete, fully assembled [*Chronicle]*' in a 'clean, dry, undamaged and readable condition' to subscribers in his designated delivery area no later than 6 a.m. Mondays through Saturdays and 7:30 a.m. on Sundays." The plaintiff also had to assemble bags of packaged newspapers and related items. The contract provided that "newspapers will be made available to plaintiff at defendant's warehouse between 1 a.m. and 4 a.m. Mondays through Saturdays and between midnight and 5 a.m. on Sundays. It is considered a breach of contract to fail "to arrive at the pick-up location on time or deliver newspapers on time, triggering an obligation for the plaintiff to pay associated costs." Following the transition from "carrier" to "dealer," the plaintiff was assigned additional delivery areas, which made it impossible for him to personally complete all the deliveries within the designated time frame. The plaintiff hired out subcontractors to deliver newspapers.

The plaintiff filed an initial complaint in May 2019, alleging eight violations under the California Labor Code, seeking a declaratory judgment, compensatory damages, economic and/or special damages and/or liquidated damages. After a case management conference, the parties filed cross motions for summary judgment on the same issue—whether the plaintiff had been properly classified as an independent contractor.

The principal test of an employment relationship, announced in *S.G. Borello & Sons, Inc. v. Department of Industrial Relations*, 769 P.2d 399 (Cal. 1989) (*Borello*), is "[w]hether the person to whom service is rendered has the right to control the manner and means of accomplishing the result desired." In *Borello*, the California Supreme Court found that harvesters were employees of Borello because of the level of control he had over their work, specifically he "retained 'pervasive control over the operation as a whole.'"

The court applied the *Borello* standard here because newspaper distribution is exempt from California Assembly Bill 5's adoption of the *Dynamex* standard. The court determined that the plaintiff was an employee under *Borello* because the defendant controlled the "manner and means" by which the plaintiff delivered newspapers. The court detailed the plaintiff's workday and found that "[a]lthough merely requiring a deliverer to deliver a readable newspaper in a timely manner to customers is not enough on its own to indicate employment, the time restrictions of when the newspaper is made available to plaintiff, the deadline to make the deliveries, the penalties of failure, and the supplemental tasks he must complete show that plaintiff has little freedom over his working hours or the way in which he completes his job."

The defendant pointed to the terms of the contract, which provided the plaintiff with certain freedoms such as choosing delivery vehicle, delivery order, sorting locations, and subcontractors. The court countered that in reality, "there are crucial restrictions in the way plaintiff completes his job." The court then explained that the plaintiff lacked control over the facilities or equipment used to complete his job. Specifically, the court found that the plaintiff's choice in vehicle is dependent on his ability to afford a vehicle for deliveries, separate from his personal vehicle, and the plaintiff's sorting space is subleased from the defendant and not in the plaintiff's sole control. Although the contract does not require the plaintiff to sublet space from the defendant, subletting from the defendant is the most "reasonable and efficient option" because it is where the defendant makes newspapers available. The court found that the "[p]laintiff's choices are thus, in practice, a function of the size of his route, weather, and financial situation—much of which is outside his control."

The defendant also emphasized the difference between "carriers" and "distributors," as well as the plaintiff's ability to subcontract out his work. The court reasoned that a plaintiff's job title and ability to subcontract is not dispositive of control, pointing to facts in the *Borello* case where the harvesters could, and did, assign work to family members.

Setting aside the ability to subcontract, the court looked to guidance from the California Court of Appeal in *Antelope Valley Press v. Poizner*, 75 Cal. Rptr. 3d 887 (Cal. Ct. App. 2008), where deliverers for the Antelope Valley Press (carrier) signed contracts that allowed for the hiring of employees and substitutes when the carrier deemed it necessary and only in a vehicle controlled by the carrier. This factor weighed in favor of finding the deliverers to be employees. In this case, the plaintiff's ability to subcontract was not as explicitly limited, but the defendant retained much control. Even though the plaintiff could hire whomever he wanted to complete deliveries, "[a]fter the defendant assigned additional delivery areas to defendant in 2008, his most reasonable option w[as] be to keep on the deliverers who were already working that route as subcontractors, which is exactly what plaintiff" did. The plaintiff continued to deliver in the same area he always did to maintain his pay and believes he could not find additional subcontractors for this work because of the pay. Additionally, the size of his assigned delivery area also limited his ability to hire subcontractors and limited his working hours. Ultimately, the court found that the defendant did not merely control results, but also controlled the "means and method by which plaintiff completes his work," thus making him an employee.

To further support his contention that the *Borello* test weighed in his favor, the plaintiff cited to *Antelope Valley Press*. The court noted that this case was distinguishable from *Antelope Valley Press* because the restrictions at issue were not as demanding. However, the court did note several similarities. Like in *Antelope Valley Press*, the plaintiff could be terminated without cause on thirty days' notice, which was indicative of an employer-employee relationship. Also, in *Antelope Valley Press*, the court found the "simplicity of newspaper delivery to weigh in favor of a finding that deliverers were employees."

The court also considered a number of secondary factors beyond the "control test." These could include any of the following: (1) whether the one performing services is engaged in a distinct occupation or business; (2) the type of occupation, specifically, whether in the locality, the work is usually done under the direction of the principal or by a specialist without supervision; (3) the skill required for the occupation; (4) whether the principal or the worker supplies the "the instrumentalities, tools, and the place of work for the person performing the work; (5) the length of time for which the services are to be performed; (6) whether the worker is paid by time or by the job; (7) whether the work is a part of the regular business of the principal; and (8) whether the parties believe they are establishing an employer-employee relationship.

Here, the court previewed a number of secondary factors that weighed in favor of finding that improper classification occurred and the plaintiff was truly an employee. The court pointed to the plaintiff's length of service. Even though he annually signed contracts, his relationship with the defendant was permanent. The court also noted that the defendant's primary

business included all steps of the publication process, from production to delivery, and "[p]laintiff's delivery services are thus neither distinct nor separate from defendant's primary business."

Some factors weighed against the conclusion that the plaintiff was an employee of defendants. The plaintiff's tax forms indicated that he was a contractor. Newspaper deliveries have historically been delivered by independent contractors. In response to a customer complaint, the plaintiff could cure by redelivering the paper or explaining why the complaint was unfounded. The plaintiff was also autonomous, and the defendant did not exercise much supervision over his work. And the defendant paid the plaintiff on a piecework basis. Even in light of these factors indicative of an independent contractor relationship, the court granted the plaintiff's motion for summary judgment because overall, the secondary factors "still weigh in favor of the conclusion that defendant is an employee." Thus, the defendant had improperly classified him as an independent contractor.

The defendant also moved for summary judgment on the basis that the plaintiff's amended initial disclosures on damages were insufficient under Federal Rule of Civil Procedure 26(a) because they did not include calculations for each category of damages. Because the plaintiff did not provide specific calculations in his amended disclosures, the court found that he violated Rule 26(a)(iii). The plaintiff contended that he provided the specific calculations to defense counsel during the parties' mediation, but statements made during mediation are inadmissible. The defendant argued that this nondisclosure warranted exclusion of damages at trial.

To assess whether exclusion was appropriate, the court looked to five factors other courts in the district consider to determine if non-disclosure is "justified or harmless." They include: (1) the surprise to the party against whom the evidence would be offered; (2) the ability of that party to cure the surprise; (3) the extent to which allowing the evidence would disrupt the trial; (4) the importance of the evidence; and (5) the non-disclosing party's explanation for its failure to disclose the evidence." Applying these factors, the court found first, that the damages in the case were complex given the piece-rate nature of plaintiff's wages. It would, thus, be difficult for the defendant to determine how the plaintiff calculated a lump-sum damage amount without the plaintiff properly providing the calculations under Rule 26. This undue burden and surprise favored the defendant. Second, the ability to cure the default weighed in the plaintiff's favor. The postponement of the trial in light of coronavirus would allow the plaintiff to cure some of the surprise. Third, considering the preceding factors, allowing the evidence was not likely to disrupt trial. Fourth, because damages are a key part of the case, the evidence at issue was essential. Fifth, the plaintiff's counsel provided an insufficient explanation for his failure to disclose. The court noted that normally all of these factors would weigh in defendant's favor, but because the trial was delayed due to the coronavirus, that weight decreased.

Ultimately, the court denied the defendant's motion for summary judgment and allowed the plaintiff to amend his disclosures again to comply with Rule 26, although the plaintiff had to pay all of the defendant's expenses and fees incurred in following up on the amended disclosures, including a new deposition of the plaintiff.

***Massey v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 16,679, 2020 WL 5700874 (Ill. Cir. Ct. June 24, 2020)**
This case is discussed under the topic heading "COVID-19."

NONCOMPETE AGREEMENTS

***AmeriSpec, LLC v. Sutko Real Estate Services, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,683, 2020 WL 3913584 (W.D. Tenn. July 10, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

***Interim Healthcare, Inc. v. Interim Healthcare of Southeast Louisiana*, Bus. Franchise Guide (CCH) ¶ 16,666, WL 3078531 (S.D. Fla. June 10, 2020)**
This case is discussed under the topic heading "Jurisdiction."

ORAL AGREEMENTS

***Keen Edge Co. v. Wright Manufacturing, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,712, 2020 WL 4926664 (E.D. Wis. Aug. 21, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

PETROLEUM MARKETING PRACTICES ACT (PMPA)

***Nevada DeAnza Family Ltd. Partnership v. Tesoro Refining & Marketing, LLC*, Bus. Franchise Guide (CCH) ¶ 16,697, 2020 WL 4284827 (N.D. Cal. Jul. 27, 2020)**
The U.S. District Court for the Northern District of California upheld a franchisor's termination of a franchise agreement when it found that the Petroleum Marketing Practices Act (PMPA) did not include hydrogen as a renewable fuel under Section 2807 of the PMPA.

The plaintiff, Nevada DeAnza Family Limited Partnership, owned a fueling station in Sunnyvale, California (Sunnyvale Station). In July 2016, the plaintiff entered into an agreement (Site Lease) with plaintiff-intervenor First Element Fuel, Inc., whereby the plaintiff leased a portion of the Sunnyvale Station to the plaintiff-intervenor for the installation of hydrogen fuel dispensers. The plaintiff's site plan showed that the hydrogen fuel dispensers would be located under the station's canopy. The plaintiff and the plaintiff-intervenor contended that they spent a significant amount of time

and money since 2016 installing the hydrogen dispensers at the Sunnyvale Station.

During 2016, the plaintiff also began negotiating an exclusive fuel supply and branding agreement with defendant Tesoro Refining & Marketing Company LLC (Tesoro). The plaintiff alleged that it informed the defendant of its plan to install the hydrogen fuel dispensers under the fuel canopy, and the defendant did not object. In December 2016, the plaintiff and Tesoro entered into a retail service agreement (RSA) pursuant to which the plaintiff would rebrand the Sunnyvale Station as a "Mobil." After rebranding the station, the plaintiff allegedly informed the defendant's successor, Marathon Petroleum Corporation (Marathon), of its intention to install the hydrogen dispensers and received no objection.

Subsequently, in 2019, Marathon informed the plaintiff that it would not allow the plaintiff to install the hydrogen fuel dispensers under the canopy. The next year, the defendant terminated the RSA based on the construction of the hydrogen dispensers, which resulted in the plaintiff's loss of its fuel contract and branding contract. The plaintiff-intervenor alleged that the termination resulted in a loss of funds associated with missing the California Energy Commission Grant's opening deadline for hydrogen dispensers, and over $600,000 in missed credit generation.

The plaintiff filed suit for rescission of contract, fraud, and violation of the California Unfair Competition Law (UCL) against Tesoro and Marathon (collectively, the defendants). After intervening, the plaintiff-intervenor filed a complaint against the defendants for interference of a contractual relationship, violation of the UCL, and declaratory judgment. The defendants filed a motion to dismiss the plaintiff-intervenor's complaint for lack of jurisdiction due to the presence of a political question under Federal Rule of Civil Procedure 12(b)(1) and for failure to state a claim under Rule 12(b)(6).

First, the court considered the key issue in the case: whether hydrogen fuel is a renewable fuel under the PMPA. The court determined it is not. The plaintiff-intervenor argued that hydrogen is protected by the PMPA, which would mean that its installation of the hydrogen dispensers at the plaintiff's gas station did not violate any agreement with the defendants. The defendants countered that their contract rescission was legitimate because hydrogen is not a renewable fuel under the act.

The PMPA prohibits any franchise-related document from restricting either the installation of a renewable fuel tank or pump on a franchisee's marketing premises or the converting, advertising, or selling of renewable fuel. The PMPA defines renewable fuel for purposes of § 2807 as fuel that is either: "(A) at least 85 percent of the volume of which consists of ethanol; or (B) any mixture of biodiesel and diesel or renewable diesel determined without regard to any use of kerosene and containing at least 20 percent biodiesel or renewable diesel." The parties agreed that the hydrogen fuel did not meet either definition. Nonetheless, the plaintiff-intervenor argued that

the court should interpret the PMPA to include hydrogen as a renewable fuel because its use is endorsed and encouraged at both the state and federal level. The court was unpersuaded by this argument, pointing to the clear and unambiguous language of the PMPA, which left no room for expansion as to what it protects. Accordingly, the court found that hydrogen fuel is not a renewable fuel under the PMPA.

Then, the court evaluated whether the plaintiff-intervenor's claims presented a political question, which would deprive the court of its subject matter jurisdiction. The political question doctrine "excludes from judicial review those controversies which revolve around policy choices and value determinations constitutionally committed for resolution" to Congress or the Executive Branch. The court looked to the six factors established by the U.S. Supreme Court in *Baker v. Carr*, 369 U.S. 186 (1962), to ascertain if a political question was implicated: "(1) a textually demonstrable constitutional commitment of the issue to a coordinate political department; (2) a lack of judicially discoverable and manageable standards for resolving it; (3) the impossibility of deciding without an initial policy determination of a kind clearly for nonjudicial discretion; (4) the impossibility of a court's undertaking independent resolution without expressing lack of the respect due coordinate branches of government; (5) an unusual need for unquestioning adherence to a political decision already made; or (6) the potentiality of embarrassment from multifarious pronouncements by various departments on one question."

The defendants argued that the intervenor's complaint aimed to expand the definition of renewable fuel to include hydrogen, which triggered the political question doctrine, but the court disagreed. Because the political question doctrine requires analysis of each claim, the court discussed each of the plaintiff-intervenor's claims in turn.

First, the court analyzed the plaintiff-intervenor's request for declaratory relief. The defendants argued that the claim presented a political question under the first *Baker* factor because the claim asked the court to amend an existing law, which is a power of the legislative branch alone. The court disagreed because the court needed only to determine whether the PMPA's intent "was to include hydrogen once the fuel became commercially available for vehicles." By doing so, the court was "engag[ing] in the 'familiar judicial exercise' of reading and applying a statute, conscious of the purpose expressed by Congress." For the second and third *Baker* factors, the court rejected the defendants' argument that it needed to evaluate the nation's energy and environmental policy to decide Congress's intention. Instead, the court could determine Congress' intent based on the plain language of the PMPA. The court determined that the fourth *Baker* factor did not apply because the court did not need to replace Congress's "renewable fuel" definition, but instead involved applying Congress' existing definition of "renewable fuel" to hydrogen. The defendants conceded that the fifth *Baker* factor did not apply, and, finally, the court found that the sixth factor did not apply

either. Because the court was not adding to the definition of "renewable fuel," there was no risk that the pronouncements of the legislative branch would conflict with those of the judicial branch. The motion to dismiss on this basis was denied.

Second, the court turned to the plaintiff-intervenor's claim that Tesoro intentionally interfered with the Site Lease. The court found that the intentional interference element of the claim was not impacted by the court's interpretation of the PMPA, whether the act encompasses hydrogen as a renewable fuel or not.

Third, the court turned to the plaintiff-intervenor's UCL claim that Tesoro's misrepresentation to the plaintiff was designed to induce the plaintiff to enter into the RSA. The plaintiff-intervenor alleged that Tesoro's refusal to allow a hydrogen fuel station violates the PMPA. Because this argument required the court to read and apply a statute, none of the *Baker* factors applied to the plaintiff-intervenor's UCL claim. Therefore, the court denied the defendants' motion to dismiss the complaint-in-intervention on the basis that it presented a political question.

The court then turned to the defendants' Rule 12(b)(6) motion to dismiss for failure to state a claim. The court first analyzed the plaintiff-intervenor's claim that the defendants intentionally interfered with its contractual relationship with the plaintiff. This claim requires the following elements: "(1) a valid contract between plaintiff and a third party; (2) defendant's knowledge of this contract; (3) defendant's intentional acts designed to induce a breach or disruption of the contractual relationship; (4) actual breach or disruption of the contractual relationship; and (5) resulting damage." The court found that the intervenor-complaint failed to allege facts establishing the third element, Tesoro's intent to disrupt the contract.

Intent could be shown by allegations that "(1) Tesoro's specific purpose was to disrupt the Site Lease or (2) Tesoro knew that interference of the Site Lease was a necessary consequence of their action or substantially certain to occur." As to the first method, the plaintiff-intervenor pointed to three actions by Tesoro that "interfered with the Site Lease: falsely representing its position on the dispensers, asking for further details on the dispenser which resulted in months of unnecessary discussion, and terminating the RSA." However, the court did not consider these actions to indicate Tesoro's intent to interfere with the contract between the plaintiff and plaintiff-intervenor. The plaintiff-intervenor alleged that Tesoro's franchise recruiter "knew that Tesoro would not have approved a Hydrogen Dispenser under the canopy," and "in the interest of expanding the Mobil brand into Northern California, he failed to disclose this material fact to [the plaintiff]." In the court's view, this at best suggested that Tesoro might have intended to mislead the plaintiff to close the deal, but had nothing to do with the intervenor. Moreover, the obstruction of the hydrogen dispensers and subsequent termination of the RSA did not demonstrate that Tesoro wanted to interfere with the Site Lease because there could be other business explanations for terminating the

RSA. In fact, it would be unreasonable to assume that Tesoro would ruin a business relationship with the plaintiff to interfere with the Site Lease when Tesoro would not benefit from doing so.

The court then turned to the second method for showing intent and found that the plaintiff-intervenor failed to allege sufficient facts demonstrating that Tesoro knew with substantial certainty that its actions would interfere with the Site Lease. The court discussed that the plaintiff had an obligation to read the RSA, and upon a reading of the RSA, the plaintiff would have seen that it prohibited the plaintiff from operating ancillary businesses without written consent from Tesoro. Additionally, the complaint did not allege that Tesoro knew the specific terms of the Site Lease, and as such, Tesoro "would not have known with certainty that asking for further details on the dispenser or terminating the RSA would cause undue delay to the performance of the Site Lease." The court held that although the plaintiff-intervenor alleged how Tesoro interfered with Site Lease, it did not demonstrate that such interference was intentional. As such, the court granted the defendants' motion to dismiss, but granted the plaintiff-intervenor leave to amend its claim because it possibly could cure the deficiencies by including additional facts.

Next, the court evaluated the plaintiff-intervenor's claim for relief under the UCL. A plaintiff alleging a violation of the UCL may only obtain restitution and/or injunctive relief. Here, the plaintiff-intervenor sought an injunction requiring the defendants to accept hydrogen as "renewable fuel" under the PMPA. Because the court found that the PMPA's definition of "renewable fuel" does not include hydrogen, the court could not grant the injunction sought. Put simply, Tesoro did not violate the plaintiff's statutory rights by refusing to allow the plaintiff to install hydrogen fuel dispensers at its gas station, and there was nothing for the court to enjoin. As a result, the court granted the defendants' motion to dismiss the UCL claim. However, because the plaintiff-intervenor could seek alternative equitable remedies under the UCL, the court granted leave to amend the UCL claim.

Last, the court considered plaintiff-intervenor's request for a declaratory judgment that hydrogen fuel constitutes a renewable fuel under the PMPA and that the PMPA prohibited Tesoro from refusing to allow hydrogen dispensers at the Sunnyvale Station. As discussed earlier, the court refused to find that the PMPA's definition of "renewable fuel" included hydrogen. As such, the court dismissed this claim without leave to amend.

STATUTORY CLAIMS

Arruda v. Curves International, Inc., Bus. Franchise Guide (CCH) ¶ 16,692, 2020 WL 4289380 (W.D. Tex. July 27, 2020)

The U.S. District Court for the Western District of Texas granted Curves International, Inc. (Curves International), Curves NA, Inc. (Curves NA), and North Castle Partners (North Castle) (collectively, the defendants), their

motion to dismiss an action brought by a group of Curves franchisees asserting violations of the Racketeer Influenced and Corrupt Organization Act (RICO). With the federal RICO claim dismissed, and diversity jurisdiction lacking, the court declined to exercise supplemental jurisdiction over the franchisees' breach of contract claims and dismissed those claims without prejudice.

The plaintiffs, a group of Curves franchisees, alleged that the defendants "concealed relevant information regarding the state of the Curves System from current and prospective franchisees and that Defendant Curves International (and later Curves NA) systematically breached its agreements with Plaintiffs." Each of the plaintiffs was a party to a franchise agreement with either Curves International or Curves NA (collectively, Curves). The plaintiffs alleged that Curves represented to each plaintiff that it would provide them with opening support, training, ongoing support, assistance selling memberships, marketing, weight loss guidance, internal and external promotions to generate business, advertising, and brand maintenance. They further alleged that these representations were made to, and relied upon, by the plaintiffs in their decision to purchase a Curves franchise. The plaintiffs also alleged that by March 30, 2018, Curves NA had assumed all of Curves International's obligations, responsibilities, and liabilities under those agreements. As such, the plaintiffs brought action against both Curves International and Curves NA, alleging breach of the franchise agreements and seeking damages resulting from such breaches.

The plaintiffs also sought damages against the defendants for RICO violations, alleging that the defendants engaged in mail and wire fraud "by devising and executing a scheme . . . to defraud [the p]laintiffs which consisted of deliberately and knowingly having franchise agreements signed and renewed, collecting franchise and transfer fees, franchise royalty fees and advertising fees with full knowledge that such franchisees would ultimately fail." Specifically, the plaintiffs alleged that Curves International and North Castle hid the results of a marketing study, which revealed that the Curves name had a "negative halo" and that Curves franchise locations would continue to close at a rate of more than fifteen percent per year if nothing was done." According to the complaint allegations, the defendants also hid information from an "Operating Blueprint" document detailing North Castle's plan to "prune" over 1,000 unsustainable locations. Moreover, the "fraudulent conduct" continued after Curves International was sold to Curves NA.

In response to the lawsuit, the defendants filed a motion to dismiss, "claiming [p]laintiffs' breach of contract and RICO claims were untimely and that they were inadequately pled."

First, the court analyzed the plaintiffs' RICO claim. "To state a § 1962(c) civil RICO claim, a plaintiff must allege: (1) conduct (2) of an enterprise (3) through a pattern of racketeering activity." An act of racketeering activity is often referred to as a "predicate act," which in turn includes criminal activities such as mail and wire fraud. To constitute "racketeering activity,"

the plaintiff must show that there are two or more predicate criminal acts that are both related and "amount to or pose a threat of continued criminal activity." The court found that the plaintiffs failed to sufficiently allege a predicate act to state viable RICO claims.

The plaintiffs brought civil RICO claims against the defendants based on mail and wire fraud. Mail and wire fraud claims require: "(1) a scheme to defraud; (2) the use of mails or, if by wire, the interstate use of the wires to execute the scheme; (3) the use of mails or wires being incident to the essential execution of the scheme; and (4) actual injury to the plaintiff." RICO claims based on allegations of fraud are subject to the heightened pleading burden imposed by Rule 9(b). In this case, the plaintiffs failed under Rule 9(b) to plead the fraud with particularity because they did not allege that the defendants had a duty "to disclose the omitted information regarding the state of the Curves System in their communications with Plaintiffs."

Specifically, the plaintiffs argued that pursuant to the Federal Trade Commission's Franchise Rule (FTC Rule), Curves International and then Curves NA, as franchisors, had a duty to disclose that "their trade name and system had developed a 'negative halo' in the market (i.e. 'marketing study') and North Castle's intention to 'prune' franchises (i.e. 'Operating Blueprint')." The plaintiffs pointed to the FTC Rule's requirement that franchisors disclose "[t]he general market for the product or service the franchisee will offer . . . consider[ing] factors such as whether the market is developed or developing, whether the goods will be sold primarily to a certain group, and whether sales are seasonal." According to the plaintiffs, the mailing and wiring of misleading and fraudulent FDDs were examples of predicate RICO crimes committed by the defendants.

Plaintiffs conceded that the FTC Rule does not provide a private right of action, but asserted that the FTC Rule imposed a duty on franchisors that "may be the basis for a cause of action in fraud or RICO." The court rejected this assertion, consistent with other courts' rulings that there is no private right of action under the FTC Rule. The court noted that a small number of jurisdictions hold that violations of the FTC Rule could give rise to a state law claim, but Texas does not have a specific franchise law and, as such, does not impose any additional disclosure requirements on franchisors.

The court then considered and rejected the premise that the plaintiffs could use the FTC Rule as the basis for finding an independent violation of the Texas Deceptive Trade Practices Act (DTPA). To reach this conclusion, it relied on a prior decision of the Fifth Circuit setting forth this rule.

Additionally, the plaintiffs could not rely on alleged violations of the FTC Rule as a basis for common law fraud under Texas law. Under Texas law, the franchise relationship does not create confidential or fiduciary duties, and "there is no duty to disclose without evidence of a confidential or fiduciary relationship." Moreover, allowing the plaintiffs to use violations of the FTC Rule as the basis for state common law fraud claims would effectively allow a private cause of action under the FTC Rule.

The court then went onto explain that even if the FTC Rule imposed an actionable duty on defendants, the RICO claim would still fail. First, the plaintiffs failed to demonstrate that the FTC Rule required disclosure of the information in the Operating Blueprint and marketing study in the FDDs. Second, the plaintiffs did not allege that defendant North Castle shared this information with either Curves International or Curves NA, so it was unclear that either franchisor could have disclosed this omitted information in the FDDs.

In response to the plaintiffs' allegations that the predicate acts included mail and wire fraud through "forwarding of franchise agreements, emails, and other correspondence to franchisees and prospective franchisees," the court also found that the FTC Rule "does not create a duty upon franchisors to disclose information with current franchisees and these alleged communications cannot be predicate acts." The court also refused to allow references to other documents (without specifics)—for example, "other electronic communications," "other correspondence" and "other representations"—to form the basis for mail or wire fraud. The court expressed hesitance to "allow ordinary business contract or fraud disputes to be transformed into federal RICO claims," drawing a distinction between a series of broken promises that form the basis of a breach of contract claim and a claim of racketeering under RICO. Ultimately, the court dismissed the plaintiffs' civil RICO claim because the plaintiffs did not present any viable allegations of mail or wire fraud.

Next, the court considered the alternative ground of whether the plaintiffs had standing to bring a civil RICO claim and found that they did not. To state a civil RICO claim, a plaintiff must have standing to sue. Case law holds that a plaintiff must show that the RICO violation was both the but-for and proximate cause of the injury. The plaintiffs relied on a Fifth Circuit case, *Torres v. SGE Management, LLC*, 838 F.3d 629, 637 (5th Cir. 2016), which held that a person can be injured by a pattern of mail fraud even if he did not rely on any of the misrepresentations. The court found the *Torres* case unpersuasive because it involved a pyramid scheme where the plaintiff's injuries arose from the payment structure of the scheme and "the inherent concealment of the inevitableness of those injuries." In this case, the injuries did not arise from the payment structure of the scheme, but from non-disclosed information. Even if the plaintiffs successfully pled that the FTC Rule required disclosure of the information at issue, such information was only available after many of the plaintiffs received the FDDs and entered into franchise agreements with Curves. Accordingly, the court held that "even if [ ] it was a predicate act for Defendants to not disclose the information from the marketing study to prospective franchisees in an FDD, these plaintiffs would not have been harmed by Defendants' conduct, as they would have entered into the franchise agreements before the completion of the marketing study."

Last, the court considered the plaintiffs' remaining state law, breach of contract claims and dismissed them without prejudice. A court may have

subject matter jurisdiction over related stated law claims in a RICO case through supplemental jurisdiction. Here, the RICO claim was dismissed; thus, the court was obligated to examine its subject matter jurisdiction sua sponte. The court concluded that there was no diversity of citizenship. The court then declined to exercise its discretion to keep the cases pursuant to supplemental jurisdiction because "none of the factors in 28 U.S.C. § 1367(c) weigh[ed] in favor of retaining supplemental jurisdiction over the remaining state law claims, and declining supplemental jurisdiction impair[ed] neither judicial economy, convenience, fairness, nor comity." The court then dismissed the state law claims without prejudice.

***Griffith v. Coney Food Corp.*, Bus. Franchise Guide (CCH) ¶ 16,711, 2020 WL 4748452 (E.D.N.Y Aug. 17, 2020)**

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

***Hayhurst v. Keller Williams Realty, Inc.*, Bus, Franchise Guide (CCH) ¶ 16,690, 2020 WL 4208046 (M.D.N.C. July 22, 2020)**

A consumer, Brian Hayhurst (Hayhurst), alleged that Keller Williams Realty, Inc. (Keller Williams) violated the Telephone Consumer Protection Act (TCPA) when it or its agents called Hayhurst without prior express written consent using a pre-recorded voice and automated telephone dialing systems (ATDS), despite the fact that Hayhurst's phone number was registered on the national do-not-call registry. Keller Williams moved to dismiss for failure to state a claim, arguing that Hayhurst could not pursue direct liability and had not sufficiently alleged vicarious liability or that he had received a call from an automated telephone. The U.S. District Court for the Middle District of North Carolina denied Keller Williams' motion to dismiss.

Keller Williams is one of the largest real estate franchise systems in the world. As part of its training curriculum, Keller Williams provides realtors with marketing tools and training materials, including the following: scripts to use when calling individuals; lists of phone numbers of potential customers; tools to automatically dial phone numbers; instructional videos about using expired listings to generate leads; directions to purchase lead lists and call them using an autodialer; promotion of Landvoice, a Keller Williams-approved vendor that sells lists of real estate leads to agents, researches telephone numbers associated with such leads, and provides agents with an online automatic telephone dialing system that allows them to load the lists of leads and then dial them; a training session developed by the Chief Executive Officer of KW MAPS Coaching that centers around obtaining Landvoice-generated leads and autodialing them; and promotion of RedX, a company similar to Landvoice, in Keller Williams' magazine.

Hayhurst originally registered his cell phone number on the do-not-call registry in July 2003. Nevertheless, he received a call on his cell phone in June 2019. The caller left a pre-recorded message (which contained language similar to that in the scripts provided by Keller Williams during its

training program), in which she identified herself as "Karmel from Keller Williams Realty." A few days later, Hayhurst received a second call from what appeared to be an autodialer. The caller once again identified herself as Karmel from Keller Williams. The following day, Hayhurst received another call. When he answered, he heard several seconds of dead air before an operator identified herself and stated she was calling on behalf of a Keller Williams agent. When Hayhurst asked how she got his phone number, she said "from the RedX system they are using."

Following the calls, Hayhurst initiated a putative class action, alleging Keller Williams violated the TCPA. The TCPA makes it unlawful "for any person . . . to make any call (other than a call for emergency purposes or made with the prior express consent of the called party) using an automatic telephone dialing system or any artificial or prerecorded voice" to any cell phone number. It is also unlawful for anyone to make a telephone solicitation, without prior consent, to any phone number included in the national do-not-call registry. Keller Williams moved to dismiss for failure to state a claim.

As an initial matter, the parties agreed that Keller Williams did not make the calls and that the case raised the question of whether Keller Williams could be held vicariously liable. The parties, thus, disputed the sufficiency of the allegations in support of vicarious liability. Keller Williams argued that Hayhurst failed to allege that the calls were made on its behalf. The court analyzed the existence of an agency relationship between Keller Williams and the callers. An agency relationship, according to the court, arises when one person (a principal) manifests assent to another person (an agent) that the agent shall act on the principal's behalf and the agent consents so to act. Although the principal's right to control the agent's actions is an essential element of agency, the court noted that the concept of control includes a wide range of meanings and that control will always be incomplete because "no agent is an automaton who mindlessly executes commands." An agent acts with actual authority when the agent reasonably believes that the principal wishes the agent so to act. Alternatively, an agent may act under implied authority when an agent "acts in a manner in which the agent believes the principal wishes the agent to act based on the agent's reasonable interpretation of the principal's manifestation in light of the principal's objectives and other facts known to the agent." Once an agency relationship is formed, vicarious liability rules ordinarily make principals vicariously liable for acts of their agents that are within the scope of the agents' authority.

The court found that Hayhurst had sufficiently alleged an agency relationship between Keller Williams and the individuals who called him, such that Keller Williams could be vicariously liable for the individuals' actions. Hayhurst's allegations demonstrated that Keller Williams manifested its assent for its realtors to act on its behalf, subject to its control, and the realtors who called Hayhurst so acted. The court noted, for example, that Keller Williams provided realtors with instructions and resources for auto-dialing phone numbers through its training programs and materials, which the court

considered to be "an integral part" of Keller Williams' franchise system and "the means by which Keller Williams controls the manner in which realtors market for new listings."

In addition, the court found that the allegations showed that Karmel and someone else on behalf of Keller Williams acted with actual authority when they called Hayhurst "in the face of Keller Williams' specific, detailed training and materials," as well as with implied authority because a reasonable realtor would interpret Keller Williams' extensive training operations as manifestation of an expectation that agents obtain lists of phone numbers from approved vendors and call them using an automatic dialer.

The court also found that the real estate agents who called Hayhurst plausibly did so with apparent authority. The court explained that "an agent is imbued with apparent authority to bind his or her principal if a third person could reasonably interpret acts or omissions of the principal as indicating that the agent has authority to act on behalf of the principal." Under these circumstances, manifestation only needs to be "traceable" to the principal; the principal need not have any direct contact with the third party. Here, the court found that the content of the telephone calls made to Hayhurst was traceable to Keller Williams by way of its extensive training and materials and because the callers associated themselves with Keller Williams. As such, the court found that Hayhurst sufficiently alleged an agency relationship and actual and apparent authority.

The court was also not persuaded by Keller Williams' attempts to dismiss the amended complaint by binding Hayhurst to abandoned allegations from his original complaint. Hayhurst initially alleged that Keller Williams trained and directed realtors to use Landvoice, but those allegations showed that Keller Williams could not be vicariously liable for the calls to Hayhurst because he received a call through RedX, not from Landvoice. In his original complaint, Hayhurst also cited a video allegedly produced and used by Keller Williams to train realtors how to use Landvoice, but the video actually showed that the calls at issue should not have been made because the numbers were on the do-not-call registry. Hayhurst omitted these allegations from his amended complaint. The court explained that the prior allegations should not be considered at the motion to dismiss stage. As such, the court only assessed the allegations in the amended complaint and found them to be sufficient.

Finally, the court analyzed Keller Williams' argument that the allegations did not establish that Hayhurst received calls from an ATDS. Keller Williams argued that the realtors were not using an ATDS because their dialing system could not dial numbers without human intervention. For purposes of the TCPA, an ATDS is equipment which has the capacity (1) to store or produce phone numbers to be called, using a random or sequential number generator; and (2) to dial such numbers.

The court acknowledged that a circuit split exists regarding the definition of an ATDS. Some circuits have determined that an ATDS is one that stores

phone numbers using a random or sequential number generator or produces phone numbers using a random or sequential number generator. Other circuits have determined that a device qualifies as an ATDS if it stores phone numbers to be called and calls them, even if those numbers were not generated by a random or sequential number generator. Here, the court found the latter definition to be more persuasive because it better effectuated Congress' intent. "By referring to the relevant device as an *automatic* telephone *dialing* system, Congress made clear that it was targeting equipment that could engage in automatic dialing, rather than equipment that operated without any human oversight or control."

In light of this definition of an ATDS, the court found that Hayhurst sufficiently alleged that Keller Williams' systems constituted an ATDS because they had the capacity to store a list of phone numbers and then dial them automatically. The court thought it was reasonable to infer that Keller Williams' systems were dialing the phone numbers, even if the realtor was directing the system to do so. As a result, the court denied Keller Williams' motion to dismiss.

***Keen Edge Co. v. Wright Manufacturing, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,712, 2020 WL 4926664 (E.D. Wis. Aug. 21, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

***S.J. v. Choice Hotels International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,689, 2020 WL 4059569 (E.D.N.Y. July 20, 2020)**
S.J., an alleged sex trafficking victim, brought an action against Choice Hotels International, Inc. (Choice Hotels), Wyndham Hotels & Resorts, Inc. (Wyndham), and Howard Johnson International, Inc. (Howard Johnson) (collectively, the franchisor defendants), and the franchise owners of two franchised hotels under the William Wilberforce Trafficking Victims Protection Reauthorization Act of 2008 (TVPRA), New York Social Services Law § 483-bb (NYSSL), and state negligence law, alleging that each defendant knowingly benefited from facilitating a venture (i.e., a franchised hotel) that they knew, or should have known, was engaging in sex trafficking. The U.S. District Court for the Eastern District of New York granted the franchisor defendants' motions to dismiss for failure to state a claim upon which relief can be granted for all claims, except the negligence claim.

The plaintiff was trafficked for commercial sex for three years, beginning at the age of ten. The defendants are the franchise owners or franchisors of two hotels in New York City where the sex trafficking allegedly took place—an Econo Lodge in the Bronx (Bronx Econo Lodge) and a Howard Johnson Inn in Queens (Queens Howard Johnson). Choice Hotels franchised the Econo Lodge brand to the Bronx Econo Lodge franchisee. Although it does not own or operate the Bronx Econo Lodge, the plaintiff alleged that Choice Hotels controlled the franchisee's training and policies, as well as received a percentage of gross revenue generated by the hotel, including revenue from

the rates charged for the rooms where the plaintiff was trafficked. Wyndham owns Howard Johnson and is the franchisor of Wyndham and Howard Johnson hotels. Wyndham franchised the Howard Johnson brand to the Queens Howard Johnson franchisee. Both Wyndham and Howard Johnson allegedly received a percentage of the gross revenue generated by the Queens Howard Johnson's operations, including revenue from the rates charged on the rooms here the plaintiff was trafficked.

The plaintiff alleged that over the three years that she was trafficked, the staff at the two hotels had regular contact with her and her principal trafficker, witnessing numerous signs of physical abuse and other obvious signs of sex trafficking. She further alleged that the defendants knew or should have known that sex trafficking often occurred on properties associated with their brands, and as such, the defendants had a legal duty to safeguard her against sex trafficking. The plaintiff pointed to news stories covering reported or confirmed cases of sex trafficking at branded properties of the franchisor defendants and to the partnership of the franchisor defendants with End Child Prostitution and Trafficking to develop training for hotel employees to identify the signs of sex trafficking. Because of this, the defendants allegedly knew, or should have known, about the plaintiff's trafficking and financially benefited from her trafficking, in violation of the TVPRA and NYSSL.

The plaintiff also contended that Choice Hotels, Wyndham, and Howard Johnson were negligent by failing to adequately distribute information to assist employees in "identifying human trafficking; provide a process for elevating human trafficking concerns within the organization; and/or train staff on human trafficking and corporate responsibility issues." The plaintiff further sought to hold the franchisor defendants vicariously liable for the negligence of the franchisees through an agency theory based on the franchisor's systemic controls over the franchisees' operations, including hosting online booking applications for the hotels; requiring the hotels to use the brands' customer rewards programs; setting employee wages; making certain employment decisions; advertising for employment; sharing profits; standardizing training methods for employees; requiring that individual hotel owners build and maintain the facility in a specified manner; standardizing rules of operation; conducting regular inspections of the hotel facilities; and fixing accommodation prices (Control Factors).

Choice Hotels, Wyndham, and Howard Johnson moved to dismiss the claims against them, contending they neither had actual knowledge of the plaintiff's sex trafficking nor committed any overt acts of participation in the sex trafficking to be liable under the TVPRA. They further argued that NYSSL, enacted in 2015, did not apply retroactively to the activity that caused the plaintiff's injuries, which lasted from 2006 to 2009. Finally, the franchisor defendants maintained that whatever supervisory role they may have had over the Bronx Econo Lodge and Queens Howard Johnson did not establish an agency relationship giving rise to vicarious liability.

First, the court evaluated the franchisor defendants' motion to dismiss the TVPRA claim based on their assertion that the plaintiff failed to plead all the required categories of knowledge under the act. To establish, liability under the TVPRA, the plaintiff must show that: "(1) the person or entity must 'knowingly benefit, financially or by receiving anything of value,' (2) from participating in a venture, (3) that the 'person knew or should have known has engaged in an act in violation of this chapter.'" The court agreed with another court's requirement that a civil plaintiff also show that the person had knowledge of "some participation in the sex trafficking act itself."

Based on this broader understanding of the TVPRA, a person should be held liable if he should have known that he was facilitating sex trafficking, even if he did not directly participate. The court provided two examples applying this standard. One, this standard would reach the president of a primary school that witnessed inappropriate conduct between the head of the school and a student, and had also "shunned a[n] . . . administrator . . . after she tried to stop [further] sexual abuse" of other students. The second example would reach a hotel whose staff members rent out rooms to people it knew or should have known were engaging in sex trafficking.

The court declined, however, to apply the plaintiff's theory of liability that she was "only required to show that Defendant[s] 'should have known' that sex trafficking was occurring on [their] property under a negligence standard." That theory would lead to a result where it would be easier to prove the liability of hotel franchisors, who are further removed from the sex trafficking, than the liability of actual hotel franchisees. A plaintiff must show that a hotel franchisee "was or should have been aware of specific sex trafficking conduct in order to violate the TVPRA." As such, a hotel franchisor cannot be held liable when it only has an abstract awareness of sex trafficking in general. To meet the knowledge element, the hotel franchisors must have had knowledge about a specific sex trafficking venture. Here, the plaintiff did not allege that the hotel franchisors had the requisite knowledge of a specific sex trafficking venture to be held directly liable under the TVPRA.

Similarly unavailing was the plaintiff's vicarious liability argument premised on an agency theory to indirectly impose liability on the franchisor defendants under the TVPRA. New York agency law generally provides that a franchisee is not an agent of the franchisor. The court noted that franchisors may be held accountable for the acts of franchisees if they exercise "complete control over the day-to-day operations of the franchisee's business," which is a high standard. That the standard is not met by merely alleging that the franchisor can terminate the franchise agreement if it disapproves of the franchisee's conduct or if it has rights to re-enter the franchisee's business. Although the plaintiff set forth several facts about training and policies, including the Control Factors, they were limited to uniformity and standardization of the brand. The plaintiff's allegations were, thus, inadequate as to the franchisor defendants' complete control over the Bronx Econo Lodge and Queens Howard Johnson.

The court also dismissed the plaintiff's claim under NYSSL § 483-bb(c) because it only became effective on January 19, 2016, and the plaintiff's sex trafficking allegedly took place between 2006 and 2009.

Last, the court analyzed the plaintiff's negligence claim, which relied on the plaintiff's conclusion that the franchisor defendants exercised "complete control" over the two franchised hotels where the plaintiff was trafficked. As the court already determined on the TVPRA claim, the Control Factors alleged did not establish vicarious liability against the franchisor defendants.

As for direct negligence, to avoid dismissal, the plaintiff must have alleged: "(1) a duty owed to plaintiff, (2) a breach of that duty, (3) causation, and (4) damages." The franchisor defendants only challenged the duty prong. The court pointed out that there is authority in New York suggesting that a franchisor may owe a duty of care to a franchisee's customers. Here, the franchisor defendants acknowledged the foreseeability and continuation of sex trafficking in their franchisees' hotels, and made public commitments to prevent child sex trafficking. Thus, the court found that the franchisor defendants owed the plaintiff a duty in this case.

In light of the foregoing, the court granted the franchisor defendants' motions to dismiss the TVPRA and NYSSL claims, but the negligence claim survived.

TERMINATION AND NONRENEWAL

***AmeriSpec, LLC v. Sutko Real Estate Services, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,683, 2020 WL 3913584 (W.D. Tenn. July 10, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

***Halcyon Syndicate Ltd. v. Graham Beck Enterprises (PTY), Ltd.*, Bus. Franchise Guide (CCH) ¶ 16,687, 2020 WL 4051865 (N.D. Cal. July 20, 2020)**
This case is discussed under the topic heading "Jurisdiction."

***In re Jonesboro Tractor Sales, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,698, 619 B.R. 223 (Bankr. E.D. Ark. 2020)**
This case is discussed under the topic heading "Bankruptcy."

***Interim Healthcare, Inc. v. Interim Healthcare of Southeast Louisiana*, Bus. Franchise Guide (CCH) ¶ 16,666, 2020 WL 3078531 (S.D. Fla. June 10, 2020)**
This case is discussed under the topic heading "Jurisdiction."

***Keen Edge Co. v. Wright Manufacturing, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,712, 2020 WL 4926664 (E.D. Wis. Aug. 21, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

TORTIOUS INTERFERENCE

***Midway Labs USA, LLC, v. South Service Trading, S.A.*, Bus. Franchise Guide (CCH) ¶ 16,660, 2020 WL 2494608 (S.D. Fla. May 14, 2020)**
This case is discussed under the topic heading "Damages."

***Nevada DeAnza Family Ltd. Partnership v. Tesoro Refining & Marketing, LLC*, Bus. Franchise Guide (CCH) ¶ 16,697, 2020 WL 4284827 (N.D. Cal. Jul. 27, 2020)**
This case is discussed under the topic heading "Petroleum Marketing Practices Act."

TRADEMARK INFRINGEMENT

***Interim Healthcare, Inc v. Interim Healthcare of Southeast Louisiana*, Bus. Franchise Guide (CCH) ¶ 16,666, 2020 WL 3078531 (S.D. Fla. June 10, 2020)**
This case is discussed under the topic heading "Jurisdiction."

***OsteoStrong Franchising, LLC v. Richter*, Bus. Franchise Guide (CCH) ¶ 16,706, 2020 WL 4584007 (D.N.M. Aug. 10. 2020)**
This case is discussed under the topic heading "Trade Secrets."

***Smash Franchise Partners, LLC v. Kanda Holdings, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,709, 2020 WL 4692287 (Del. Ch. Aug. 13, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

TRADE SECRETS

***OsteoStrong Franchising, LLC v. Richter*, Bus. Franchise Guide (CCH) ¶ 16,706, 2020 WL 4584007 (D.N.M. Aug. 10. 2020)**
The U.S. District Court for the District of New Mexico dismissed all claims brought by OsteoStrong Franchising, LLC (OsteoStrong or the plaintiff) against a would-be franchisee for trademark infringement and trade secret misappropriation.

In December 2015, Sheila Nixon (Nixon) visited an OsteoStrong location in Albuquerque, New Mexico and began communication with regional developers, Sean and Charla Simpson (the Simpsons) about a potential franchise. Nixon executed a non-disclosure agreement (NDA), agreeing not to share confidential information disclosed to her by OsteoStrong. Nixon was interested in OsteoStrong's BioDensity equipment, which is manufactured and sold by Performance Health Systems, an unrelated third party. Nixon and her husband, Roland Richter (Richter), owned a Santa Fe restaurant. In May 2016, Nixon indicated that she planned on opening an OsteoStrong

center in Santa Fe. In June 2016, she issued a second statement regarding the same in the restaurant newsletter.

OsteoStrong then informed Nixon that it would no longer be using the BioDensity equipment and would instead use its own proprietary equipment, even though it was prohibited by a restraining order from marketing or selling such equipment at the time. Nixon and Richter submitted a franchise application on July 5, 2016, which OsteoStrong ultimately rejected because Nixon and Richter would not attest to a merger clause due to oral representations from the franchisor's representatives that were inconsistent with the information in the application.

About six months after OsteoStrong rejected Nixon and Richter's franchise application, they opened DancingBones, LLC (DancingBones), an independent business utilizing BioDensity equipment, in a location close to their restaurant. Although there was no OsteoStrong location in Santa Fe at the time, Dr. Lawrence Canfield opened one in June 2018 and was aware of DancingBones when he opened the facility. After the opening of Dr. Canfield's facility, the defendants were involved in litigation with the Simpsons for misappropriation of confidential, proprietary, and trade secret information, which included the same twelve categories of misappropriation asserted by OsteoStrong in this case—for example, confidential call scripts, a pro forma, company documents, and lead generation techniques. That litigation settled.

OsteoStrong filed this case alleging that the defendants (1) misappropriated OsteoStrong's proprietary information and trade secrets to launch their own competing business and (2) advertised using OsteoStrong's mark and manipulated internet searches such that the defendants' business address appeared in place of OsteoStrong's in violation of both federal and New Mexico law. The complaint asserted claims for misappropriation under the Defend Trade Secrets Act of 2016 (DTSA) and the New Mexico Uniform Trade Secrets Act (NMUTSA); breach of contract; unfair competition under the Lanham Act; and trademark infringement under the Lanham Act. The defendants moved for summary judgment on all claims.

First, the court granted summary judgment in favor of the defendants on OsteoStrong's trade secret misappropriation claim under the DTSA and NMUTSA. The NMUTSA and the DTSA define trade secrets similarly, which fundamentally requires confidentiality and value. The plaintiff maintained that it took reasonable steps, including requiring an NDA, to safeguard the confidentiality of its information. However, the court agreed with the defendants' assertion that the plaintiff failed to demonstrate that the defendants ever received or used confidential information and further failed to specify what trade secrets were allegedly misappropriated by the defendants.

The court discussed that neither the defendants nor the Simpsons could adequately set forth specifics as to what information constituted a trade

secret, and the plaintiff did not provide evidence that the defendants used the confidential information (beyond setting up the DancingBones entity). Dr. Canfield's separate testimony did not support the plaintiff's claim. Dr. Canfield testified that the training included both confidential and non-confidential information and that proprietary data was only available via a secure server on the plaintiff's web portal. He also testified that he was not informed by OsteoStrong that call scripts were confidential or secret. In addition to the plaintiff's failure to substantiate its claim or meet its burden to oppose summary judgment, the plaintiff did not cite any cases in support of its assertions and looked only to the definition of trade secrets under the DTSA and NMUTSA. Because of the plaintiff's evidentiary shortcomings, coupled with the defendant's evidence, the court granted summary judgment in defendant's favor on the plaintiff's misappropriation claims under the DTSA and NMUTSA.

Next, the court granted the defendants' motion for summary judgment on the plaintiff's breach of contract claim. The plaintiff relied on a non-compete provision in two NDAs the defendants executed in 2016, but it failed to demonstrate what trade secrets were at issue and what confidential information was purportedly disclosed to the defendants and thereafter misappropriated.

The court also granted the defendants' motion for summary judgment on the plaintiff's claim that the defendants unfairly competed in violation of the Lanham Act, 15 U.S.C. § 1125. The plaintiff alleged that the defendants "misappropriated OsteoStrong's goodwill for their own benefit" when DancingBones advertised that they were opening an OsteoStrong location in Santa Fe, and pointed to the NDA language that Nixon signed when she visited the Albuquerque OsteoStrong as a customer, which did not include any geographical or temporal restrictions. In New Mexico, a restrictive covenant is enforceable within "reasonable limits of time and space." The court held that this blanket non-compete provision, required by a "mere expression of interest" in a potential business opportunity, was unreasonable. The court then expressed dissatisfaction with the threadbare and confusing allegations in OsteoStrong's complaint on this count, and OsteoStrong's failure to speak to the validity of the non-compete provision in response to the defendants' motion. The court therefore granted summary judgment in favor of the defendants.

Last, the court also granted summary judgment in favor of the defendants on the plaintiff's trademark infringement claim. The plaintiff argued that the defendants caused consumer confusion "as to the origin of the respective parties' services" and that the defendants misappropriated the plaintiff's goodwill. The defendants asserted that this claim was based only the announcement by Nixon in the restaurant newsletter of her plans to open an OsteoStrong center in Santa Fe.

The court examined the elements of a trademark infringement violation under 15 U.S.C. § 1114(1). First, the defendants argued that the plaintiff did not establish the requisite intent element because the newsletter was

circulated prior to the signing of a franchise agreement with the plaintiff, and the defendants did intend to follow through with a franchise, which was evidenced by the execution of the franchise application after the announcement. Second, the defendants asserted that the plaintiff did not demonstrate consumer confusion, when it claimed that internet search engine results for "OsteoStrong Santa Fe" returned the contact information for DancingBones and the archived copies of the defendants' newsletters. Nixon's newsletters preceded the opening of any location, and thus, she did not have contact information at the time. Further, OsteoStrong offered no evidence that the erroneous search results were caused by or the responsibility of the defendants. Instead, OsteoStrong's response was replete with procedural deficiencies, including noncompliance with the local rules, and conclusory statements of fact without appropriate citations to the record. In light of OsteoStrong's legal and evidentiary deficiencies, the court grated the defendants' summary judgment motion on OsteoStrong's trademark infringement claim.

Accordingly, the court granted summary judgment on all of OsteoStrong's claims in favor of the would-be franchisee.

***Smash Franchise Partners, LLC v. Kanda Holdings, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,709, 2020 WL 4692287 (Del. Ch. Aug. 13, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

UNFAIR COMPETITION/UNFAIR AND DECEPTIVE PRACTICES

***Arruda v. Curves International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,692, 2020 WL 4289380 (W.D. Tex. July 27, 2020)**
This case is discussed under the topic heading "Statutory Claims."

***Elsayed v. Family Fare LLC*, Bus. Franchise Guide (CCH) ¶ 16,707, 2020 WL 4586788 (M.D.N.C. Aug. 10, 2020)**
This case is discussed under topic heading "Labor and Employment."

***Midway Labs USA, LLC, v. South Service Trading, S.A.*, Bus. Franchise Guide (CCH) ¶ 16,660, 2020 WL 2494608 (S.D. Fla. May 14, 2020)**
This case is discussed under the topic heading "Damages."

***Nevada DeAnza Family Ltd. Partnership v. Tesoro Refining & Marketing LLC*, Bus. Franchise Guide (CCH) ¶ 16,697, 2020 WL 4284827 (N.D. Cal. Jul. 27, 2020)**
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***OsteoStrong Franchising, LLC v. Richter*, Bus. Franchise Guide (CCH) ¶ 16,706, 2020 WL 4584007 (D.N.M. Aug. 10. 2020)**
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***Smash Franchise Partners, LLC v. Kanda Holdings, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,709, 2020 WL 4692287 (Del. Ch. Aug. 13, 2020)**
This case is discussed under the topic heading "Injunctive Relief."

VICARIOUS LIABILITY

***Hayhurst v. Keller Williams Realty, Inc.*, Bus, Franchise Guide (CCH) ¶ 16,690, 2020 WL 4208046 (M.D.N.C. July 22, 2020)**
This case is discussed under the topic heading "Statutory Claims."

***S.J. v. Choice Hotels International, Inc.*, Bus. Franchise Guide (CCH) ¶ 16,689, 2020 WL 4059569 (E.D.N.Y. July 20, 2020)**
This case is discussed under the topic heading "Statutory Claims."