WHEN CHANGES IN THE LAW
BRING ON CHANGES IN THE SYSTEM

Ted P. Pearce
Driven Brands, Inc.

and

Joel R. Buckberg
Baker Donelson Bearman Caldwell & Berkowitz, P.C.

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# TABLE OF CONTENTS

**I.** INTRODUCTION .................................................................................................................. 3

**II.** CONSTITUTIONAL CHANGE – THE DEATH AND REBIRTH OF THE IN-TERM COVENANT AGAINST COMPETITION IN GEORGIA ................................................................. 4

**III.** RESALE PRICE MAINTENANCE WITH AND SINCE THE LEEGIN CASE ................... 12

  The Federal Agencies. .............................................................................................................. 13

**IV.** NEW YORK SALES TAX REPORTING STATUTE AND REPORTING/AUDITING REQUIREMENTS .............................................................................................................................. 14

  A. Information Required to be Provided on the Returns. ....................................................... 15

  B. Other Issues. ....................................................................................................................... 17

**V.** EMPLOYMENT LAW CHANGES ...................................................................................... 18

  A. Massachusetts Worker’s Compensation Statute. ............................................................... 18

  B. How Franchisors Become Tangled in the Employment Web ........................................... 20

**VI.** ARBITRATION AFTER *NINO V. JEWELRY EXCHANGE* ........................................... 22

**VII.** VICARIOUS LIABILITY ................................................................................................ 23


**VIII.** TAXATION WITHOUT REPRESENTATION – *KFC CORP. V. IOWA DEPARTMENT OF REVENUE* ....................................................................................................................... 28

**IX.** PATIENT PROTECTION AND AFFORDABLE CARE ACT .......................................... 30

**X.** BUSINESS MODEL OBsolescence: PROFound EFFECTS ON THE SYSTEM BUSINESS MODEL FROM CHANGES IN THE LAW ..................................................................................... 31

  A. Non-working Models. ......................................................................................................... 31

  B. Tanning Bed Prohibitions. ................................................................................................ 32

**XI.** CHANGES IN SOCIAL MEDIA LAWS AND LAWS GOVERNING CUSTOMER DATA INTERCHANGE BETWEEN FRANCHISEES AND FRANCHISOR ........................................ 33

**XII.** ARIZONA IMMIGRATION LAW .................................................................................... 36

  A. *Arizona Contractors Association, Inc. v. Candelaria*, .................................................... 36

  B. *Chicanos Por La Causa, Inc. v. Napolitano* ................................................................... 38

XIII.  FTC GUIDELINES ON TESTIMONIALS AND ENDORSEMENTS .................................41

XIV.  CAN SPAM ACT ........................................................................................................43
I. INTRODUCTION

Franchisors offer and sell franchises for long terms, often 15 or 20 years. This practice facilitates financing, particularly for bricks and mortar stores and large capital investment franchises. Even the Internal Revenue Code contemplates a 15 year life span for franchises, mandating amortization of intangible initial franchise fees over the fifteen year period. Given the rapid pace of technological and societal change on worldwide basis, how can the drafter of a franchise agreement predict with certainty whether the underlying legal and factual assumptions embedded into the logic of the contractual terms will survive for the duration of the term? If such assumptions suffer modest or catastrophic change, will the franchise concept or the franchise contract survive? What would be the impact of such a change on the franchise relationship and the relative rights, responsibilities and risk allocations between franchisor and franchisee?

The permutations and possibilities of major legal environmental change are infinite. Rather than focus on abstract change and speculation or the legal doctrines of commercial frustration or commercial impossibility, we chose to focus on concrete examples of legal environment precedents that impact how franchise systems may operate. Some of these are franchise-centric, and others affect a broader segment of businesses and employers. In each case, the change will or could affect the strategy, tactics or culture of affected franchise systems.

The only constant in life is change. For both franchisees and franchisors that form the basis of a franchise system, the one sure thing that they can each count on during the tenure of their franchise relationship is that the franchise system that existed at the time that they came together surely will not be same as the franchise system at the time the relationship ends. If either the franchisee or the franchisor believes that the franchise system will not undergo change during term of the franchise agreement then their belief is likely to be unrealistic.

Franchise systems exposed to ever changing markets must also deal with the ever changing legal-grid. When a franchisor composes its franchise agreement, management and its advisors must try to not only anticipate changes in the market but to the extent that the team is able, it must reckon with the changing legal landscape. Likewise, the franchisee must be both adaptive and prepared to make changes in the manner that it conducts the franchised business. Either party gains little solace in blaming the other party for necessary adaptation to the changes in the franchise system. What franchisee and franchisor must both do is to understand how these changes can be integrated into their business model.

This paper will address the recently changing legal landscape from the perspectives of both the franchisee and the franchisor, but most importantly from the perspective of the franchise business model. Recent changes to time honored traditions in the antitrust law as well as the sea change brought about by the Patient Protection and Affordable Care Act are just two examples of legal adaptations that franchisees and franchisors must undergo to keep their franchise business model relevant. The focus of this paper will focus primarily on the potential effects that these legal changes will have on franchising rather than presenting a detailed analysis of the new laws and judicial decisions. In some cases the legal changes will provide a franchisor more flexibility to operate their system in a more competitive manner, to which

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1 The authors wish to thank Brian Romanzo, Associate General Counsel for Driven Brands, Inc. and Christine Bocek of the University Of Mississippi School Of Law for their assistance with the research and drafting of this paper.

2 See Internal Revenue Code §§ 197(f); 263A; Treas. Reg. § 1.197; 1.263A.
franchisees may object. Conversely, other legal changes will place franchisors in a more serious zone of legal danger than they have experienced in the past. Yet with other legal changes it will behoove the franchisor and the franchisee to embrace those changes in a cooperative manner in order to avoid government, judicial or private interference in the manner in which they conduct business. In all cases, the ever changing legal environment will need to be addressed in tandem by both the franchisee and the franchisor.

II. CONSTITUTIONAL CHANGE – THE DEATH AND REBIRTH OF THE IN-TERM COVENANT AGAINST COMPETITION IN GEORGIA

Franchise agreements in business format systems without proprietary product differentiation traditionally include both in-term and post-term non-competition covenants to protect the system from competition from within – by franchisees who leverage the training, information and experience learned in the operation of their franchise businesses- to operate parallel or copycat businesses under different names. Unlike multi-unit, multi-brand franchisees that deploy different franchises in different locations, the copy-cat store devalues the brand by populating potential growth markets with competitors offering substitutable services. Franchisors argue that but for the learning curve offered by the franchise system experience to the operator, no such store would have been opened by the operator. The negative cannot be disproven unless the operator has prior business experience in the same line of business and a track record of success. When growth of the franchise system is blunted by home grown copy-cats, all franchisees suffer from lesser marketing fund contributions and loss of benefit from the "billboard effect" of simply having open locations with brand signage in more markets.

Franchisees argue that as long as they are not violating any confidentiality undertaking regarding proprietary information and competing with their own stores, they should suffer no restriction on their ability to open and operate any lawful business at their own risk and expense. The price paid in fees to the franchisor reflects the market price for the value of the services provided to and intellectual property licensed to the franchisee, for the franchised location.

In Atlanta Bread Company International, Inc. v. Lupton-Smith, the Georgia Supreme Court affirmed the Georgia Court of Appeals holding that Atlanta Bread's in-term covenant not to compete was unenforceable.\(^3\) Sean Lupton-Smith ("Smith") was the owner of five fast casual restaurant franchises granted by Atlanta Bread Company International, Inc. ("Atlanta Bread").\(^4\) Atlanta Bread moved to terminate the franchise agreements on the grounds that Smith violated the in-term non-competition covenant because he was operating a competing business, PJ's Coffee and Lounge.\(^5\) Smith filed a complaint and obtained a temporary restraining order, but, when the order was lifted, Atlanta Bread acquired the five stores from Smith for $840,000.\(^6\) Subsequently, Smith amended his complaint and sought damages for wrongful termination of the franchise agreements.\(^7\) The Court of Appeals found that the non-competition covenants in the franchise agreement were unreasonable under Georgia law and therefore unenforceable, but the non-disclosure restriction was enforceable as to Atlanta Bread's trade secrets.\(^8\)

\(^3\) 679 S.E.2d 722, 725 (Ga. 2009).
\(^5\) Id. at 744.
\(^6\) Id. at 744-45.
\(^7\) Id.
\(^8\) See Atlanta Bread Co. Int'l v. Lupton-Smith, 663 S.E.2d 743 (Ga. Ct. App. 2008). The three clauses stated:
Practitioners were of the view that until the *Atlanta Bread* ruling, an in-term non-competition covenant was not subject to the same scrutiny and analysis as the post-term covenant, and was generally thought to be enforceable.

The Court of Appeals referred to the three contract provisions at issue as Restrictions 1 through 3. The opinion relied on *Jackson & Coker, Inc. v. Hart*, stating that the Court declined to "enforce a franchise agreement restrictive covenant, even an in-term covenant, restricting trade unless the restrictive covenant meets the reasonableness standards promulgated in Georgia." For a restrictive covenant to be reasonable, it must provide specific limitations as to scope, time and territory. The Court of Appeals found that Restriction 1 (listed as "a" in the agreement), failed to "specify with particularity the nature of the business activities in which Smith was forbidden to engage" and was, therefore, unreasonable. Restriction 1 also lacked the necessary territorial restriction, and the Court of Appeals held that the covenant was in restraint of trade and unenforceable. In its opinion, the Court of Appeals gave several examples of when the language in Restriction 1 might prohibit acts such that it was unreasonable. For instance, the court stated:

If Smith were to own an interest in a coffee shop that sold baked goods purchased from an unrelated supplier, in an area where Atlanta Bread Company did not compete, Smith would still be in violation of Restriction 1. Likewise, if Smith were to take a position of janitor in a deli, he also would be in violation of Restriction 1.

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a. During the term of this Agreement, neither Franchisee nor any Principal Shareholder, for so long as such Principal Shareholder owns an Interest in Franchisee, may, without the prior written consent of Franchisor, directly or indirectly engage in, or acquire any financial or beneficial interest in (including any interest in corporations, partnerships, trusts, unincorporated associations or joint ventures), advise, help, guarantee loans or make loans to, any bakery/deli business whose method of operation is similar to that employed by store units within the System.

b. Neither Franchisee, for one (1) year following the termination of this Agreement, nor any Principal Shareholder, for one (1) year following the termination of all of his or her Interest in Franchisee or in the termination of this Agreement, whichever occurs first, may directly or indirectly engage in, or acquire any financial or beneficial interest in (including any interest in corporations, partnerships, trusts, unincorporated associations or joint ventures), advise, help, guarantee loans or make loans to, any bakery/deli business whose method of operation is similar to that employed by bakery/deli stores within the System which is located within a twenty (20) mile radius of any store unit within the System.

c. Neither Franchisee nor any Shareholder shall at any time (i) appropriate or use the trade secrets incorporated in the System, or any portion thereof, in any business which is not within the System, (ii) disclose or reveal any portion of the System to any person, other than to Franchisee's Store employees as an incident of their training, ... (iv) communicate, divulge or use for the benefit of any other person or entity any confidential information, knowledge or know-how concerning the methods of development or operation of a store utilizing the System, which may be communicated by Franchisor in connection with the franchise granted hereunder.


10 *Atlanta Bread*, 679 S.E.2d at 724.

11 *Atlanta Bread*, 663 S.E.2d at 747.

12 *Id.* at 748.

13 *Id.* at 747.
The Court further found that Restriction 2 was unreasonable because it contained "shifting and expanding territorial restrictions so that the restriction could not "be determined until the date of the [franchisee's] termination" and was "too indefinite to be enforced." 14 "If the covenant allows territories to be added during the course of the agreement, the covenant is unenforceable." 15 Finally, the Court of Appeals found that Restriction 3, the non-disclosure clause, because it lacked a time limitation, was only enforceable as to trade secrets as defined in the Georgia trade secret statute, O.C.GA. § 10-1-761(4).

On appeal to the Supreme Court of Georgia, the issue was whether the Court of Appeals had erred in finding that the in-term covenant not to compete was unreasonable and an unenforceable restraint on trade. 16 The Supreme Court found that the in-term non-compete was subject to strict scrutiny, stating that there was "no distinction as to the level of scrutiny applied based on whether the restraint occurs during the term of the agreement or after the agreement has been terminated." 17 The opinion harps on the public policy of Georgia against restraints on trade "designed to lessen competition," 18 and states that a "non-competition covenant entered into in connection with a franchise or employment contract is enforceable, but only where it is strictly limited in time and territorial effect and is otherwise reasonable considering the business interest of [the party] sought to be protected and the effect on the franchisee." 19 The Court cited the Georgia Constitution, 20 and stated "this Court has rejected a legislative attempt to usurp the application of standards of reasonableness to noncompetition covenants in employment agreements and, by extension, in franchise agreements." 21 The Court then affirmed the Court of Appeals, finding the Restrictive Covenant 1 unreasonable because it lacked a territorial limitation, and further finding that "blue-pencil doctrine of severability" could not be applied to in

14 Id. at 748 (quoting Koger Properties v. Adams-Cates Co., 274 S.E.2d 329 (Ga. 1981)).

15 Id.

16 Atlanta Bread, 679 S.E.2d 722, 723.

17 Id. at 725.

18 Id. at 724.

19 Id. (quoting Allen v. Hub Cap Heaven, Inc., 484 S.E.2d 259 (1997)).

20 Ga. Const. of 1983, Art. III, Sec. VI, Par. V(c)("The General Assembly shall not have the power to authorize any contract or agreement which may have the effect of or which is intended to have the effect of defeating or lessening competition, or encouraging a monopoly, which are hereby declared to be unlawful and void.").

21 Atlanta Bread, 679 S.E.2d at 724-25 (referring to the Georgia Supreme Court's ruling in Jackson & Cowart, Inc. v. Hart which found section 13-8-2.1 of the Georgia Code unconstitutional).

22 Restrictive Covenant 1:

During the term of this Agreement, neither Franchisee nor any Principal Shareholder, for so long as such Principal Shareholder owns an Interest in Franchisee, may, without the prior written consent of Franchisor, directly or indirectly engage in, or acquire any financial or beneficial interest in (including any interest in corporations, partnerships, trusts, unincorporated associations or joint ventures), advise, help, guarantee loans or make loans to, any bakery/deli business whose method of operation is similar to that employed by store units within the System.

Id. at 723.
term restraints in a franchise agreement so that a court could not insert a territorial limitation to render the provision enforceable.23

In response to the Supreme Court's ruling, the General Assembly enacted HB 173 in 2009, dealing with restrictive covenants. It was "contingently effective on the passage of a constitutional amendment."24 In 2010, the General Assembly enacted HR 178, the constitutional amendment needed for HB 173, and the voters of Georgia "ratified the constitutional amendment on November 2, 2010."25 "It has been suggested by certain parties that because of the effective date provisions of HB 173, there may be some question about the validity of that legislation. It is the intention of this Act to remove any such uncertainty by substantially reenacting the substantive provisions of HB 173."26 House Bill 30 contains changes to Code section 13-8-2, as well as the repeal of Article 4 and replacement of those provisions.27 The new statutes largely try to replace, and in several instances are directly contrary to, the case law relied upon by the courts in Atlanta Bread.

First, the amendment to the Georgia Constitution accomplished a delegation of authority to the Georgia legislature to manage restrictive covenants, replacing judicial interpretation of the Constitution as the means of providing certainty about the law. Ga. Const. of 1983, Art. III, Sec. VI, Par. V(c), which once stated "The General Assembly shall not have the power to authorize any contract or agreement which may have the effect of or which is intended to have the effect of defeating or lessening competition, or encouraging a monopoly, which are hereby declared to be unlawful and void" now instead reads as follows "(c) (1) The General Assembly shall not have the power to authorize any contract or agreement which may have the effect of or which is intended to have the effect of encouraging a monopoly, which is hereby declared to be unlawful and void."

Second, the new Article 4 statutes on "Restrictive Covenants in Contracts" make several important changes that expand the concept of reasonableness of a restrictive covenant, create presumptions that are beneficial to the party seeking to enforce the covenant, and allow courts to modify restraint provisions that do not comply with the provisions of section 13-8-53.28 The General Assembly explained its motivation for changing the statutes in section 13-8-50:

The General Assembly finds that reasonable restrictive covenants contained in employment and commercial contracts serve the legitimate purpose of protecting legitimate business interests and creating an environment that is favorable to attracting commercial enterprise to Georgia and keeping existing businesses within the state. Further, the General Assembly desires to provide statutory guidance so that all parties to such agreements may be certain of the validity and enforceability of such provisions and may know their rights and duties according to such provisions.29

23 Id. at 725. "[T]he blue pencil marks, but it does not write." Id. (quoting New Atlanta Ear, Nose & Throat Assoc., P.C. v. Pratt, 560 S.E.2d 268 (2202).
28 See GA. CODE ANN. §§13-8-53 to 13-8-56.
29 GA. CODE ANN. §13-8-50.
Section 13-8-53 provides that "[n]otwithstanding any other provision of this chapter, enforcement of contracts that restrict competition during the term of a restrictive covenant, so long as such restrictions are reasonable in time, geographic area, and scope of prohibited activities, shall be permitted." While the statute eases requirements for covenants during the in-term period, it also limits the types of employees against which covenants that restrict competition after the term of employment may be held. The requirements for designating the scope of the restrictive covenant are set forth in Section 13-8-53(c)(1)-(3). "Whenever a description of activities, products, or services, or geographic areas, is required by the Code section, any description that provides fair notice of the maximum reasonable scope of the restraint shall satisfy such requirement, even if the description is generalized and could possibly be stated more narrowly to exclude extraneous matters." Additionally, Section 13-8-53(c)(2) states:

(2) Activities, products, or services shall be considered sufficiently described if a reference to the activities, products, or services is provided and qualified by the phrase 'of the type conducted, authorized, offered, or provided within two years prior to termination' or similar language containing the same or a lesser time period. The phrase 'the territory where the employee is working at the time of termination' or similar language shall be considered sufficient as a description of geographic areas if the person or entity bound by the restraint can reasonably determine the maximum reasonable scope of the restraint at the time of termination.

These requirements are less strict than those held by the Georgia Supreme Court, in that they do allow for change to territory and scope during the duration of the restrictive covenant, without such change rendering the covenant void and unreasonable. Section 13-8-53(d) then finds "[a]ny restrictive covenant not in compliance with the provisions of this article" unlawful, void and unenforceable. However, subsection (d) also allows a court to modify "a covenant that is otherwise void and unenforceable so long as the modification does not render the covenant more restrictive with regard to the employee than as originally drafted by the parties." This contradicts the Georgia Supreme Court's holding in Atlanta Bread, overruling long-held judicial principles of restraint that precludes use the judicial blue pencil doctrine to try and fix or save a covenant that is found to be unenforceable as drafted.

Interestingly, the General Assembly also included language allowing a court to modify a contractually specified restraint in section 13-8-54(b). It states:

In any action concerning enforcement of a restrictive covenant, a court shall not enforce a restrictive covenant unless it is in compliance with the provisions of Code Section 13-8-53; provided, however, that if a court finds that a contractually specified restraint does not comply with the provisions of Code Section 13-8-53, then the court may modify the

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30 GA. CODE ANN. §13-8-53(a).
31 GA. CODE ANN. §13-8-53(a).
32 GA. CODE ANN. §13-8-53(c)(1).
33 GA. CODE ANN. §13-8-53(c)(2).
34 GA. CODE ANN. §13-8-53(d).
35 Id.
36 See Atlanta Bread, 679 S.E.2d at 725.
restraint provision and grant only the relief reasonably necessary to protect such interest or interests and to achieve the original intent of the contracting parties to the extent possible.\textsuperscript{37}

We note that the statute uses the permissive "may" instead of mandating that the court must blue pencil, in deference to the Georgia Supreme Court's sentiment in \textit{Atlanta Bread} and other case law to the effect that judicial reluctance to use the blue pencil power granted legislatively will remain. The approach reflects Georgia's tradition and philosophy of conservative jurisprudence, reflected in an unwillingness to legislate or second guess business decision makers.

The final major change, in contradiction to Atlanta Bread, are the presumptions set forth in section 13-8-56. The statute provides that "[i]n determining the reasonableness of a restrictive covenant that limits or restricts competition during or after the term of an employment or business relationship, the court shall make the following presumptions:

(1) During the term of the relationship, a time period equal to or measured by duration of the parties' business or commercial relationship is reasonable . . .\textsuperscript{38}

(2) A geographic territory which includes the areas in which the employer does business at any time during the parties' relationship, even if not known at the time of entry into the restrictive covenant, is reasonable provided that:

(A) The total distance encompassed by the provisions of the covenant also is reasonable;

(B) The agreement contains a list of particular competitors as prohibited employers for a limited period of time after the term of employment or a business or commercial relationship; or

(C) Both subparagraphs (A) and (B) of this paragraph;

(3) The scope of competition restricted is measured by the business of the employer or other person or entity in whose favor the restrictive covenant is given; provided, however, that a court shall not refuse to enforce the provisions of a restrictive covenant because the person seeking enforcement establishes that a restrictive covenant has been violated but has not proven that the covenant has been violated as to the entire scope of the prohibited activities of the person seeking enforcement or as to the entire geographic area of the covenant; and

(4) Any restriction that operates during the term of [a] . . . franchise . . .shall not be considered unreasonable because it lacks any specific limitation upon scope of activity, duration, or geographic area so long as it promotes or protects the purpose or subject matter of the agreement or relationship or deters any potential conflict of interest."\textsuperscript{39}

\textsuperscript{37} \textsc{Ga. Code Ann.} §13-8-54(b)(emphasis added).


\textsuperscript{39} \textsc{Ga. Code Ann.} §13-8-56.
These provisions collectively overturn the Georgia Supreme Court in *Atlanta Bread*, but they should also be discussed separately.

Part (1) changes the parameters for duration in a restrictive covenant to cover the entire term of the franchise, but the duration was not reached in *Atlanta Bread*, as the geographical and scope requirements were unreasonable.

Part (2) addresses geographic territory and the statute directly conflicts with *Koger Properties* and its progeny, as well as the holding in *Atlanta Bread*.\(^{40}\) This allows the geographic territory to change and to include "the areas in which the employer does business at any time during the parties’ relationship," as opposed to the approach in *Koger* that required the geography be set at the point the parties entered the covenant.\(^{41}\) *Koger*, relied on by *Atlanta Bread*, specifically held that "[i]f the covenant's language allows territories to added during the course of the agreement, the covenant is unenforceable."\(^{42}\) The primary reason that the Georgia Supreme Court found the restrictive covenant in Atlanta Bread unreasonable was it lacked "any territorial limitation." This reasoning affirmed the Court of Appeals, which had found that the language allowed the area covered by the covenant to expand as Atlanta Bread added restaurants and contained "'shifting and expanding' territorial restrictions."\(^{43}\)

The other problem with the restrictive covenants in Atlanta Bread is resolved by Part (3) of section 13-8-56. It allows the scope of the competition restricted to be measured by the business of the employer, which may contradict the *Atlanta Bread* holding. The Court of Appeals in *Atlanta Bread* stated that Restriction 1, beyond its lack of territorial limitation, also failed to define the bakery/deli business and to specify the restricted activities with sufficient particularity.\(^{44}\) Though Part (3) does not state that there is no longer a requirement that a party list the specific activities to be restricted, it does appear to include all business in which an employer engages in that list.

Finally, Part (4) throws the specificity requirements and seemingly stringent requirements discussed in Atlanta Bread out the window by stating that so long as the restriction "promotes or protects the purpose or subject matter of the agreement or relationship or deters any potential conflict of interest" it is reasonable despite shortcomings in specifying scope, duration or geographic area.

Thus, the changes made by the Georgia legislature and the Georgia voters, in amending the state constitution, have largely taken the sting out of *Atlanta Bread Company International, Inc. v. Lupton-Smith*, on paper. However, it remains to be seen whether the courts will refuse to assert their new powers in interpreting the new statutes so as to frustrate legislative intentions, or, alternatively, if they will refuse to exercise the powers granted within the statutes, for instance the newly authorized blue pencil provisions. The Georgia legislature stated in section 13-8-50, its intent to alter the anti-business stance of *Atlanta Bread* by "creating an environment

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\(^{40}\) *Koger Properties*, 274 S.E.2d 329; *Atlanta Bread*, 663 S.E.2d 743; *Atlanta Bread*, 679 S.E.2d 722.

\(^{41}\) *GA. CODE ANN.* §13-8-56(2); *Koger Properties*, 274 S.E.2d 329.

\(^{42}\) *Atlanta Bread*, 663 S.E.2d 743, 748 (quoting *Koger Properties*, 274 S.E.2d 329).

\(^{43}\) *Atlanta Bread*, 663 S.E.2d at 747-48 (quoting New Atlanta Ear, Nose & Throat Assoc. v. Pratt, 560 S.E.2d 268).

\(^{44}\) *Atlanta Bread*, 663 S.E.2d at 747.
that is favorable to attracting commercial enterprise and keeping existing business within the state.45

The uncertainty affecting Georgia franchising since Atlanta Bread remains after this intensive period of activity on the legislative and constitutional fronts. The judicial implementation of the statute and the constitutional amendment may be tinged with nostalgia for the judicial policymaking of Atlanta Bread and its antecedents. The people of Georgia have spoken clearly in favor of reasonable restraints to protect businesses subject to Georgia law from "internal" competition. The practical issue with Atlanta Bread and its "fixed point in time" approach was the presumption of static business relationships as of inception of the contract. While this concept is not unmanageable in the employment context, where short term contracts and employment at will make constant administration of covenants the norm, the long term nature of franchise agreements argue strongly for distinguishing these two genres. Franchisees can obtain current information about the location of existing units daily from the brand web site, and the Franchise Disclosure Document ("FDD") lists development transactions and the locations of existing units to provide certainty at any point in time. With the disclosures in Items 12, 17 and 20, a franchisee has the information needed to decide whether the restrictive covenant will be acceptable at the inception, and the exact nature of the restrictions at any point during the term.

Other than California, the authors are not aware of any other state that refuses to enforce in-term non-competition agreements, although Indiana and Texas essentially limit in-term non-competition covenants to the same area as the exclusive area granted to the franchisee.46 Other states impose statutory restrictions on non-competition covenants as restraints of trade. Practitioners understand that enforceability of covenants in states other than California cannot be predicted with certainty, because so much of enforceability depends on the facts and circumstances of each particular enforcement action.

While the details associated with Atlanta Bread are significant in their own right, the lesson for practitioners representing the franchisor assigned to create brand-protection covenants must plan for the eventuality that the covenant will not be enforced as written, if at all. A brand protection covenant plan must then cover separately the alternative means by which an existing or terminated franchisee could compete with the franchise system. Practitioners understand that confidentiality agreements and covenants are inherently limited in their application and difficult to enforce unless the breach is patently obvious and efforts to disguise the purloined material ineffective. The keys to protecting the system from internecine competition then depend on covenants to prevent solicitation of customers and system employees for a competing business. Those covenants may not be meaningful deterrents to fellow franchisees who wish to operate competitive businesses. The best protection, besides a proprietary product or supply chain that differentiates the brand from its competitors, is a system with few open spaces in its system map. Even those measures may not be enough protection if franchisees can harvest their training and knowledge for similar business opportunities. For a system in a state where in-term covenants are limited or unenforceable, the sharing of unit performance information or benchmarking data may need to be limited or avoided, as strong performers shown on brand performance data reports identify markets where non-system competition may be promising.

45 GA. CODE ANN. §13-8-50.

There are many instances where a franchisor may wish to market its products through its franchisees at a standard minimum price in order to present a consistent price point to the brand’s retail consumers. Prior to the Leegin case, franchisors were constrained from enforcing a minimum price structure other than through the Colgate doctrine or through Minimum Advertising Price (“MAP”) programs. Even in the instance where discussions were had with the non-conforming franchisee there was a risk that the franchisor would unknowingly enter into a vertical pricing arrangement that would be characterized as a Resale Price Maintenance Agreement (“RPM”) violative of the antitrust laws.

Before the Leegin case if a manufacturer or retailer entered into a vertical agreement to set resale prices such vertical pricing agreements were deemed to be a per se violation of the antitrust laws. Under these laws a manufacturer or retailer was prevented from entering into an agreement with either its distributor or manufacturer to set either minimum or maximum prices. The issue of maximum prices was settled in 1997 with the Kahn case, where such arrangements would be decided on a rule of reason basis, thus abandoning the per se standard of review. Then in 2007 the Supreme Court in Leegin found that minimum pricing arrangements also should be considered on a rule of reason basis, thus ostensibly giving a manufacturer and retailer greater latitude to set minimum prices in which to sell their products or services. After having lost at the trial and the appellate level, Leegin decided to focus its appeal on whether its conduct of setting minimum prices should be judged on a per se or rule of reason basis. Justice Kennedy writing for the majority agreed with Leegin and held that the rule of reason analysis should prevail. In reaching that conclusion, the Court identified two factors where RPM could be deemed to be anti-competitive: 1) what party, the supplier or the retailer, initiated the restrictive agreement; and (2) whether the party initiating the restrictive price enjoys market power.

Not all of the judges aligned themselves with Justice Kennedy. In his dissent, Justice Breyer estimated that minimum resale price restrictions could add $300 billion to annual consumer costs.

On its surface the Leegin decision would seem to provide franchisors with sufficient latitude to require their franchisees to adjust their prices to a minimum level when the franchisor believes that charging a minimum price would be in the best interests of its retail customers and thus pro-competitive, presumably to the benefit of the franchisees. Without this mechanism franchisors would argue that it would be difficult to use the pricing mechanics of their chain to be competitive and provide support for the service levels needed to sell and support their products. Conversely, franchisees are prone to argue that requiring them to charge a minimum price for

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51 Leegin Creative Leather Products, Inc., 551 U.S. at 907.
52 Id.
53 Id. at 893-894.
54 Id. at 926.
their products or services would undermine their competitive abilities in the market place. This dynamic tension would continue to exist as it had with the advent of the Khan decision.

More than push-back from its franchisees, franchisors should expect push-back on minimum pricing from the several states, and from the Federal agencies if the policy is motivated by anti-competitive, not pro-competitive factors. The rule of reason does not translate into per se legal for minimum resale prices. Some of the more pronounced objections to the Leegin case have been from Maryland. At the present time, this State is the only state that explicitly prohibits RPM. The Maryland Commercial Code provides that any contract, combination, or conspiracy that sets minimum prices constitutes an unreasonable restraint of trade.\(^{55}\) Both New York and New Jersey also look disfavorably upon RPM, and while finding such conduct illegal they have not explicitly found them to be per se illegal.

In addition to Maryland, New Jersey and New York other States have fallen in line behind the Breyer dissent and have found or seek to enforce their state laws that provide that RPM is per se illegal or otherwise enforceable.\(^{56}\)

**The Federal Agencies.**

Both federal agencies charged with enforcing the antitrust laws, the FTC and the Department of Justice, have taken different approaches to addressing Resale Price Maintenance agreements. The FTC in the case of *Nine West Group, Inc.* FTC Docket No. c-3937 (May 6, 2008) took the position that because Nine West had not initiated RPM on its own, lacked dominant market share, and there was no dominant retailers involved in Nine’s Action there was no finding of a per se violation of the RPM. That being said however, the FTC required Nine West to file periodic reports describing its use of RPM and the resulting effects on its prices and sales.\(^{57}\)

The Justice Department (“Department”) was more definitive to its approach to RPM. The Department devised a structured rule of reason analysis that constituted a framework for manufacturers and retailers to use in handling resale price maintenance. Under this structure analysis, a plaintiff would be required to show 1) the existence of a minimum RPM agreement and 2) the presence of structural market conditions under which RPM is likely to be anticompetitive. Once the plaintiff had established its prime facie case the burden would shift to the defendants where they would be required to show that 1) plaintiffs’ allegation of market share is erroneous and 2) the RPM is actually pro-competitive.

In addition to the Federal agencies trying to put the brakes on Leegin the Congress also has made various attempts to repeal the Leegin decision by placing RPM back into the per se violation box. Additionally attempts have been made by certain congressional representatives to amend the existing antitrust laws to specifically make resale price maintenance a specified violation of Article 1 of the Sherman Act.\(^{58}\) While none of these legislative initiatives have

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56 For a thorough review of how the states address Resale Price Maintenance See *Antitrust Law and Practical Approaches to Vertical Pricing Programs Four Years After Leegin*, 44\(^{th}\) International Franchise Association Legal Symposium, May 2011, Washington D.C.

57 Id. at 6.

58 Id. at 10.
obtained traction, one must believe that at this time it would be premature to announce the death knell of *Dr. Miles*.

So what is the complexion of the legal landscape after the *Leegin* decision franchising? The *Leegin* decision gives franchisors the hope or sense that the resale price maintenance agreements are technically legal. But the adversarial positions taken by the States, the abundant case law that has challenged this practice over many years and the doors left open by the Supreme Court to challenge anti-competitive conduct should cause any franchisor to think that a resale price agreement with its franchisees could well be the subject a private or governmental challenge. It is thus likely that franchisors will continue to manage their franchise chains under the Colgate doctrine and keep resale pricing as a unilateral decision through Minimum Advertised Price Programs.\(^{59}\) While such programs may not be as attractive to franchisors, they certainly are safer for the risk averse.

IV. NEW YORK SALES TAX REPORTING STATUTE AND REPORTING/AUDITING REQUIREMENTS

Franchise finances generally rely on voluntary compliance and reporting from franchisees for accurate data on gross sales and transactional data from customer transactions of the franchise. Franchise systems use varying methods to verify gross sales, including examining copies of sales tax returns filed with state tax authorities. State sales tax statutes impose substantial civil and criminal penalties on reporting and payment violations, wreaking far more severe damage to the property or liberty interests of the retail merchant, than damage stemming from any franchise agreement violation. Franchisors travel on this penalty-avoidance behavior of franchisees to limit the auditing of franchised businesses to egregious cases, or as part of a rotation program that audits franchisees on a random basis periodically. Review of state sales tax forms is frequently the most efficient means of gross revenue auditing.

In a change that approximates the "man bites dog" story line, New York state legislators and tax administrators enacted a revenue auditor force-extender concept in 2009 in Subpart G of Part V-1 of Chapter 57 of the Laws of 2009. Franchisors must now file information returns regarding their transactions with franchisees who are vendors required to collect state and local sales tax in New York. The obligation extends to every franchisor that has at least one franchisee required to be registered as a sales tax vendor in New York. The law borrows the definitions of franchisee and franchisor from the franchise regulatory provisions of the New York General Business Law.\(^{60}\) To implement this law, the Department of Taxation and Finance ("DTF") issued certain bulletins: TSB-M-09(9) on July 7, 2009 and TSB-M-09 (9.1)(S) on August 18, 2009. The law has not been codified as part of the New York State Tax Law, and no regulation has been promulgated by DTF to implement the law.


\(^{60}\) NY Gen. Bus. Law § 681 (4), (5).
The first information returns required under the new law were due in September 2009. The next information returns were due in March 2010. Subsequently, annual information returns are due on or before March 20th of each year, and will cover the period from March 1st of the previous year through February 28 (29) of the current year. The annual information returns must be filed using the procedure prescribed by the DTF.

A. Information Required to be Provided on the Returns.

Franchisors that are required to file an information return under the new law must provide the following information for the period covered by the return for each franchise location of its franchisees doing business in New York State that are required to be registered as sales tax vendors. Franchisors must file their information return electronically through the DTF Web site: http://www.nystax.gov/sbc/thirdpty.htm.

1. Franchisee Information.
   - legal name of each franchisee;
   - phone number of each franchisee;
   - DBA name of each franchisee (if different than legal name);
   - the name of the owner of each franchisee (e.g., principal shareholder, general partner);
   - franchisee's Federal Employer Identification Number (EIN/Federal ID Number), which would be the franchisee's owner's Social Security Number if the franchisee is a sole proprietor;
   - franchisee's New York State Sales Tax Certificate of Authority number(s);

2. Franchise Information.
   - beginning date of each franchise;
   - each franchise location's physical address;
   - mailing address of each franchise location if different than physical address;
   - gross sales in New York State for each franchise location as reported to the franchisor for the period covered by the return;
   - gross sales in New York State for each franchise location as audited by the franchisor if different than reported by the franchisee;
   - if known, the amount of New York state and local sales tax collected at each franchise location by each franchisee for the period covered by the return;
   - amount of royalty payments, if any, for each franchise location, made to the franchisor;
   - for each franchise location, where applicable, the royalty percentage of gross sales reported (if royalty payments are based on a computation other than percentage of gross sales give details of that computation);
• amount of sales, if any, made to each franchise location by the franchisor or companies affiliated with the franchisor; and

• the amount of any sales made to each franchise location by any supplier designated by the franchisor.

The DTF forms offer no safe harbor for the franchisor that did not collect much of this information, and offers no solution to a franchisor that did not reserve the power to collect such information in its franchise agreement, except perhaps through a general audit right or the right to receive financial statements or information. The law and regulation make an irrebuttable presumption that the franchisor has the right to the information and that the franchisee will supply accurate information to the franchisor. The law also presumes that the DTF has jurisdiction over an out of state franchisor with no nexus with New York other than franchises sold in compliance with the New York franchise law. Other presumptions are that the franchise agreement defines gross sales in the same manner as state tax law, and that franchisors will have access to electronic point of sale systems and accounting systems to obtain this gross sales information from the franchisee’s records if there is no submission of the information voluntarily. To extend its dwindling resources, the State of New York has instituted its own version of a not-so-confidential informant program to compel franchisors to “snitch” on their own franchisees.


Franchisors that are required to file information returns must give to each franchisee included on the return a statement showing the same information reported for that franchisee in the information return. The statement given to each franchisee may be in a summary format, but it must include the identifying information pertinent to the franchisee along with the gross sales of each franchise location of the franchisee, royalty payments and sales made to the franchisee for each franchise location as reported to the DTF on the return. The information provided on the return, when necessary, will be used to determine the accuracy of income and sales tax returns that the franchisees have filed with the DTF. The statement must be given to each franchisee on or before March 20th of each year. There is no specific form for this statement. Therefore, franchisors can use any format for the statement as long as it can be verified by the DTF that the statement was sent to each franchisee in a proper and timely manner.

4. Penalties.

If a franchisor fails to comply with the law, the following penalties will apply:

(1) If a franchisor fails to:

• provide any of the information as required on the information return;

• include information on the information return that is true and correct; or

• provide to each affected franchisee, on or before March 20th of each year, the statement as described above;

the franchisor is subject to a penalty of $500 for 10 or fewer failures and up to $50 for each additional failure.
(2) If a franchisor fails to timely file an information return, in addition to the penalties described above, a penalty of not less than $500 but up to $2000, will apply to each failure.

The penalties described above cannot exceed a total of $10,000 for any filing period.

B. Other Issues.

If the DTF determines that any failure to comply with the requirements of the law was entirely due to reasonable cause and not to willful neglect, the penalties as described above will be waived. This benign procedure appears in TSB 9.1 and has no basis in the law. The franchisor is required to report the information provided to it by the franchisee, and not required to verify or audit the reported information.

The Tax Law contains strict secrecy provisions to protect the confidentiality of tax returns and tax return information. Consequently, DTF limits access to return information collected through the Department's Web site to only those employees or subcontractors who need access to the information in the performance of their official duties. DTF will be using the information provided by franchisors to determine the accuracy of income and sales tax returns filed by franchisees.

What impact does this law have on the relationship between franchisor and franchisee in New York? Whether the law is constitutional has yet to be determined. If *KFC Corp. v. Iowa Department of Revenue* (see below) offers precedent, the constitutional challenge will be an uphill battle. Assuming that the law survives constitutional challenge, the dynamic and culture of franchisors operating in New York has been changed by the state law deputizing franchisors as enforcers of New York state sales tax reporting laws and regulations. Whether this burden ratchets up the tension in New York franchise relationships will play out as participants gain more experience with the law.

The decisions of a franchisee on dealing with state or federal tax issues have not traditionally been the subject of franchisor interest beyond mere assurance of compliance. Indeed, case law suggests that franchisors seeking to terminate franchises for tax-related covenant breaches were at times faced with trial courts skeptical of the materiality of the breach. In the case of *Dunkin' Donuts Incorporated, et al. v. Omar Martinez, et al.* the U.S. District Court for the Southern District of Florida upheld termination a franchise agreement based on the unproven tax fraud of the franchisee. In this case, the franchisee used the business as a piggy bank to pay personal expenses for the franchisee's family that were deducted as business expenses and not reported or taxed as income to the franchisee. The conduct was perpetrated "willfully, systematically, pervasively, and repeatedly" according to the Court, but the franchisees were not the subject of IRS audit, investigation or prosecution for tax evasion. The Court found that the potential prosecution for criminal tax evasion activity was sufficient to justify termination under the provision in the franchise agreement that allowed

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termination for conduct that is potentially injurious to the good will of the marks and reputation of the system, citing several other Dunkin' termination cases.63

Will the New York tax reporting regime spawn imitators among other states? With states more dependent on sales taxes, any notion of success by New York in enhancing sales tax collections or reducing audit expenses will likely produce more state interest in the third party reporting concept. Franchisors without the means or authority to collect the information should be mindful of opportunities to assert the right to obtain the necessary information under a broad reading of the "compliance with all laws" provision in most franchise agreements. Policy influencers should be lobbying state legislative and tax authorities for affirmative regulations to accompany the franchisor's reporting requirement that will mandate reporting of such information to the franchisor to the extent not already compelled under the existing franchise agreement obligations of the franchisee. Since tax reporting may grow more esoteric over time with the imposition of new and novel forms of taxation, franchisors may wish to write the following or similar language into franchise agreements:

Franchisee shall provide to Franchisor in a timely manner and in the appropriate form, format and medium all information about the business, finances, revenues, expenses, ownership and other attributes of the Franchised Business or Franchisee necessary for Franchisor to complete and file any information, form tax or other return with any taxing authority as required under applicable law. The parties covenant to cooperate to address and preserve any rights of either party under such applicable law to contest the application of, correct any information or filing, obtain a waiver or exemption from, or otherwise effect compliance with, such law.

V. EMPLOYMENT LAW CHANGES

A. Massachusetts Worker's Compensation Statute.

In November 2010 the Massachusetts legislature enacted a statute that accords employees a private right of action against employers who fail to pay the required premiums under the State’s Workers’ Compensation insurance Statute (the “Act”).64 Under this statutory scheme a plaintiff may recover damages and attorney’s fees. The key provisions of this statute provide not only employees but also competitors of those violating the Statute with this private right of action. Moreover, an employee who is wrongfully classified as an independent contractor can attach a worker’s compensation claim to their claim. The damage scheme is statutory in nature and includes actual and liquidated damages. The broad basis for this statute gives not only affected employees the ability to bring suit against their employer, but also competitors of the employer.

The key provisions to this Act are as follows:

1. Each civil action must be brought by at least three private citizens within six years of a violation.


64 MASS. GEN. LAWS. CH 152 §25C(11).
2. If there is a workers’ compensation policy in force that would be affected by the civil action, the plaintiffs must wait at least 90 days after the policy’s expiration before filing the action.

3. Before filing a suit a plaintiff must provide at least 90 days’ prior notice to the employer and any applicable insurer of their (1) intent to sue and (2) the substance of the allegations.

4. Settlements between an insurer and insured do not bar or limit the recovery available in a civil action.

5. The collective payable recovery of the plaintiffs consist of the following:
   a). 25 percent of the amount owed or $25,000, whichever is less,
   b) liquidated damages equal to 25% of the amount owed or $25,000, whichever is less;
   c) costs and reasonable attorney’s fees.

6. If an employer is held liable, the employer must make all payments it should have made under the Massachusetts workers’ compensation law.

7. Any amounts recovered by plaintiffs that are not part of the payable recovery are deposited into the Workers’ Compensation Trust Fund, which is established under M.G.L. ch 152 §65.

8. Once a civil action has been filed by plaintiffs, without their written consent, applicable insurers who did not previously file a complaint or seek arbitration to recover from the employer within 90 day period are barred from collecting. However, insurers who pay claims may recover premiums from the Workers’ Compensation Trust Fund that should have been paid to the insurer to provide coverage to the plaintiffs.

The broad expanse of this statute presents a danger to franchisees who fail to maintain a proper workers compensation policy in Massachusetts as well as those franchisees that are less than exacting on how they classify their employees. While it may seem more attractive and less bureaucratic (and less expensive from an employer tax contribution standpoint) to treat one’s employees as an independent contractor under this statute, the risks are large if the employee should have been classified as an independent contractor. Moreover, the fact that competitors and employees who are not actual victims of the failure to obtain or maintain this insurance can bring suit against the employer allows plaintiffs to act as self-appointed attorneys’ general for the State.

Lest it be thought that the only individuals within the zone of danger of this statute are franchisees, franchisors should pay special attention to this statute in light of the recent developments on the issue of franchisors being classified as employers of their franchisees. As plaintiffs are required to have at least three individuals to file their claims, that requirement gives plaintiff’s mini class action opportunities, which makes navigating this statute problematic for both franchisees and franchisors.

65 See MASS. GEN. LAWS. CH 149 §1488 for definition of Independent Contractor in Massachusetts.

**B. How Franchisors Become Tangled in the Employment Web.**

In recent statutory and case histories, franchisors are finding themselves caught in the thicket of the employer-employee relationship even when they are not employers. While the Massachusetts Coverall decision has received more than its share of attention, two decisions out of Oregon illustrate the point for franchisors that just because they characterize their relationship with their franchisees an independent contractor relationship and outside the scope of the employer-employee relationship, saying so does not make it so. In fact, what the twin Oregon decisions have opined was that whether a franchisee is an independent contractor of a franchisor does not turn on the reading of the common law definition of independent contractor.\(^{67}\) Instead, whether a franchisee is an independent contractor of a franchisor is determined upon how such term is defined in the Oregon Employment Insurance Act.\(^{68}\) Moreover, both of these cases have taken a broad reading of what constitutes service to the employer and whether the franchisee receives remuneration as an employee. While these issues will be decided on a case-by-case basis, they broad expanse of these concepts taken by the Oregon courts in their interpretation of them will leave franchisors wondering whether even a conventional franchise relationship will survive an Oregon court’s analysis.

In *Gross d/b/a Rent-A-Nerd v. Employment Department*, the franchisor, a computer referral business, appealed from a finding that one of its franchisees who sought to collect unemployment insurance after it stopped servicing the Rent-A-Nerd (“RAN”) customers, was considered to be an employee of the franchisor.\(^{69}\) In finding that the franchisee was indeed an employee the court of appeals of Oregon found that the franchisor exercised sufficient control over the franchisee technician to place him in the zone of the employee-employer relationship. In reaching this conclusion the court looked closely at the relationship between Rent-A-Nerd and its technicians, which it characterized as being independent contractors. Notwithstanding the arguments put forth by the franchisor that there was no employment relationship between the parties the court found otherwise. Specifically they saw that the customers of the putative franchisee were characterized by RAN as RAN’s customers. The franchisee was required to use RAN invoices; they were prohibited from having direct contact with the customers; the prices were set for the services rendered by the franchisor; and, where the franchisor collected a percentage of the fee from the franchisee, the court found that these strictures placed upon the franchisee in fact made him an employee under the Oregon Employment Insurance Statute. In finding that this fee splitting constituted remuneration as required by the statute, the court noted, the term remuneration “is used advisedly as one of broad meaning in order that the objects of the Unemployment Compensation Act might be achieved.”\(^{70}\)

Once the State had established its prime facie case, it was up to the franchisor to argue that the franchise relationship that it claimed existed between it and the franchisee constituted a statutory exception to the State’s case. In this case the franchisor relied upon the independent contractor exception to the statute. However, the court found that the independent contractor test used in the common law was not applicable under the Oregon Employment Insurance

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\(^{68}\) OR. REV. STAT. ANN. § 657.040(1).

\(^{69}\) *Gross v Employment Department*, 240 P.3d at 1132.

\(^{70}\) *Id.* at 1137 citing *Journal Pub. Co. v. State Unemployment Comp. Comm’n*, 155 P.2d 570, 574 (Or. 1945).
Statute. Instead, the court noted that “the test is to be found by looking at the purpose of Unemployment Insurance Act... that purpose, the court explained, is served only if the Act is construed broadly enough to include persons who although independent contractors according to the common law test are peculiarly subjected to the hazard of unemployment because of the nature of their occupation.”

In digging deeper into the defense of independent contractor the court, borrowing from the case of Employment Dept v. National Maintenance Contractors, in Gross the court likened the relationship between RAN and its would-be franchisee as “the functional equivalent to a subcontract, whereby remuneration flows from building owner to the janitorial contactor and from janitorial contactor to janitorial contractor. And given the broad reading of ORS 657.030(1) intended by the legislature - one that encompasses certain common-law independent contractor service arrangements - we conclude that the relationship between NMC and its franchisees involves the payment of remuneration for services.” Additionally, the court opined that even after reading the Oregon Franchise Statute the franchise relationship and the employment relationship were not mutually exclusive, especially because the franchise statute focused its provisions as to what constituted a franchise relationship rather than what were the consequences of the ongoing franchise relationship. In fact, according to the court, ORS 650 (the franchise statute) does not inform the question whether the relationship between the questions of whether the relationship between NMC and its franchisees could also constitute an employment relationship.

In the case of Employment Dept v. National Maintenance Contractors, the Oregon Employment Department appealed from an administrative court finding that the relationship between NMC and its franchisees did not constitute a franchise relationship. In this janitorial service case, the court of appeals found that the franchisees of a janitorial services franchisor did perform a “service” for the franchisor within the unemployment compensation tax definition of employment. Like in the Gross case the court in NMC opined that the unemployment insurance statue had a broad expanse both in determining what constituted service and remuneration, the keys to determining whether or not a servicing entity constituted an employer. In this case the court was suspect of the claimed franchise relationship from an employment perspective. As a starting point the NMC controlled which accounts were given to its franchisees, and in fact there was no guarantee that a franchisee would receive a specific account. In addition, the customers were to make all payments directly to NMC who would then give the remainder to the franchisee after taking out franchise fees. It was up to NMC to replace lost janitorial accounts for the franchisee.

As in the Gross case the court looked to the expansive reading of the Statute to find that the franchisor was more akin to an employer than a franchisee. In its opinion the court noted

71 Id. at 1136 citing Employment Dept. v. National Maintenance Contractors, 204 P.3d 151,155 (Or. 2009).
73 OR. REV. STAT. ANN. § 650.005.
74 Gross v Employment Department, 240 P.3d at 1132 citing Employment Dept. v. National Maintenance Contractors, 204 P.3d at 159.
76 Id. at 160.
that ‘[i]f an individual provides services to an employer for remuneration, the burden is on the employer to demonstrate that the service comes within an enumerated exception to the definition of employment such as the independent contractor exclusion in ORS 657.040(1).’”77 Also as in the Gross case the court was not persuaded by the franchisor’s independent contractor defense, noting that the common law test was not applicable in cases involving unemployment consideration.78 While noting that whether a franchise relationship is truly based on an independent contractor relationship is reviewed on a case–by-case basis, from the court’s perspective for all of the characteristics illustrated above, the relationship between NMC and its franchisees was closer to an employment relationship than a conventional franchisor-franchisee relationship.

In today’s world, what is a conventional franchise relationship? From the two Oregon cases it is clear that there is no absolute safe harbor in franchising. With the franchisor unable to rely upon the conventional common law test for independent contractor status, the franchisor will need to ensure that its franchise relationship with its franchisees is structured in such a manner as to give the franchisee more independence over their day-to-day operations. Controlling every aspect of the franchise relationship may provide the franchisor with security in the relationship but is certain to put them in the zone of capture by the Oregon unemployment insurance statute. Likewise, characterizing customers as the franchisor’s customers may also prove to be problematic. Since there are no cases or legislative activity on the Oregon horizon that would seem to overturn these cases, a franchisor will need to navigate this legal landscape with the utmost of care. Service franchises without bricks and mortar stores or facilities that provide high levels of service and back office support activity, like employment services and maintenance systems, will need to examine their business model to determine what, if any changes, they can make to it in order to avoid being characterized as an employee.

VI. ARBITRATION AFTER NINO V. JEWELRY EXCHANGE

Arbitration in both the consumer and franchise context is no stranger to the changing direction of legal winds. There have been numerous cases addressing the issue of unconscionability, enforcement, venue and other jurisdictional issues. It is beyond the scope of this paper to hone in on the evolution or collateral attacks leveled against the Federal Arbitration Act.79 Suffice it to say that an entire paper can be devoted to the subject, and has on numerous occasions.80 In this paper we will address one such situation, which may generate an immediate impact on how franchisors and franchisees conduct arbitration through already agreed upon arbitration provisions in their governing franchise agreements. In the case of Nino v. Jewelry Exchange, Inc., a federal appeals court found an arbitration provision in an employment agreement to be so one-sided that it was ruled to be unconscionable.81 However, of equal importance in this case was the issue of waiver. In this case the arbitration provision to the contract contained a number of provisions that the employee challenged as being very one-sided and therefore unconscionable. Included in these provisions were the requirements that

77 Id. at 156.
78 Id. at 155.
79 FAA 9 U.S.C. §1 et seq.
80 See Arbitration in 2011, Joseph S. Goode, Karen C. Marchino, and Mary McMonagle, 44th International Franchise Association Legal Symposium, May 2011, Washington D.C. This mini-treatise covers many of the recent global issues facing arbitration in varied contexts.
81 609 F3rd 191 (3rd Cir. 2010).
the parties use only one arbitrator chosen from a list of arbitrators that gave the employer the right to strike two while the employee could strike only one from the list of four potential arbitrators. Notwithstanding the arbitration provision, the former employee of Diamonds International, Nino, brought an employment discrimination claim in federal court. After fifteen months of litigation, the employer Diamonds International, sought to invoke the arbitration provision. In response to Diamond International’s motion, the district court dismissed the case and compelled the parties to resolve their dispute through arbitration.

The case was appealed. The Third Circuit Court of Appeals, relying on Virgin Islands law, held that the employment arbitration agreement was both procedurally and substantively unconscionable and the arbitration agreement was so one-sided that it precluded severability of the unconscionable terms. More importantly however, the court held that Diamonds International waived its right to arbitration by litigating the matter for fifteen months, engaging in extensive discovery, before invoking the arbitration clause. In its decision the court outlined a non-exclusive list of factors relevant to waiver of one’s right to arbitrate including timeliness of any motion to arbitrate, the extent to which both parties engaged in discovery, and the party’s assent to any pre-trial orders. This portion of the court’s decision has been relied upon in other similar cases, like for example in Traxys North America LLC v. Evraz Claymont Steel, Inc. Civ. A.09-684, 2011 WL 1775965 (D. Del May 2011).

The impact of this case on franchising, while not a sea change in the arbitrability of franchise disputes, requires that either the franchisee or the franchisor, as the case may be, from the very outset of a dispute invoke or contest the use of an arbitration clause in the franchise agreement. From both the Nino and Traxys cases, it is clear that courts will not respond favorably to radical course correction in mid voyage. If one party chooses to invoke arbitration or ignore or contest such clause, they need to do it at the outset rather than wait for a time in the dispute where the arbitration alternative appears to be more favorable.

VII. VICARIOUS LIABILITY

Franchisors walk a tightrope on the issue of avoiding vicarious liability for tortuous acts that occur at franchised locations. Franchisee and franchisor generally have aligned legal interests – neither wants to answer for the acts or omissions of the other, and neither wants the franchisor's financial statements to be introduced as the basis for calculating damages.

Historical analysis of tort claims against franchisors for negligence or other torts start with the question of whether the franchisor has any duty or obligation directly to the plaintiff based on its own acts or omissions, separate from any question of whether the franchisor is somehow liable for the acts of the franchisee. Assuming there is no direct liability because the franchisor had no privity of contract or direct legal duty to or relationship with the injured party, the plaintiff will seek to establish some basis on which the franchisor will be found legally responsible for and liable to the party for the acts or omissions of the franchisee. Courts employ agency theories of liability – a principal is liable for the acts or omissions of its actual or

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82 Id. at 208.
83 Id. at 211-214.
84 See e.g., Cynthia Klaus, Jason Murray and Heather Smedstad, Vicarious Liability, ABA Forum on Franchising 2008; Donald Horn and Joel Buckberg, Slip and Fall and More: The New Vicarious Liability, ABA Forum on Franchising 1995.
The simple execution of the franchise agreement does not create the agency unless some express agency provisions accomplish such a result. The test is the nature and extent of control by the franchisor over the franchisee. The higher the degree of actual or potential control, the higher the likelihood an agency relationship would be found.

Courts focus on the control elements of the relationship – is the franchisee permitted to exercise its independent judgment in the operation of the business, or is the level of actual or potential control so pervasive that the franchisee is more akin to an employee or the servant in a master servant relationship.

A. **Soto v. Superior Telecommunications, 2011 WL 1630893 (S.D. Cal. 2011).**

In **Soto v. Superior Telecommunications**, the plaintiff Soto, and other members of the putative class, sued franchisor 7-Eleven, Inc. (“7-Eleven”) for violation of California telecommunications services disclosure laws regarding prepaid phone cards. Soto sued 7-Eleven based on a vicarious liability theory because the prepaid phone cards at issue were purchased from 7-Eleven, Inc. store owned by franchisee Dhami Corporation (“Dhami”). Defendant Superior Telecom, Inc. (“Superior”) was also named in the complaint because it marketed, sold and serviced the prepaid telephone cards.

Section 17538.9 of the California Business and Professions Code requires that, in advertising and selling prepaid phone cards, a company shall "print legibly on the card or packaging" "the value of the card and all ancillary charges," as well as the "[a]ncillary charges for international calls to each country for which the card may be used . . . ." Plaintiff Soto...
purchased Bonita Senorita phone cards, marketed and sold by Superior, from Dhami's 7-Eleven location, each card costing him $5.00 and stating that it would provide 50 minutes of call time, but found that the cards provided less than the 50 minutes advertised.\textsuperscript{91} Soto argued that he was unaware of the "rates, charges, and fees associated with the Bonita Senorita phone card, and that had he known about the charges, he would not have purchased the card."\textsuperscript{92}

After the suit was filed, Defendant's Dhami and 7-Eleven removed the case to federal court and filed a motion to dismiss.\textsuperscript{93} However, the motion was denied, and the U.S. District Court for the Southern District of California found that despite 7-Eleven's argument that Dhami operated as an independent contractor, 7-Eleven actually controlled Dhami and a principal-agency relationship existed.\textsuperscript{94} Soto argued that "Dhami and 7-Eleven were 'joint ventures as it pertains to the retail sale of prepaid calling cards' and that they 'possess joint management and control of the sale of the Bonita Senorita cards.'"\textsuperscript{95} The District Court, taking the plaintiff's allegations as true for purposes of the motion to dismiss, found that "[t]he law is clear that a franchisee may be deemed to be the agent of the franchisor," and that, despite prior California cases where no agency relationship was found between 7-Eleven and a franchisee, the cases did "not stand for the proposition that 7-Eleven is never considered to be in an agency relationship with its franchisees."\textsuperscript{96} At the motion to dismiss stage, the question of actual or apparent agency need not be settled, as long as facts sufficient to establish apparent agency have been pled.

The facts plead by Soto that the court found sufficient such that a jury could find the existence of an apparent agency relationship were that: "7-Eleven 'require[d] its franchisees' to offer and sell certain categories of inventory, including Bonita Senorita cards;" "7-Eleven control[led] which prepaid calling cards [were] sold, negotiate[d] the purchase terms with the distributors of the cards;" oversaw "the installation and maintenance of electronic equipment applicable on that card and any additional or different prices, rates, or unit values applicable to international usage of the prepaid calling card or prepaid calling services."

(C) The minimum charge per call, such as a three-minute minimum charge, if any.

(D) The definition of the term "unit," if applicable.

(E) The billing decrement.

(F) The name of the company.

(G) The recharge policy, if any.

(H) The refund policy, if any.

(I) The expiration policy, if any.

(J) The 24–hour customer service toll-free telephone number required in paragraph (9).


\textsuperscript{92} Id.

\textsuperscript{93} Id.

\textsuperscript{94} Id. at *3-*4.

\textsuperscript{95} Id. at *2.

\textsuperscript{96} Soto v. Superior Telecomm., 2010 WL 2232145 at *4. "The hallmark of an agency relationship is that one person agrees to act on behalf of another and subject to his control." Id. at *3 (quoting In re Coupon Clearing Serv., Inc., 113 F.3d 1091, 1099 (1997)). However, because degrees of control can vary, the question of whether the franchisee is an independent contractor or an agent is ordinarily one of fact." Soto, 2010 WL 2232145 at *3 (quoting Kuchta v. Allied Builders Corp., 21 Cal.App.3d 541, 547 (1971)).
used to activate and ‘charge’ the cards at the register;” and "Dhami and 7-Eleven ‘share[d] in the profits and losses of the Bonita Senorita cards.” Based on the factual allegations in the complaint, the court denied 7-Eleven’s and Dhami’s motions to dismiss.98

The U.S. District Court for the Southern District of California also cited Kuchta v. Allied Builders Corporation, which provides factors considered in determining whether there is an implied agency relationship between the franchisor and franchisee.99 The elements were: (1) whether the franchisor controlled the location of the franchisee’s place of business; (2) prescribed the minimum display equipment; (3) regulated the quality of goods used or sold; (4) approved the design and utility of the construction; (5) had the right of inspection; and (6) shared in the profits.100

Based on this reported decision, a single stock-keeping unit ("SKU") that was effectively placed in the franchisee's store under a program negotiated and administered by the franchisor was sufficient to avoid dismissal of a case against the franchisor involving that SKU. Whether the facts sustain the case past summary judgment is a different issue, for the Court notes that many cases are decided in favor of the franchisor at summary judgment when all relevant facts are presented. Degrees of control are a fact question and not susceptible to early dismissal. Does every product or service program mandated by a franchisor reallocate risk associated with the program to the franchisor?


In deciding whether or not to affirm the trial court's denial of defendant franchisor Douglas Aquatics' ("Douglas") motion to dismiss for lack of personal jurisdiction, the North Carolina Court of Appeals looked to whether minimum contacts were established by franchisee of Douglas, Douglas Aquatics Charlotte, LLC, due to agency relationship.101 The court denied the appeal of the denial of the motion to dismiss, upholding the trial court's finding of personal jurisdiction, on the basis of implied agency, or agency by estoppel.102

The court based its decision on the fact that Douglas listed its Charlotte franchise location on the company's website as one of its own locations, represented that the company had 30 years of pool installation experience, and that the contract entered into with the Plaintiff stated that "Douglas Aquatics, Inc., shall excavate for the pool, steel reinforcing bars, place concrete, install pool piping, fitting, install all filtration and swimming pool equipment, provide and install tile, install concrete coping[,] concrete decking and quartz interior, per specifications and plans."103 The court found the plaintiff's reliance on these alleged facts in entering into the

98 Id. at *5.
99 Id. (citing Kuchta, 21 Cal.App.3d at 547).
100 Id.
102 Id. at 759-60.
103 Id. at 764-64. The cases quotes the relevant portions of the complaint for alleging agency:

2. Plaintiff's Verified Complaint alleges proper jurisdiction over [Appellant] by virtue of the services provided in North Carolina through its agent [DA Charlotte].

-26-
contract for pool installation to be "consistent with ordinary care and prudence." Thus, Douglas Aquatics, Inc. was estopped from denying an agency relationship as between itself and Douglas Aquatics Charlotte, for purposes of personal jurisdiction.

The North Carolina Court of Appeals relied on settled North Carolina law that an agency relationship may be implied and may arise by estoppel where representation of such relationship was made to a third party by the principal and that third party reasonably relied on such representation to their detriment. "Pursuant to agency principles, 'vicarious liability of a franchisor for the acts of its franchisee . . . depends upon the existence of an agency relationship." Whereas here, the defendant entities are structured as franchisee and franchisor, an actual agency relationship 'is determined by the nature and extent of control and supervision retained and exercised by the franchisor over the methods or details of conducting the day-to-day operation." However, the court did not find an actual agency relationship, but instead found an implied agency which it deemed sufficient for establishing personal jurisdiction. "[A]n agency relationship may be deemed to exist for purposes of vicarious liability in the absence of an actual agency under the legal theory known alternatively as apparent agency or agency by estoppel." Agency principles, including of apparent agency . . . are no less applicable even where the issue is personal jurisdiction rather than vicarious liability per se.

4. ... [Appellant's] website ... describ[ed] [DA Charlotte] as another location of Douglas Aquatics, Inc. in Charlotte to provide pool construction needs in that area.
5. It reasonably appeared to Plaintiff from the website that the two Defendants were the same entity
7. Defendant [DA Charlotte], by and through its Manager Gabe Ortiz, represented to Plaintiff that they had been in the pool construction industry for over thirty years as stated on [Appellant's] website. Appellant did not take issue with the following findings, which are thus binding on appeal:
6. [Appellant] advertised through its website that they had been in the pool construction business since 1970 and that they received multiple industry awards for their quality work.
8. Unbeknownst to Plaintiff, Defendant [DA Charlotte] has only been in the pool construction business since 2005.
10. The construction contract for the pool ... indicated on its face in Section One ... that "Douglas Aquatics, Inc., shall excavate for the pool, install steel reinforcing bars, place concrete, install pool piping, fitting, install all filtration and swimming pool equipment, provide and install tile, install concrete coping[,] concrete decking "764 and quarts interior, per specifications and plans"....
13. Plaintiff's Complaint alleges that both Defendants knowingly held out [DA Charlotte], through the [Appellant's] website, through representations made by Gabe Ortiz, and the construction contract, as the same entity and with the same experience as [Appellant] in order to induce Plaintiff to sign a contract with Defendants.
14. The affidavit of Thomas Crouch alleges that [Appellant] has no actual control over [DA Charlotte].
15. However, Defendant [DA Charlotte] represented to Plaintiff that [Appellant] and [DA Charlotte] were one in the same entity and Plaintiff reasonably relied on those representations.

104 Id. at 767.
105 Id. at 767.
106 Id. at 764 (quoting Hayman v. Ramada Inn, Inc., 357 S.E.2d 394, 397 (1987).
107 Bauer, 698 S.E.2d at 764 (quoting Hayman, 357 S.E.2d at 397).
108 Id. (quoting Hayman, 357 S.E.2d at 397).
109 Id. at 765.
"[A] number of courts have employed the concept of actual or apparent authority to exercise jurisdiction over a principal, or alternatively, have declined to exercise jurisdiction where a claimed agency relationship is not proven."\textsuperscript{110}

Many franchisors take great pains to defeat implied or apparent agency by making clear in all advertising and brand web site content that locations are independently owned and operated as franchises, requiring customer contracts that clearly identify the real party in interest and make disclosures about the franchise, and by avoiding references in contract forms that are misidentified to the franchisor. The Douglas court reminds the parties that the retail customer never saw the actual franchise agreement, and thus has no idea whether actual agency exists. The only information a reasonable customer can reasonably rely upon is the information and advertising supplied by the brand and franchisee. The court concludes that there was insufficient control by the franchisor over the operation of the franchised business to establish actual agency. But the advertising for the Douglas brand claimed the business had been in operation for thirty years. The in-person representations made to the customer by the manager of the franchisee's operation claimed that the franchisee had been in business for the same thirty year period. The web site content, confusing contract form and the experience representation that clothed the franchisee with the franchisor's experience were the deciding factors for the court to conclude that apparent agency existed.\textsuperscript{111}

\section*{VIII. TAXATION WITHOUT REPRESENTATION – KFC CORP. V. IOWA DEPARTMENT OF REVENUE}

Since the Great Recession of 2008 state governments have been scrambling for revenues that have either been cut off by the federal government or that have been reduced by their citizens earning less income. One area that has been under attack for some years is the issue of nexus. Under this doctrine states try circumvent the interstate commerce clause of the U.S. Constitution to establish that a corporation is conducting business in their state such that it would subject it to state taxation. Franchisors have been resisting the nexus trap by relying upon the interstate commerce clause in the Constitution and the \textit{Quill} case, which held that corporate representatives who went into a state for the sole purpose of drumming-up business for their employer or company did not establish nexus such to invoke the company to state corporate or income tax liability.\textsuperscript{112}

In the case of \textit{KFC Corp v. Iowa Department of Revenue}, the Iowa Supreme court found KFC to be conducting business in the State of Iowa even though it did not have a physical presence or situs there. What will prove to be troubling to franchisors the court found a panoply of non physical contacts where it ruled that the franchisor was deriving direct benefit from the economic climate provided by the State of Iowa to KFC.\textsuperscript{113} Specifically the Court noted a number of indices of presence within the State, while not actually physical, provided KFC with certain protections afforded to those who had physical presence in the State. For example, the court found that KFC owned, managed, protected, and licensed the KFC marks and system during the years in question. In addition the franchisor entered into franchise agreements with

\begin{itemize}
\item \textsuperscript{110} Id.
\item \textsuperscript{111} For further discussion of vicarious liability of franchisors, see Herbert B. Chermside, Jr., \textit{Vicarious Liability of Private Franchisor}, Annot. 81 ALR 3d 764 (1977, supplemented in 2011).
\item \textsuperscript{113} \textit{KFC v. Iowa Department of Revenue}, 792 N.W. 2d 308, 310 (Iowa 2010).
\end{itemize}
Iowa franchisees that remitted royalty and/or license income to KFC for the use of the KFC marks. Throughout the period KFC had the right to control the use of its marks by Iowa franchisees and the right to control the nature and quality of goods sold under the marks by them. Moreover, Iowa franchisees were required to abide by KFC’s requirements relating to the specifications of equipment and other operational standards. Quality assurance activities were performed on behalf of KFC by third parties in Iowa. Even more significant was the fact that KFC franchisees could deduct from their taxable income the royalty payments made to KFC.\footnote{Id. at 311.}

Essentially, almost every aspect of the franchise relationship was used or leveraged by the State of Iowa to establish nexus by KFC with the State. The court tied all of these seemingly non-physical contacts to nexus by holding that “physical presence” is not required when a state imposes taxation on income. The court supported this finding by concluding that “the franchise right was an intangible with a direct connection to Iowa. Moreover, the Court opined that “[T]he imposition of tax on income generated by a franchisor within a state was not an undue burden on commerce, but rather a payment to government that provided the economic climate for the business to prosper.”\footnote{Id.}

The holding of the Iowa Supreme Court rested its decision on a finding that the imposition of nexus did not collide with the Commerce Clause of the U.S. Constitution and the \textit{Quill} case. The Court noted that many courts limited the use of the \textit{Quill} reasoning. Specifically the court in \textit{A&F Trademark} found \textit{Quill} to be cramped and limiting, that \textit{Quill} was driven largely by considerations of \textit{stare decisis} that was inapplicable outside the sales and use tax context and that the burden of sales and use taxes are more substantial than other taxes such as state income taxes.\footnote{\textit{A&F Trademark v. Tolson}, 167 N.C. App., 150, 605 S.E.2d 187, 194-95, cert. denied 546 U.S. 821, 126 S.Ct. 353, 163 L.Ed.2d 62 (2005).}

The court’s decision supported the \textit{Geoffrey} decision, which was one of the first to find that the absence of physical presence in a state was not critical to a finding of nexus.\footnote{\textit{Geoffrey, Inc. v. S. Carolina Tax Comm’n}, 437 S.E.2d 13, 19 (S.C. 1993).} In this case the South Carolina court found that physical presence was not necessary to establish nexus of a franchisor in the State of South Carolina. “In summary fashion they dismissed the relevance of the \textit{Quill} case. According to the \textit{Geoffrey} Court “any corporation that regularly exploits the markets of a state should be subject to its jurisdiction to impose an income tax even though not physically present.”\footnote{\textit{KFC Corp. v. Iowa} at 321, citing Jerome R. Hallerstein & Walter Hellerstein, \textit{State Taxation} ¶6.11 at 6-54 to 83 (3rd ed. 2006).}

“While the reasoning of the \textit{Geoffrey} case has been criticized as cursory and conclusory, the result has been embraced by other state courts considering whether the licensing of intangible property, such as trademarks and business methods, for use within a state provides a sufficient nexus of income tax purposes.”\footnote{Richard H. Kirk Note, \textit{Supreme Court Refuses to Re-Examine Whether Physical Presence is a Prerequisite to State Income Tax Jurisdiction: Geoffrey, Inc. v. South Carolina Tax Commission}, 48 Tax Law. 271, 276 (1994).} What makes the KFC case so significant is the shotgun approach that the court took to the franchisor-franchisee relationship. Virtually every aspect of the KFC system was taken into consideration in establishing nexus within the State of
Iowa. After reading the KFC decision a franchisor may well find itself in an untenable box with little room to maneuver. Given the scope and breadth of KFC’s activities discussed in this case, it will be difficult for franchisors to create tax planning devices that will allow it to escape nexus in this State. Moreover, it is more than likely that other states will latch on to the KFC decision to either re-write their tax laws, or to use the analysis in KFC to bolster their claims and arguments for nexus within their respective states.

**IX. PATIENT PROTECTION AND AFFORDABLE CARE ACT**

No discussions about the effect of the changing laws and judicial determinations would be complete if there was not discussion of the Patient Protection and Affordable Care Act ("Act"). Since the Act is more than 2600 pages a full analysis of it is beyond the scope of this paper. However, Section 1513 of the Act is ripe for discussion in light of the many judicial changes it has received since the Act was enacted into law. Given the challenges and the fact that no regulations have been written to interpret the Act, one can only hazard to guess what will be the final form of this section when it becomes effective for employers.

Section 1513 is entitled Shared Responsibility of Employers regarding Health Coverage. This section of the Act outlines the responsibility that an employer has to provide health insurance for their employees and the consequences for either not providing any insurance of not providing adequate insurance for their employees. This section of the Act is divided into four sections. The first two sections are substantive while section three defines the applicable terms and section 4 describes the administration and procedure applicable to this section of the Act.

Substantively these sections differentiate between those employers who do not offer the minimum essential coverage to their employees after the effective date, January 1, 2014, section (a), while section (b) addresses the consequences for employers who do not offer adequate health insurance to their employees. In section (a) an employer who does not offer essential health coverage to any of its employees then, to the extent that any such employee purchases health insurance where they are entitled to receive a premium tax credit or cost sharing reduction, whether or not it is paid, then in that case the employer is assessed a penalty equal to the product of the applicable payment amount and the number of individuals employed by the employer as full-time employees during each such month. When this section says is that if the employer does not provide the very minimum insurance to anyone of their employees, and any employee seeks insurance through a health exchange where such payment receives a premium tax credit or cost sharing reduction, then the employer will suffer a penalty equal to the cost of each such premium credit times the number of employees not receiving any health insurance.

Conversely an employer who offers health coverage to their employees but one or more of the employees is certified for health care coverage from an alternative supplier (presumably a health exchange), where they will receive a premium credit or a cost sharing reduction, regardless of the fact that the employer offered such insurance, then in that case the employer will suffer an assessment each month of 1/12 of $3,000 for each such employee.

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121 26 U.S.C. 4980H.
122 Id. at §4980H(a).
For the purposes of this section a Large Employer is defined as any organization with at least 50 full-time employees. For section (a) the term applicable monthly payment means 1/12 of $2,000. A full time employee is anyone who is employed at least 30 hours per week with a specific entity.

The upshot of these provisions is that an employer can be assessed a financial penalty for either failing to provide any health insurance or, if they do provide health insurance, if the insurance is not deemed to be affordable to certain defined employees. The effect of this section of the Act not to mention the other provisions of the Act can impose additional, and in some cases, an undue financial burden on small business. While there are not yet regulations to answer some of the questions that are bound to come up, one specific question is what happens to a small business owner who will having multiple locations under separate corporations, but who offers coordinated benefits to all of their employees, will they then be considered a Large Employer if they have more than 50 employees in the aggregate.

Likewise, at first blush it may appear to be less expensive to pay the penalty instead of providing essential health care coverage to employees. During the first year of deployment, this may in fact be true, but then should the employer expect that the penalty will go up the next year when the majority of Large Employers take the same action. If more employees gravitate to health care exchanges, what the effect will be on existing health care plans and the ability of health insurance providers to continue to provide essential health care coverage for an enterprise is not yet known. These are all questions yet to be resolved. Consequently the next two years, the time before actual implementation of the Act, will be a "wait and see" game for both franchisees and franchisors.

X. BUSINESS MODEL OBSELESCENCE: PROFOUND EFFECTS ON THE SYSTEM BUSINESS MODEL FROM CHANGES IN THE LAW

Franchised businesses are often narrowly defined by a particular good or service that forms the essence of the business. What happens if the core good or service becomes outdated, obsolete or prohibited by law? Perhaps the regulation of the business becomes more extensive and the more highly regulated business model becomes economically untenable. What should the parties committed to a long term contractual and economic relationship do to maintain their enterprise?

A. Non-working Models.

Here are some examples of business-damaging events and regulatory changes that have occurred or have the potential for major disruption of existing franchise business models:

- On demand electronic product delivery through cable television, broad band internet, and convenient mechanical kiosks, plus rapid U.S. mail delivery of movies and games chosen on-line makes video rental stores obsolete. Result: 1) the bankruptcy of Blockbuster Video chain, thousand of store closings, and the purchase of remaining assets in bankruptcy by Dish Network; and 2) Movie Gallery, Inc., parent of Hollywood Video stores, files for bankruptcy in February 2010 and is liquidated in May 2010

- The Free File Alliance and the Internal Revenue Service create an alliance to allow persons making $58,000 per year or less to prepare and file tax returns for free, pre-empting the fee-based and franchised business of preparing tax returns for this group of taxpayers, who form the largest portion of the customer base of many tax return preparation systems. Jackson Hewitt Tax Service, one of the largest U.S. tax return
preparer franchises, files for Chapter 11 bankruptcy in May 2011 after a private equity firm leverages the balance sheet with debt.

- States enact prohibitions on the med-spa business or clarifications of existing definitions of medical treatments, redefining certain services as the practice of medicine that can be performed by trained, licensed aestheticians and cosmetologists without medical supervision, limiting the range of services that can be provided or requiring an affiliation with a medical practice that will introduce a supervising physician and associated costs; the non-physician owner cannot receive a share of professional fees.

- Thanks to the reduction of mall traffic as people switch to internet shopping, the Sbarro restaurant chain files Chapter 11 bankruptcy in April 2011, as its strategy to focus on mall food courts does not produce enough revenue to meet the debt service of its acquisition debt from a 2007 private equity sale.\(^{123}\)

### B. Tanning Bed Prohibitions.

At this writing, the tanning salon business is not unlawful. One recent article reports that there are one million tanning salon visits a day in the United States, at more locations than either McDonald's or Starbucks' restaurants.\(^{124}\) But the American Academy of Dermatology, the World Health Organization and the American Academy of Pediatrics have joined forces to urge the end of the tanning industry. Since 2009, an arm of the World Health Organization has classified tanning beds as cancer-causing. Eleven states have banned tanning salon treatments for minors, usually those under 16, and a total of 32 states have tanning bed restrictions or parental consent requirements or persons under 18 years of age.\(^{125}\) Studies point to slightly elevated risk of melanoma, the deadliest form of skin cancer, for tanning bed users, when compared to persons who do not use tanning beds. According to the Indoor Tanning Association, a trade group for the tanning bed and salon industry, legislation affecting tanning, particularly for minors under 18, was considered in 25 states, and enacted in none.\(^{126}\) The Food and Drug Administration regulates the lamps used in the beds, including maximum exposure time, but does not classify tanning beds as a higher risk device.\(^{127}\) Finally, the Patient Protection and Affordable Care Act enacted a ten percent federal excise tax on indoor tanning services payable by the customer, to be collected by the service provider.\(^{128}\)

A primary customer group for the tanning industry has been teenage girls and women seeking tans for cosmetic appearance purposes. While tanning assists the body in the production of Vitamin D, the physicians' groups claim the process accelerates the aging and wrinkling of skin, as well as increasing the risk of cancer. Because the cancer may take years to develop, the user does not have an immediate concern as long as exposure is limited to the


\(^{125}\) Arizona, Arkansas, California, Connecticut, Delaware, Florida, Georgia, Illinois, Indiana, Kentucky, Louisiana, Maine, Maryland, Massachusetts, Michigan, Minnesota, Mississippi, New Hampshire, New Jersey, New York, North Carolina, North Dakota, Ohio, Oregon, Rhode Island, South Carolina, Tennessee, Texas, Utah, Virginia, Wisconsin and Wyoming.


\(^{127}\) 21 CFR § 1040.20 \textit{et seq.}

prescribed time frame and no burning occurs. Like legitimate businesses that sell cigarettes and other tobacco products lawfully to persons meeting the age requirements, tanning may follow a similar path of informed consent for adults and age restrictions for those under 18 years of age. Parental consent may act as some impediment to business, but not an absolute ban.

Fortunately for the tanning salon franchise world, the regulatory process has been slow, legislative and inconsistent. Lobbying can be effective in such an environment to forestall or soften the impact of bans or consent laws. The franchisor has time to react and plan, and the opportunity to ameliorate the impact with broader product and service offerings. Unlike the rapid onset of technological obsolescence that hit the video rental industry, with its purpose built stores and large inventories of movies on tape and then DVD or blu-ray format media, the tanning salon can diversity into a more fulsome health and wellness experience.129 Like other businesses faced with material changes in their environments, a tanning salon franchise can choose whether to provide more services to the same customers, or seek a larger customer base for its existing services, expanding the scope of its marketing and altering the retail experience to cater to other demographics. Drafting the franchise agreement with the foresight and flexibility to recognize and react to the potential impact of technological and environmental change, then taking a sound and collaborative approach to externalities, allowed these businesses to survive and others who were not so fortunate to wither.

XI. CHANGES IN SOCIAL MEDIA LAWS AND LAWS GOVERNING CUSTOMER DATA INTERCHANGE BETWEEN FRANCHISEES AND FRANCHISOR

Franchise systems are certainly not immune to the ever changing landscape of social media. One in every fourteen people in the world has a Facebook account and there are over 100 million LinkedIn in professionals in over 200 countries.130 LinkedIn celebrated its 100 million membership milestone by releasing membership statistics. The company reports that the peak hour of LinkedIn services is around noon on a workday.131 What this means in the franchising context is both franchisors and franchisees are using social media, exchanging information, and at a rapid rate. With a click of a mouse, a franchisee can exchange proprietary information, breach a contract, or even potentially commit tortuous activity on the web.

Just one week prior to LinkedIn reaching its 100 millionth user, TEKsystems, Inc. reached a milestone in the social media legal world by filing the first-known social media based restrictive covenant lawsuit.132 In its complaint, TEKsystems allege that its former employees and their present employer violated certain non-competition, non-solicitation, and non-disclosure agreements by, among other things, soliciting key TEKsystems customers using LinkedIn.133 In their employment agreements, the former TEKsystems employees had agreed to not contact, solicit, or induce any person who had been a “contract employee” during the two-year period prior to the date of termination and about whom the employee knew by reason of their employment with TEKsystems, to: cease working for TEKsystems, refrain from beginning work


132 TEKsystems, Inc. v. Hammernick et. al., No 0:10-cv-00819, (N.D. Min. 2010).

133 id. at 9-10.
with TEKsystems, or provide services to any individual, corporation, or entity whose business is competitive with TEKsystems. One of the defendants had communicated with twenty of TEKsystems’ contract employees using LinkedIn and had “connected” with certain TEKsystems’ employees through LinkedIn.

While the TEKsystems case is set for trial in the United States District Court, District of Minnesota beyond the date of publication, it raises important questions for franchise systems. Can simply requesting to be someone’s “friend” on their personal Facebook account or connecting with a professional on their personal LinkedIn account constitute solicitation in violation of a non-solicitation or non-compete agreement? Interestingly, TEKsystems’ non-solicitation agreement did not specifically prohibit the employees from engaging in social media solicitation. More than likely, at the time the employment agreement was drafted by TEKsystems, the parties did not contemplate the advent of social media. If they had done so, this case might be easier to decide for the District of Minnesota. If the District of Minnesota finds for the Defendants, this case will serve as an important lesson for franchisors to specifically provide for social media prohibitions in non-compete, non-solicitation, and non-disclosure agreements.

TEKsystems specifically named Horizontal Integration, Inc. as a Defendant, the competitor-employer of the former TEKsystems employees. The basis for Horizontal Integration’s liability is a tortuous interference claim. TEKsystems allege that by Horizontal Integration continuing to employ TEKsystems employees and ratifying their breaches of the TEKsystems employment agreements, Horizontal Integration is tortuously interfering with TEKsystems’ contracts. What does this mean for the franchise system? If the court were to find for TEKsystems on the tortuous interference claim, franchisors would be exposed to liability by hiring former competitors who use social media at the workplace as a basis for business development. To avoid such liability, franchisors should strongly monitor the use of social media accounts through a carefully crafted social media policy or even, to the extent possible, prevent the use of social media in its entirety.

The TEKSystems case at least tangentially raises another question, namely, who “owns” one’s LinkedIn or social media account? Is it the employer or the employee? Imagine a hypothetical scenario where a franchisor’s sales employee stores contact lists on his personal LinkedIn account. The sales employee may even use LinkedIn to troll his work email account for potential contacts. The sales employee may keep such information under his personal LinkedIn profile which lists his past employment. In addition, the account is stored on LinkedIn’s servers which are accessible using the employee’s own password. Can the franchisor claim that such client lists are proprietary when they are stored on the employee’s own personal LinkedIn account? There are very few cases that address this issue. The English courts have held that where an employee keeps all his contacts in his employer’s Microsoft Outlook email system on

134 Id. at 6-8; 12-14; 17-18.
135 Id. at 10.
136 Id. at 24-25.
137 Id.
138 Email trolling is a process by which social media providers can troll one’s email account contact list for further social media connections such as Facebook friends or LinkedIn professional connections at the social media user’s election.
the employer’s server, the Outlook contact lists belong to the employer.\textsuperscript{139} However, in our scenario LinkedIn accounts and Facebook accounts are not stored on employer’s servers, but on third party servers. This issue of ownership based on the location of servers because even more problematic with the advent of cloud computing.\textsuperscript{140}

Given the ease with which information can be exchanged, any ambiguity with respect to who “owns” such proprietary information may again be resolved through a carefully crafted social media policy. The social media policy might prevent employees from trolling their work email account using social media or may prevent employees from using social media in its entirety. In addition, franchisor/employers may block LinkedIn or other social media through their internet service provider firewall. The greater control the employer exerts over the propriety customer lists, the greater likelihood the employer may claim that such a list is a trade secret worthy of protection.\textsuperscript{141}

With the advent of social media, we see a proliferation of information exchange and with it greater risk that such information may be used to violate a contract. The TEKSystems case will answer important questions concerning solicitation in a digital age, but it would serve franchise systems well if we think about how to avoid such liability before the franchise world is faced with a TEKsystems complaint of its own.

\textsuperscript{139} Penwell Publishing (UK) Ltd. v. Ornstein et. al. [2007] EWHC 1570.

\textsuperscript{140} Cloud computing refers to computational services such a data or software being accessible through an internet connection rather than on one’s domestic computer hardware. Cloud computing moves the situs of data away from a personal computer so that data can be accessible from anywhere using any device. See e.g., Rivka Tadjer, What is Cloud Computing? P.C. Mag., available at: http://www.pcmag.com/article2/0,2817,2372163,00.asp (last visited on June 15, 2011).

\textsuperscript{141} The Uniform Trade Secrets Act defines “trade secret” as “information, including a formula, pattern, compilation, program device, method, technique, or process, that: (i) derives independent economic value, actual or potential, from not being generally known to, and not being readily ascertainable by proper means by, other persons who can obtain economic value from its disclosure or use, and (ii) is the subject of efforts that are reasonable under the circumstances to maintain its secrecy.” (Unif. Trade Secrets Act § 1(4) (amended 1985).
XII. ARIZONA IMMIGRATION LAW

Franchise agreements usually include a covenant to the effect that the franchisee will comply with applicable laws in the operation of the franchised business. The agreements also typically include a careful delineation of the franchisee's rights to control the circumstances of employing its employees and reserve no power for the franchisor to interfere with or control the terms and conditions of employment, recruitment, selection, scheduling, promotion, discipline or discharge. But many franchise systems rely on ample supplies of low-wage labor to staff the business, particularly for menial positions on late or night shifts. The temptation to hire persons with questionable credentials is powerful when the applicants are simply grateful to be gainfully employed at U.S. wage levels. As a result, franchisees view hiring of illegal immigrants as a matter of economic freedom and business necessity. Until a rational federal immigration policy allows legal immigration to supply labor for such jobs, franchises depend on whatever labor that can be employed to fill their rosters.

States seeking to curtail illegal immigrant employment such as Arizona enact legislation intended to empower state and local governments and private employers to enforce existing Federal immigration policy. These efforts are challenged by various actors in the labor and civil rights arena. Labor-intensive businesses like many franchises are caught in the vise of the need for labor and the demands of documentation and proof of citizenship. If the labor supply is inadequate at the wage rate the business can afford and the cost of compliance too high, the business may well fail.

A. Arizona Contractors Association, Inc. v. Candelaria

This case is a challenge to the Legal Arizona Worker's Act (the "Act") as facially unconstitutional. The trial court found that the Act was, in fact, constitutional, based on a lack of preemption by federal law, its conformity with federal law requirements, the existence of proper due process provided for by the Act, and the Commerce Clause not applying to the constitutionality of the Act because it did not involve interstate commerce. The federal law at issue in the case was the Immigration Reform and Control Act of 1986 ("IRCA") and the Illegal Immigration Reform and Immigrant Responsibility Act of 1996 ("IIRIRA"). The IRCA set form the Form I-9 employee verification program and, under it, Congress also declared that IRCA "preempt[s] any State or local law imposing civil or criminal sanctions (other than through licensing or similar laws) upon those who employ, recruit or refer for a fee for employment, unauthorized aliens." The IIRIRA "directed the Attorney General to conduct three pilot programs to improve the employment verification system," one of which was the Basic Pilot

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145 534 F.Supp.2d 1036 (D. Ariz. 2008)(continuing the cause of action as presented in Arizona Contractors Association v. Napolitano, 526 F.Supp.2d 968 (D Ariz. 2007), but without those plaintiffs found to not have standing.)
149 Candelaria, 534 F.Supp.2d at 1041-42 (quoting 8 U.S.C. § 1324a(h)(2)).
The Basic Pilot Program is known as E-Verify now, and is an internet based system which "reports the work authorization status of a new hire to an employer by checking records at the Social Security Administration (SSA), Department of Homeland Security (DHS) and U.S. Citizenship and Immigration Services (USCIS)."  

The Plaintiffs in the case were non-profit employer organizations and they argued that the statute was unconstitutional for four main reasons: (1) the IRCA preempts state law; (2) the Legal Arizona Worker's Act conflicts with the purposes and objectives of Congress; (3) the Act does not provide employers with adequate procedural due process; and (4) the Act violates the Commerce Clause. The district court explained its decision on the following basis:

1. The IRCA language actually authorizes the type of action set forth by the Arizona Act, specifically the language says "(other than through licensing and similar laws)" and the Act "authorizes state courts to suspend or revoke the business licenses of employers who knowingly or intentionally employ unauthorized aliens," and the Act does not intrude on the federal government's plenary power over the field of immigration because it does not determine "who should or should not be admitted into the country, and the conditions under which a legal entrant may remain."  

2. The Act does not conflict with the purposes and objectives of Congress because preemption only exists when "compliance with both State and federal law is impossible, or when state law 'stands as an obstacle to the accomplishment and execution of the full purposes and objectives of Congress." The court reasoned that:
   
   (a) the Act's licensing sanctions did not conflict with the purposes and objectives of Congress because the federal laws also "prohibit employers from 'knowingly' employing an unauthorized alien;" and

   (b) the Act's failure to contain a prohibition on discrimination is not at conflict with federal law because "Arizonans are protected by the prohibitions against discrimination in IRCA, other federal laws, and Arizona law;"  

3. The Act does provide employers with proper procedural due process because section 23-212(H) provides that "[n]o employer may be sanctioned without a full evidentiary hearing in the Superior Court of Arizona," and that the court "cannot find an employee unauthorized absent a federal determination to that effect under 8 U.S.C. § 1373(c)."  

4. "The Act does not regulate employees completely outside of the State" because "employee" is defined as "[a]ny person who performs employment services for an employer who is licensed to do business in the State." Further, the enforcement
provisions require that the action be filed "in the county where the unauthorized alien is employed" which precludes the extraterritorial application of the Act.\textsuperscript{156}

B. \textit{Chicanos Por La Causa, Inc. v. Napolitano}\textsuperscript{157}.

The Plaintiffs in \textit{Arizona Contractors Association, Inc. v. Candelaria} appealed the ruling of the District Court to the Ninth Circuit, and several other district court cases dealing with the Legal Arizona Worker's Act were consolidated. The issues were whether the state Act was preempted by federal law and whether there was a violation of procedural due process rights of the employers.\textsuperscript{158} The Ninth Circuit affirmed the district courts' findings, holding that there was no preemption and no due process violation.\textsuperscript{159}

The Act was found to fall under the IRCA savings clause, section 1324a(h)(2), which states: "The provisions of this section preempt any State or local law imposing civil or criminal sanctions (other than through licensing and similar laws) upon those who employ, or recruit or refer for a fee for employment, unauthorized aliens."\textsuperscript{160} This was based on U.S. Supreme Court precedent that "the authority to regulate the employment of unauthorized workers is 'within the mainstream' of the state's police power,"\textsuperscript{161} the Ninth Circuit's interpretation of what "license" meant, and the Ninth Circuit rejecting the Plaintiffs' argument that state sanctions could only be imposed under the IRCA after a "federal determination of an alien's unauthorized status."\textsuperscript{162} Additionally, no implied preemption existed because the Ninth Circuit rejected the argument that mandating E-verify in the Arizona law conflicted with Congressional intent to keep the use voluntary, and the court's finding that there was no evidence the sanctions under the Act would be harsher than those under IRCA because there had not been any enforcement action under the Act yet.\textsuperscript{163}

As to procedural due process, the Ninth Circuit cited the procedural requirements of notice and an opportunity to be heard prior to deprivation of a property interest and then found that the procedures set forth in the Act for bringing an enforcement action were sufficient. This was based on interpretation of section 23-212(H) as providing a hearing at which the "rebuttable presumption created by the federal determination of an employee's unauthorized status" may be overcome.\textsuperscript{164} This provision was interpreted in light of the provisions in section 23-212(B):

When investigating a complaint, the attorney general or county attorney shall verify the work authorization of the alleged unauthorized alien with the federal government pursuant to 8 United States Code § 1373(c). A state, county or local official shall not attempt to

\textsuperscript{156} \textit{Id.} at 1061 (emphasis in original).

\textsuperscript{157} 558 F.3d 856 (9th Cir. 2008)

\textsuperscript{158} \textit{Chicanos Por La Causa, Inc. v. Napolitano}, 558 F.3d 856, 859-60 (9th Cir. 2008).

\textsuperscript{159} \textit{Id.} at 869.

\textsuperscript{160} \textit{Id.} at 864.

\textsuperscript{161} \textit{Id.} at 864 (quoting De Canas v. Bica, 424 U.S. 351, 356 (1976)).

\textsuperscript{162} \textit{Id.} at 856.

\textsuperscript{163} \textit{Id.} at 867-68.

\textsuperscript{164} \textit{Chicanos Por La Causa, Inc}, 558 F.3d at 868.
independently make a final determination on whether an alien is authorized to work in the United States.\textsuperscript{165}

The Ninth Circuit, therefore, found the Act facially constitutional.\textsuperscript{166}


When the issue as of the constitutionality of the Legal Arizona Worker's Act reached the U.S. Supreme Court, it too found that the Act was not preempted by federal law and therefore constitutional.

"Federal immigration law expressly preempts any state or local law imposing civil or criminal sanction (other than through licensing and similar laws) upon those who employ, . . . unauthorized aliens.' 8 U.S.C. § 1324a(h)(2). A recently enacted Arizona statute—the Legal Arizona Worker's Act—provides that the licenses of state employers that knowingly or intentionally employ unauthorized aliens may be, and in certain circumstances must be, suspended or revoked. The law also requires that all Arizona employers use a federal electronic verification system to confirm that the workers they employ are legally authorized workers. The question presented is whether federal immigration law preempts those provisions of Arizona law. Because we conclude that the State's licensing provisions fall squarely within the federal statute's savings clause and that the Arizona regulation does not otherwise conflict with federal law, we hold that the Arizona law is not preempted."\textsuperscript{167}

The Supreme Court also laid out how the law works and will apply to employers, based on its interpretation:

(1) "Under the Arizona law, if an individual files a complaint alleging that an employer has hired an unauthorized alien, the attorney general or the county attorney first verifies the employee's work authorization with the Federal Government pursuant to 8 U.S.C. § 1373(c)."\textsuperscript{168}

(a) "Section 1373(c) provides that the Federal Government 'shall respond to an inquiry by a' State 'seeking to verify or ascertain the citizenship or immigration status of any individual . . . by providing the requested verification or status information.'"\textsuperscript{169}

\textsuperscript{165} \textit{ARIZ. REV. STAT.} § 23-212(B).

\textsuperscript{166} \textit{Chicanos Por La Causa, Inc.}, 558 F.3d at 869.


\textsuperscript{168} \textit{ARIZ. REV. STAT. ANN.} § 23–212(B).

\textsuperscript{169} 8 U.S.C. § 1373(c).
(b) "The Arizona law expressly prohibits state, county, or local officials from attempting to independently make a final determination on whether an alien is authorized to work in the United States."\(^ {170}\)

(2) "If the § 1373(c) inquiry reveals that a worker is an unauthorized alien, the attorney general or the county attorney must notify United States Immigration and Customs Enforcement officials, notify local law enforcement, and bring an action against the employer."\(^ {171}\)

(3) "When a complaint is brought against an employer under Arizona law, 'the court shall consider only the federal government's determination pursuant to' 8 U.S.C. § 1373(c) in 'determining whether an employee is an unauthorized alien.'\(^ {172}\) "Good-faith compliance with the federal I–9 process provides employers prosecuted by the State with an affirmative defense."\(^ {173}\)

(4) "A first instance of 'knowingly employ[ing] an unauthorized alien' requires that the court order the employer to terminate the employment of all unauthorized aliens and file quarterly reports on all new hires for a probationary period of three years."\(^ {174}\) "The court may also 'order the appropriate agencies to suspend all licenses ... that are held by the employer for [a period] not to exceed ten business days.'\(^ {175}\)

(a) "For a first intentional violation, the court must order the employer to terminate the employment of all unauthorized aliens and file quarterly reports on all new hires for a probationary period of five years."\(^ {176}\) "The court must also suspend all the employer's licenses for a minimum of 10 days."\(^ {177}\)

(5) "A second knowing violation requires that the adjudicating court 'permanently revoke all licenses that are held by the employer specific to the business location where the unauthorized alien performed work.'\(^ {178}\)

(a) "A second intentional violation requires the permanent revocation of all business licenses."\(^ {179}\)

\(^{170}\) Arizona Revised Statutes Annotated § 23–212(B).

\(^{171}\) Arizona Revised Statutes Annotated § 23–212(C)(1)–(3), (D).

\(^{172}\) Arizona Revised Statutes Annotated § 23–212(H). Arizona explained in the case, and the Supreme Court agreed, that "this provision does not permit the State to establish [an employee's] unlawful status apart from the federal determination," and it "instead operates to 'ensure that the employer has an opportunity to rebut the evidence presented to establish a worker's unlawful status.'" Whiting, 2011 WL 2039365, *12 n. 7.

\(^{173}\) See Arizona Revised Statutes Annotated § 23–212(J).

\(^{174}\) Arizona Revised Statutes Annotated § 23–212(A), (F)(1)(a)-(b).

\(^{175}\) Arizona Revised Statutes Annotated § 23–212(F)(1)(d).

\(^{176}\) Arizona Revised Statutes Annotated § 23–212.01(A), (F)(1)(a)-(b).

\(^{177}\) Arizona Revised Statutes Annotated § 23–212.01(A), (F)(1)(a)-(b).

\(^{178}\) Arizona Revised Statutes Annotated § 23–212(F)(2).

\(^{179}\) Arizona Revised Statutes Annotated § 23–212.01(F)(2).
(b) "With respect to both knowing and intentional violations, a violation qualifies as a 'second violation' only if it occurs at the same business location as the first violation, during the time that the employer is already on probation for a violation at that location."  

(c) "License" in the Arizona statute, includes "documents such as articles of incorporation, certificates of partnership, and grants of authority to foreign companies to transact business in the State."  

(5) "The Arizona law also requires that 'every employer, after hiring an employee, shall verify the employment eligibility of the employee' by using E–Verify." Proof of verifying the employment authorization of an employee through the e-verify program creates a rebuttable presumption that an employer did not knowingly employ an unauthorized alien.  

Justice Breyer and Justice Ginsberg dissented. They argued that there was preemption of Arizona's law by federal law based on the state's actions against employers falling into the "civil sanctions" that are listed in the IRCA section 1324a(h)(2). The majority found that the Arizona definition of "license," which encompassed articles of incorporation, certificates of partnership, and grants of authority to foreign companies . . . ," was not itself a "licensing law" but was "at the very least 'similar' to a licensing law, and therefore comfortably within the savings clause." The dissent found that dictionary definitions of the word license, though broad enough to encompass Arizona's definition, were not proper where the meaning of the word needed to be derived from the context of the IRCA and the intent of Congress. Contrary to the majority, the dissent found that license, as used in the IRCA, did not include "articles of incorporation, certificates of partnership, and grants of authority to foreign companies . . ." such that the Arizona law was preempted by the IRCA because it did not fall within the savings clause.  

XIII. FTC GUIDELINES ON TESTIMONIALS AND ENDORSEMENTS  

Much like social media's changing landscape, new web based technology is altering the Federal Trade Commission's (FTC) regulatory framework. Effective December 1, 2009, the FTC
put forth new administrative interpretations of the law ("Guide") to help advertisers comply with the Federal Trade Commission Act (15 U.S.C. 45) in a digital age.\(^\text{188}\) Under the old Guide, which was last updated in 1980, it was a question as to whether digital media such as Facebook, Twitter, or LinkedIn and word of mouth marketing campaigns would fall under the FTC’s scope. Given the new Guide specifically addresses bloggers and other digital media, there is no doubt that social media falls within the FTC’s ambit.\(^\text{189}\) What this means for franchise systems is the need for both franchisors and franchisees to comply with the new FTC Guides in an effort to avoid harsh penalties.

Under the old Guide, an advertisement that portrays a consumer’s experience with a product that was not typical with the average consumer needed to clearly disclose a “results not typical” disclaimer in the advertisement. This safe harbor provision is abolished under the new Guide and advertisers must now substantiate a claim with empirical evidence concerning what might be a typical customer experience.\(^\text{190}\) For example, if an advertisement features testimonials that states, “I lost fifty pounds by using Diet Drug X,” and consumers generally do not lose fifty pounds with Diet Drug X, the advertisement must disclose generally achieved outcomes (e.g. “most consumers lose at least ten pounds”).\(^\text{191}\)

In addition to the new empirical typicality requirement, the FTC Guide sets forth new disclosure requirements for material connections in advertisements.\(^\text{192}\) This new provision is targeted directly at the blogosphere and digital media. The Guide provides, “[w]here there exists a connection between the endorser and the seller of the advertised product that might materially affect the weight or credibility of the endorsement (i.e., the connection is not reasonably expected by the audience), such a connection must be fully disclosed.”\(^\text{193}\) This disclosure requirement does not cover traditional advertisements with a celebrity endorser endorsing a certain product because the audience would expect the celebrity to be compensated by the product manufacturer. What raises concern for the FTC are endorsers who are not generally known by the public endorsing products without revealing their compensation. In this context, the FTC Guide specifically addresses digital media. For example, the Guide highlights an example where a video game blogger reviews a popular video game and posts such a review on his blog. What the consuming audience does not know is the fact the blogger received free video games from the manufacturer for his endorsements. In order to avoid deceiving the consuming public, the video game blogger must clearly and conspicuously disclose his free video game compensation in the blog endorsement.\(^\text{194}\)

The new FTC Guide causes greatest concern for franchise systems that use social media as a marketing device. The new Guide makes clear that both advertisers and the social media or blogging endorser can both be liable for non-compliance with the FTC Act. The genesis for holding the advertiser liable for non-compliance or deceptive statements made by a

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\(^{189}\) Id.

\(^{190}\) 16 C.F.R. § 255.2.

\(^{191}\) Id.

\(^{192}\) 16 C.F.R. § 255.5.

\(^{193}\) Id.

\(^{194}\) Id.
blogger is the fact that while the advertiser cannot control the comments made by the third-party blogger, the advertiser assumed the risk by using social media or blogs.\textsuperscript{195} By using social media, it is up to the advertiser to know what is being said about the advertiser’s product. For example, if a product franchise system uses a blogger to endorse its product and the blogger does not disclose any material connection with the product franchise system or the blogger otherwise violates the FTC Act, the advertiser can be held liable. The FTC will take into account the extent to which the advertiser monitored the blogging activity and communicated its message and guidelines to the social media marketer.\textsuperscript{196} Accordingly, it will serve franchise systems well to closely monitor third party bloggers and provide detailed guidelines in conformity with the new FTC Guide.

The new FTC Guide implements the same legal principals into the changing world of consumer generated digital media. The overriding principals are the same, namely, protecting the consuming public from harmful or deceptive advertisements. The remedies to correct such harmful advertisements include a $10,000 fine for every violative advertisement, cease and desist orders and injunctions, as well as corrective advertising and informational remedies.\textsuperscript{197} Franchise systems must be mindful of the new Guide as it applies to social media in order to avoid any liability.

XIV. CAN SPAM ACT

In order to address the negative effects of mass email marketing, Congress passed and the Controlling the Assault of Non-Solicited Pornography and Marketing Act of 2003 ("CAN-SPAM Act").\textsuperscript{198} The CAN-SPAM Act does not only apply to junk email messages but covers "any electronic mail message the primary purpose of which is the commercial advertisement or promotion of a commercial product or service."\textsuperscript{199} Each prohibited email message may carry with it monetary damages for violators which include not only the internet marketing companies, but the advertisers themselves. This can expose the franchise system to liability for employing or engaging in mass email marketing that violates certain provision of the CAN-SPAM Act.

The rationale for the CAN-SPAM Act is to prevent mass email marketing messages from deceiving the consuming public.\textsuperscript{200} Accordingly, the CAN-SPAM Act requires all email headers on electronic mail messages being sent for purposes of commercial advertising to have accurate "From," "To," "Reply-To" information and all routing information must be accurate.\textsuperscript{201} In addition all email subject lines of such messages must accurately reflect the content of the message.\textsuperscript{202} The electronic message must have a clear and conspicuous message that identifies the correspondence as an advertisement as well as a valid postal address.\textsuperscript{203}


\textsuperscript{196} id.

\textsuperscript{197} 15 U.S.C.A. § 45 (West).

\textsuperscript{198} 15 U.S.C.A. § 7701 (West).

\textsuperscript{199} id.

\textsuperscript{200} id.

\textsuperscript{201} 15 U.S.C.A. § 7704 (West).

\textsuperscript{202} id.

\textsuperscript{203} id.
The Act also addresses unwanted or unsolicited email messages. CAN-SPAM requires the sender of electronic mail messages sent for purposes of commercial advertisement to display a clear and conspicuous explanation in the electronic message of how the recipient can opt out of getting the email correspondence in the future.\footnote{Id.} There must be an easy means of opting-out of receiving the message in the future, the sender cannot charge any opt-out fee, and any request to opt-out must be honored within ten business days of receiving the request. Once the email recipient opts out, the sender is prohibited from selling or transferring the email message in the form of a mailing list.\footnote{15 U.S.C.A. § 7704 (West).}

What causes concern for the franchise system is the broad scope of liability the CAN-SPAM Act imposes on violators. Much like the FTC Guide’s imposition of broad liability upon third-party offenders for deceptive advertisements, CAN-SPAM imposes liability on not only the internet marketing companies sending mass email messages, but upon the advertisers themselves. Under the Act, those who use mass electronic message marketing cannot simply contract away their responsibility. Rather, the Act imposes liability on persons who know or should have known commercial electronic email messages were being sent in violation of Section 7704(a)(1) CAN-SPAM.\footnote{15 U.S.C.A. § 7705 (West).} For example, if a franchisor uses an internet marketing company to promote its product, and the internet marketing company includes a deceptive “header” on its mass electronic mail message, the franchisor can be held liable under CAN-SPAM for as much as $16,000 per unlawful email message.\footnote{Bureau of Consumer Protection, Advertising and Marketing on the Internet: Rules of the Road, available at http://business.ftc.gov/documents/bus28-advertising-and-marketing-internet-rules-road (last visited on June 15, 2011).}

Recently the United States District Court, Northern District of California expanded the scope of the CAN-SPAM Act as far as the definition of electronic mail. In \textit{Facebook, Inc. v. Maxbounty, Inc.}, Judge Jeremy Fogel held that the CAN-SPAM Act applies to social networking communications in which an electronic message is not delivered to an “inbox.”\footnote{Facebook, Inc. v. MaxBounty, Inc., CV-10-4712-JF, 2011 WL 1120046 (N.D. Cal. Mar. 28, 2011).} Facebook argued, among other things, that Defendant Maxbounty violated the CAN-SPAM Act by creating fake Facebook sites to redirect Facebook users away from Facebook.com to third party commercial sites.\footnote{Id. at *2.} The court determined that an expansive understanding of electronic messages to cover Maxbounty’s social media activity is consistent with the intent of Congress under CAN-SPAM to mitigate the number of misleading commercial communications that overburden infrastructure of the internet.\footnote{Id. at *5.}

The \textit{Facebook} case seems to fill a regulatory gap between CAN-SPAM and the FTC Act whereby deceptive social media messages that are not endorsements are unlawful. What CAN-SPAM Act, the new FTC Guide, and \textit{Facebook v. Maxbounty} all mean for the franchise system is a need to be wary when using social media or mass electronic mail messaging when marketing products or services. The franchise system may lessen their likelihood of liability by

\begin{footnotesize}
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\item \footnote{Id.}{Id.}
\item \footnote{15 U.S.C.A. § 7704 (West).}{15 U.S.C.A. § 7704 (West).}
\item \footnote{15 U.S.C.A. § 7705 (West).}{15 U.S.C.A. § 7705 (West).}
\item \footnote{Id. at *2.}{Id. at *2.}
\item \footnote{Id. at *5.}{Id. at *5.}
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implementing a social media policy indicating how a franchisor’s employees, their franchisee, social media and marketing groups use social media in a digital age.
Biographies

JOEL R. BUCKBERG

Joel Buckberg is Of Counsel in the Nashville and Atlanta offices of Baker Donelson Bearman Caldwell & Berkowitz, PC. He counsels business clients, particularly in hospitality, franchising and distribution, on strategic planning, transactions, financing, mergers and acquisitions, regulatory compliance international trade and operations. Active in the International Franchise Association (IFA), he serves as administrator for the IFA's Franchise Compliance Training Program, a remedial educational program for violators of federal and state franchise regulations. He is a legal advisor and trainer for IFA's FranGuard compliance and business culture training program. He served as co-editor of the 2009 edition of Annual Developments in Franchise and Distribution Law published by the American Bar Association, and is a frequent speaker at IFA Legal Symposium and ABA Forum on Franchising meetings. He is the editor of Baker Donelson's *Hospitalitas* electronic newsletter on franchising and hospitality. Additionally, Mr. Buckberg serves as the host for the IFA's quarterly Franchise Business Network meetings in Tennessee, Alabama and Mississippi. He is admitted to practice in Texas, Georgia, New Jersey and Tennessee. He holds J.D. and M.B.A. degrees from Vanderbilt University, and a B.A. from Union College. Prior to joining the firm, he was Executive Vice President and Deputy General Counsel of Cendant Corporation, and engaged in private and in-house practice in Houston and Atlanta. Mr. Buckberg is a member of the U.S. Coast Guard Auxiliary and is a volunteer for the American Lung Association.

TED P. PEARCE

Ted P. Pearce is Vice President and General Counsel for Driven Brands, Inc., which is the holding company for Meineke Car Care Centers, Inc., MAACO Franchising, Inc., Econo Lube N'Tune and Auto Qual. Driven Brands is based in Charlotte, North Carolina. Prior to being appointed to the position of General Counsel in November 1982, he was in private practice specializing in commercial litigation.

Mr. Pearce received his Bachelor's Degree, with honors, from the University of Virginia in 1973 and his J.D. from Syracuse University in 1977. He is a member of the Texas Bar Association, Wisconsin Bar Association, and North Carolina Bar Association. In addition, Mr. Pearce is past Chairman of the Corporate Counsel Section of the North Carolina Bar Association, and a former member of the board of directors for the American Bar Association Forum on Franchising.