FREQUENTLY ARISING ISSUES IN LITIGATION

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I. HANDLING DEFAULTS AND TERMINATIONS EFFECTIVELY AND LAWFULLY

A. Introduction

Issuing a default or terminating a franchise are serious matters. From the franchisor's perspective, it is essential that its franchisees comply with their responsibilities under the franchise agreement (e.g., paying royalties and the like) and that it take all appropriate steps to protect the brand. From the franchisee's perspective, the franchised business is often his/her sole or principal source of income. From either party's perspective, issuing a default or terminating a franchise are likely to have far-reaching consequences. For this reason, it is important that a franchisor carefully consider the pros and cons before issuing a default or terminating a franchise. This section of the paper focuses on some of the issues that should be addressed before issuing a notice, as well as some of the basics for ensuring that the notice is lawful.

B. What are the Potential Grounds for the Default or Termination?

All franchisee defaults are not equal. Some are straightforward and clear cut (e.g., failing to pay royalties or advertising fees); others, depending on the circumstances, may be somewhat subjective (e.g., failing to comply with certain aspects of the franchise system); some are relatively minor (e.g., failing to provide the franchisor with complete financial records in a timely manner); others are so significant they may warrant an immediate termination of the franchise agreement (e.g., abandoning the franchise or being convicted of a felony); and still others are complicated by the fact that the franchisor subleases the premises to the franchisee or has financed the franchisee's equipment. As counsel for a franchisor, it is important to recognize that the nature of the default will generally dictate the appropriate course of action. The more subjective and less clear-cut a default, the more likely it is that the franchisee will contest the matter and the more critical it is that the default or termination be thoroughly and properly documented.

1. Monetary Breaches.

As a general rule, a franchisee's failure to pay amounts owed to the franchisor is unambiguous and provides a clear basis for issuing a notice of default and, in the event the franchisee fails to cure the breach in a timely manner, grounds for terminating the franchise agreement. There are, of course, exceptions to the general rule and counsel should be aware of them when investigating the facts regarding the default. For example, (i) will the franchisee dispute that it owes money to the franchisor; (ii) is the amount owed relatively minor (and, therefore, the failure to pay the amount owed in a timely manner arguably does not warrant terminating the franchise agreement); (iii) are there extenuating circumstances that may have contributed to the default (*e.g.*, a disaster of some sort); (iv) has the franchisor historically <u>not</u> issued defaults for unpaid royalties, etc. other than in the most egregious of circumstances; or (v) has the franchisor explicitly or implicitly told the franchisee "not to worry about it." The answers to these and similar questions may mean that what appears to be a relatively routine monetary default is, under the circumstances, surprisingly complicated. Notwithstanding, monetary defaults are usually as straightforward as it gets in the spectrum of potential defaults by a franchisee.

2. Failing to Comply with the Franchise "Program."

The essence of the franchise business model is a uniform method of operation. This, and the related intellectual property, is what the franchisor is selling and what the franchisee is purchasing. Virtually all, if not all, franchise agreements require that the franchisee comply in all respects with the franchise program. The franchisor rightfully believes that consistency and uniformity of operation amongst its franchisees is essential to the success of the individual franchisees, the franchise system as a whole and, of course, the franchisor. It is not surprising then that franchisors are typically adamant that their franchisees follow the program. It is equally unsurprising that some franchisees do not follow the program to the proverbial "letter" either because they think that some aspect of the program is not that important or because they think they know more than the franchisor about what works in their particular territory.

Issuing a default or terminating a franchise on the ground that the franchisee has failed to comply with the program, however, is often fraught with complications. This is especially true when the default is subjective and/or the franchisor's enforcement policies have historically been lax or inconsistent. It is important that counsel carefully review the circumstances of the default, the evidence that supports the default and determine that the default is material before issuing a notice of default or termination.

3. Standards Breaches.

In an effort to improve overall performance within the franchise system, some franchise agreements provide that a franchisee will be in breach of the agreement if his/her performance falls below certain targeted levels. On an operations level, consistent application of these types of provisions can be difficult. Issuing a default or terminating a franchise on this basis may be also problematic. Counsel and the franchisor need to carefully review the standards, the criteria upon which they are based, the procedures for determining the franchisee's performance and whether such procedures are uniformly applied before proceeding with a default or termination on the basis of a franchisee's failure to meet the standards or criteria.

4. Repeated Breaches of the Franchise Agreement.

Many franchise agreements and state franchise relationship laws provide that a franchisee's multiple breaches of the agreement (cured or uncured) within a certain period of time constitute "good cause" for terminating the franchise.[2] While these types

[2] *See, e.g.*, Cal. Bus. & Prof. Code § 20021(f) [good cause exists to terminate a franchise if "the franchisee, after curing any failure in accordance with Section 20020, engages in the same non-compliance whether or not such non-compliance is corrected after

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of provisions may seem like a safe harbor "catch-all" that will justify the termination of a franchise in many circumstances, it is important that counsel and the franchisor carefully consider both the number and materiality of the defaults before relying on a provision of this sort as the sole basis for the termination. Has the franchisee repeatedly breached material provisions of the franchise agreement? Has the franchisee been warned in writing about the breaches and that the franchise may be terminated in the event of additional or future non-compliance? Is the franchisee's default history more egregious than that of other franchisees? The answer to these sorts of questions will govern whether a notice of termination should be issued on the basis of multiple defaults.

5. Breaches of Other Agreements.

In many franchise systems, the franchisor and franchisee are parties to other agreements (*e.g.,* lease agreements and financing agreements). In addition, the franchisee may have signed a payment agreement, promissory note or guaranty agreement. Counsel will need to carefully review all of the relevant agreements and determine whether a franchisee's breach of another agreement constitutes a default of the franchise agreement.

C. Investigation By Counsel

1. The Franchise Agreement and Other Related Agreements.

The starting point for determining whether a notice of default or termination is appropriate is, of course, the franchise agreement. What does it say? It is essential that counsel review the franchise agreement as a whole and, in particular, the operative provisions of the agreement (the default/termination section and the section(s) that cover the issue(s) that form the basis of the default/termination). In reviewing the franchise agreement, counsel should be on the lookout for potential ambiguities, inconsistencies within the agreement as to what the franchisee is supposed to do or not do and when, and any dispute resolution provision or other provisions that may be relevant (*e.g.*, a choice of law provision). Counsel should also consider whether the relevant provisions of the franchise agreement are potentially unconscionable or otherwise unenforceable.

As mentioned above, there may be other agreements that the franchisee has breached or that are somehow relevant to the default/termination process. Counsel will need to carefully review any other applicable agreements and be aware of differences or inconsistencies between them (*e.g.,* notice or cure requirements).

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notice"], and (g) [good cause exists to terminate a franchise if "the franchisee repeatedly fails to comply with one or more requirements of the franchise, whether or not corrected after notice."]; *see also* Iowa Code § 523H.7(3)(f); 815 Ill. Comp. Stat. § 705/19(c)(4); N.J. Stat. Ann. § 56:10-5.

2. State Franchise Relationship Laws.

Many states, as well as Puerto Rico and the U.S. Virgin Islands, have some form of statutory franchise law that cover franchisee defaults and terminations to one degree or another.[3] It is essential that counsel be familiar with the statute to the extent one is applicable. In particular, counsel should be on the lookout for differences between provisions in the franchise agreement and any applicable statute. For example, is the cure period required by the statute longer than that provided for in the agreement? Does the franchise agreement provide for termination in circumstances that are not expressly covered by or that are expressly precluded by an applicable state franchise law? If yes, a termination may not be appropriate, may be more likely to be contested or may be altogether impermissible. In all events, it is important that the franchisor comply with any applicable statute. Failing to do so may expose the franchisor to a claim of wrongful termination, damages and, in some states, penalties.

3. The Franchisor's Files.

It is also essential that counsel review the franchisor's files regarding the franchisee before issuing a notice of default or termination. A thorough review of the correspondence, e-mail, notes, accounting records and any other documents of consequence are essential to understanding the whole story. This is especially important when dealing with breaches of the franchise agreement that are not straightforward or obviously major. Has the franchisor previously warned the franchisee about the conduct? Was it required to do so? Even if not, should it have warned the franchisee? Has the franchisor complied with its obligations under the franchise agreement? Are the operating manual and similar documents consistent with the relevant provisions in the franchise agreement? Has the franchisor offered assistance to the franchisee? Did the franchisor comply with all of the necessary initial disclosure obligations? These and other similar questions need to be asked and satisfactorily answered. During the course of investigating a default by a franchisee, it is not uncommon for counsel to discover that there are unexpected complications that need to be finessed before or as part of the default/termination process.

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[3] *See, e.g.,* Ark. Code § 4-72-201, *et seq.*; Cal. Bus. & Prof. Code § 20000, *et seq.*; Conn. Gen. Stat. § 42-133e, *et seq.*; Del. Code Ann. Title 6 § 2551, *et seq.*; Haw. Rev. Stat. § 482E-6; 815 Ill. Comp. Stat. § 705/1, *et seq.*; Ind. Code § 23-2-2.7(1-7); Iowa Code § 523H.1, *et seq.* and 537A.10; Md. Code § 11-1301, *et seq.*; Mich. Comp. Laws § 445.1501, *et seq.*; Minn. Stat. § 80C.01, *et seq.*; Miss. Code Ann. § 75-24-51, *et seq.*; Mo. Rev. Stat. § 407.400, *et seq.*; Neb. Rev. Stat. § 87-401, *et seq.*; N.J. Stat. Ann. § 56:10-1, *et seq.*; S.D. Codified Laws § 37-5A-1, *et seq.*; Va. Code Ann. § 13.1-557, *et seq.*; Wash. Rev. Code § 19.100.180, *et seq.*; Wis. Stat. § 135.01, *et seq.*; P.R. Laws Ann. Title § 278, *et seq.*; V.I. Code Ann. Title 12A, § 130, *et seq.*

D. Key "Business" Issues to Consider Up Front

1. What Does the Client Really Want?

While the answer to this question may seem relatively obvious, it is not always the case. There are many factors and potential issues that should be considered before issuing a notice of termination (and to a somewhat lesser extent, a notice of default). Depending on the relative sophistication and experience of the client, it may be necessary for counsel to carefully explore the client's objectives. At a minimum, it is always a good idea.

2. Are there Viable Alternatives that are Consistent with the Client's Objectives?

As noted above, a notice of default and, certainly, a termination of a franchise are serious matters. Before embarking on a course of action that is certain to cost money, likely to be contentious and may end in litigation, counsel and the franchisor should consider whether there are other workable alternatives. In some circumstances, there may be no good reason not to proceed with issuing a notice of default and/or termination. In other circumstances, there may be no choice but to proceed with issuing a notice because the default is so serious (*e.g.*, where the franchisee's actions have created an imminent risk to public health or safety). There are, however, occasions when the underlying problem may be remedied by a voluntary change in the day-to-day management or the ownership of the franchise. While the time to fully explore these and other alternatives is often after a notice of default or termination has been served, the concepts should at least be raised in advance so that the client will have had an opportunity to give the issues some thought before the matter comes to a head.

3. Customer Issues.

It is also important, and in some instances critical, that the franchisor consider and be prepared for the potential customer-related fallout from a termination. At a minimum, terminating a franchise will cause at least some inconvenience and disruption to the franchisee's customers. In other circumstances, there may be significant consequences. This is especially the case when the franchisee sells an ongoing, service-based program to the public (*e.g.*, a series of classes). In such cases, time-consuming customer service, refund and other related issues are likely to arise. While these issues may technically be the franchisee's problems, as a practical matter the franchisor needs to develop a game plan for how to handle them in advance of the termination. Are there other nearby franchisees who can service the needs of the customers? Should the franchisor issue refunds to preserve customer goodwill? Is it likely that customers will contact the franchisor to complain or with questions? If yes, it may be necessary to prepare a script for the customer service representatives in advance of the termination to ensure that there is a consistent message to and appropriate support for the customers.

E. Key "Legal" Issues to Consider Up Front

1. What Law Applies?

Many franchise agreements contain a choice of law provision. While choice of law provisions are routinely enforced in a variety of contexts (provided there is a rational basis for choosing the designated forum), they may be unenforceable or of limited enforceability in the franchise context. For example, some state franchise relationship laws may arguably preclude the application of a choice of law provision altogether or, at a minimum, preclude its application to statutory franchise claims for wrongful termination and the like.[4] Even in the absence of a statutory franchise law, counsel will need to carefully analyze the choice of law issue given that there may be significant differences in the potentially applicable state laws regarding notice, cure and other matters relevant to the default/termination process.

2. What Should the Notice Include?

As a starting point, it is essential that the notice comply with the requirements of the franchise agreement and any applicable state franchise relationship law. To the extent the franchise agreement is not particularly specific and/or there is no governing franchise relationship law, the notice should, at a minimum, specifically set forth the default(s) in question, how and when the default(s) must be cured (if applicable), the grounds for the termination (if applicable), and the relevant sections of the franchise agreement. Note -- this issue is discussed in more detail below.

3. Is There a Cure Period?

For most defaults, the typical franchise agreement requires that the franchisee be provided with an opportunity to cure the default. The length of the "cure period" may be as short as five (5) days to as long as ninety (90) days. In addition, some state franchise laws require specific cure periods. It is critical that the franchisor provide the franchisee with the appropriate opportunity to cure. The consequences for failing to do so may be significant (*e.g.*, a claim for wrongful termination and damages). In the event that an applicable state franchise relationship law provides for a longer cure period than that provided for in the franchise agreement, the longer period applies. In the event of multiple defaults for which there are different cure periods, it is generally more prudent to apply the longest applicable period to all of the defaults rather than have separate cure periods for each of the defaults.

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[4] *See*, *e.g.*, Cal. Bus. & Prof. Code § 20010 ["Any condition, stipulation or provision purporting to bind any person to waive compliance with any provision of this law is contrary to public policy and void."]; *see also* Iowa Code §§ 523H.14, 537A.10; Md. Code § 11-1306; Mich. Comp. Laws § 445.1527(f); Wash. Rev. Code § 19.100.180(2)(c).

4. Waiver, Estoppel and Similar Defenses.

The issue of whether the franchisor has waived its right to issue a default or termination notice (or is estopped from doing so) is frequently raised as a defense by the franchisee. More often than not, these sorts of defenses are unsuccessful. However, they are clearly fact-specific and it is important that counsel investigate whether there is any factual support for them before issuing a notice of default or termination and, if so, whether anything can or should be done to eliminate the defense in advance. It is worth noting that while these defenses are generally unsuccessful, they frequently increase the cost of and cause a delay in effecting a termination.

5. Selective Enforcement / Discrimination.

Several states specifically prohibit a franchisor from treating its franchisees differently in connection with the application or enforcement of the terms of the franchise agreement unless there is a reasonable basis for the disparate treatment.[5] Even in states where it is not expressly precluded by statute, the issue is often raised by the franchisee in response to a default or as a defense to a termination under the rubric of "selective enforcement." If other franchisees have engaged in the identical or similar conduct, the franchisor will need to have a compelling explanation for treating one franchisee differently from another franchisee. Much like waiver and estoppel defenses, these sorts of arguments are generally unsuccessful, but they are fact-specific and often increase the cost and time it takes to complete a termination.

6. Alternative Dispute Resolution ("ADR") Provisions.

Many, if not most, franchise agreements have ADR provisions that come into play in the default and termination process. For example, the agreement may require (i) that the parties attempt to resolve any dispute prior to the issuance of a default or termination, or (ii) mandatory post-termination ADR (*e.g.*, mediation and/or arbitration). While ADR provisions are usually enforceable, there are some potential limitations. For example, the ADR provision may be subject to attack as unconscionable if it is one-sided and/or imposes a disproportionate burden on the franchisee. Additionally, some states will not enforce an ADR provision that requires a franchisee to pursue his/her claims in an out-of-state forum.[6]

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[5] *See, e.g.,* Haw. Rev. Stat. § 482E-6(2)(C); Ind. Code § 23-2-2.7(2)(5); 815 Ill. Comp. Stat. § 705/18; Wash. Rev. Stat. 19.100.180(2)(c).

[6] *See, e.g.,* Cal. Bus. & Prof. Code § 20040.5 ["A provision in a franchise agreement restricting venue to a forum outside this state is void with respect to any claim arising under or relating to a franchise agreement involving a franchise business operating within this state."]; Mich. Comp. Laws § 445.1527(e); Iowa Code §§ 523H.3.1, 537A.10.

7. Inventory, Etc. Repurchase.

Several of the states with franchise relationship laws require the franchisor to repurchase the franchisee's inventory, supplies, equipment and the like in the event the franchise is terminated or the franchisor fails to renew the franchise without good cause.[7] In other states, the franchisor must compensate the franchisee for his/her inventory, etc. even if the termination or decision to not renew the franchise was appropriate.[8] The franchisor should consider the cost of repurchasing the franchisee's inventory, etc. and other related issues as part of the process of determining whether to terminate a franchise. Unfortunately, valuing the inventory, supplies and the other items that the franchisor is required to repurchase is frequently problematic. In some instances either the applicable state franchise relationship law and/or the franchise agreement will identify the appropriate value (*e.g.*, fair market value or replacement cost) and/or a methodology for establishing the value. Notwithstanding, but not surprisingly, there is often a difference of opinion between the franchisor and the former franchisee as to the value of the inventory, etc.

Even if there is no statutory or contractual requirement that the franchisor repurchase the terminated franchisee's inventory and other franchise-specific supplies/equipment, the franchisor should nonetheless consider repurchasing these items. In addition to reducing the potential for misappropriation or misuse of proprietary/confidential products and information, a post-termination payment to the franchisee may go a long way towards reducing the likelihood of litigation.

8. Develop a Game Plan In the Event the Franchisee Fails to Cure the Default or Contests the Termination.

As part of the default/termination process, franchisor and counsel should carefully consider the likely responses by the franchisee to the notice and how to proceed in those circumstances. For example, if the franchisee fails to cure a default in a timely manner, should the franchisor immediately terminate the franchise or should it give the franchisee a further opportunity to comply with the franchise agreement? In at least some instances, more may be gained by giving the franchisee a second chance. If the decision is to proceed with a termination, the franchisor should be prepared with a

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[7] *See, e.g.*, Cal. Bus. & Prof. Code § 20035 ["In the event a franchisor terminates or fails to renew a franchise other than in accordance with this chapter, the franchisor shall offer to repurchase from the franchisee the franchisee's resaleable current inventory meeting the franchisor's present standards that is required by the franchise agreement or commercial practice and held for use or sale in the franchise business at the lower of the fair wholesale market value or the price paid by the franchisee. The franchisor shall not be liable for offering to purchase personalized items which have no value to the franchisor in the business which it franchise."]; *see also* Ark. Code § 4-72-209.

[8] *See, e.g.,* Conn. Gen. Stat. § 42-133f(c); Haw. Rev. Stat. § 482E-6(3); Md. Code § 11-1304(a); Mich. Comp. Laws § 445.1527(d); Wis. Stat. § 135.045.

game plan as to how to quickly effect the termination in the event the franchisee refuses to de-identify, etc. so that it can successfully and efficiently protect its legal rights. It is perhaps even more important that the franchisor have a game plan for what to do if the franchisee contests the termination and/or continues to use the franchisor's intellectual property after the termination. Should the franchisor immediately file a lawsuit or demand for arbitration? Or, are there other alternatives that may also accomplish the franchisor's objectives of removing the franchisee from the system (*e.g.*, providing the franchisee with an opportunity to sell his/her business).

F. Preparing the Notice.

There is no "one size fits all" for a notice of default or termination. The franchise agreement and/or the state franchise relationship law generally, however, provide some guidance as to what must to be included in the notice. In all events, there are a number of items that either need to or should be included in the notice.

<u>First</u>, the notice needs to be sent in the manner and to the persons identified in the notice provision in the franchise agreement. In some circumstances, a copy of the default/termination must or should be sent to other related parties (*e.g.*, counsel for the franchisee, a guarantor or the spouse of the franchisee).

<u>Second</u>, it is important that the notice properly identify all of the appropriate parties and agreements. In the case of a franchisee who operates multiple locations, there are often a number of franchise agreements with different persons and entities involved. A failure to properly identify the appropriate agreements and parties may cause the default or termination to be void or, at a minimum, create confusion and potential delay.

<u>Third</u>, the notice should set forth in detail the particulars regarding the defaults, the operative provisions in the franchise agreement, and what must be done to cure the defaults and when. A notice that fails to specifically identify the defaults and how/when to cure the same may be unenforceable. Significantly, in the event the franchisee contests the default or termination, the notice will almost certainly be the proverbial "exhibit 1." Given this, the notice should clearly tell the franchisor's side of the story for the potential benefit of a trier of fact or mediator. This is particularly important, for example, if the default is non-monetary in nature, in which case it may be necessary to explain in the notice for the benefit of others why the default is material.

<u>Fourth</u>, in some circumstances, historical information regarding prior defaults and the default at issue should be included in the notice.

<u>Fifth</u>, the notice should set forth all or at least the key post-termination obligations on the part of the franchisee and the attendant provisions in the franchise agreement. To the extent the notice is not all-encompassing, it should be clear that the franchisee is obligated to comply with <u>all</u> of the post-termination obligations in the franchise agreement and not just those that are highlighted.

Sixth, the notice should include “no waiver” and similar language. For example, (i) ”the foregoing demand for compliance with specific post-termination obligations under the franchise agreement does not constitute a waiver of franchisor’s rights to demand that franchisee comply with any other obligations under the franchise agreement. Accordingly, franchisor expressly reserves all of its rights and remedies with respect to the franchise agreement or otherwise”; and something to the effect that (ii) “the enumeration herein of the grounds for terminating the franchise agreement does not constitute a waiver by franchisor of other defaults giving rise to grounds for terminating the franchise agreement, whether or not such additional defaults are presently known to franchisor. Accordingly, franchisor retains the right to pursue all legal rights and remedies resulting from franchisee’s further or additional defaults of the franchise agreement or otherwise.”

G. After the Termination -- Now What?

1. Customer Issues.

As mentioned above, terminating a franchise can create significant customer-related problems. The franchisor should be prepared with a game plan for how to handle these problems and be equally prepared to be flexible.

2. Key Post-Termination Obligations.

As also noted above, a notice of termination should identify all or least the key post-termination obligations of the franchisee. The key obligations will vary, of course, by franchise system. However, the following are typically important to most franchisors:

(a). Trademarks and Trade Names.

It is essential that the franchisor confirm that the terminated franchisee has ceased using its trademarks and trade names, as well as any colorable imitations thereof. In some circumstances, this may be somewhat difficult to confirm given that the former franchisee may be unwilling to give the franchisor access to his/her location. If, after a reasonable period of time to de-identify and the appropriate warnings, the former franchisee continues to use the franchisor’s trademarks and/or tradenames, the franchisor must take the necessary steps to protect its intellectual property (*e.g.*, initiating an action for trademark infringement, etc. or such other course of action as required by the franchise agreement). If the franchisor fails to do so, there is a risk (more theoretical than practical) that it might lose some of its rights to the trademarks or trade names.

(b). De-Identification.

The franchisor should make sure that the terminated franchisee changes the “look and feel” of his/her location (assuming that the former franchisee remains in business in the same location) so that the public is not confused (intentionally or otherwise) as to whether the former franchisee is still part of the franchise system or otherwise affiliated with the franchisor. Most franchisee agreements are reasonably specific about what a former franchisee must do to de-identify their prior location. The notice of termination should reiterate these obligations and, to the extent the agreement is not clear, specifically set forth what the franchisor expects and when the franchisee must complete the process.

(c). Regaining Possession of the Premises or the Equipment.

In some franchise systems, the franchisee leases the premises and/or equipment from the franchisor. In these cases, the franchisor will obviously want to regain possession of the premises and equipment upon termination. There may be different or additional requirements that the franchisor will need to follow in order to lawfully regain possession of the premises or equipment.

(d). Operating Manuals, Proprietary Software, Etc.

Most franchise agreements require that the terminated franchisee either return or destroy all operating manuals, proprietary software and other trade secret/confidential materials within a certain period of time. Some franchise agreements further require that the franchisee warrants that he/she has returned or destroyed the originals and all copies of such materials. It is important that the franchisor not let this important aspect of the termination process slip through the cracks.

(e). Telephone Numbers.

Many franchise agreements require that a franchisee transfer any telephone numbers to the franchisor upon termination. It is not uncommon, however, for the former franchisee to either refuse to transfer the numbers or be unwilling to cooperate in effecting the transfer. This often creates problems because the telephone company generally will not transfer a number without the express permission of the “owner” of the number (*i.e.*, the former franchisee). In the event the franchisee resists transferring the telephone numbers on the grounds that it will interfere with his/her new business, one potential compromise is to employ an “intercept.” When an intercept is utilized, a caller to the telephone number is asked what business she is trying to reach. If it is the franchised business, the caller is transferred to the franchisor or the nearest authorized franchisee. If it is the former franchisee’s new business, the caller is put through to the new business.

3. Post-Termination Competition.

Much can be and has been said about whether and to what extent a former franchisee can “compete” with the franchisor after his/her franchise agreement has been terminated. Most franchise agreements purport to preclude a former franchisee from competing post-termination to at least some extent. In some states, a covenant not to compete is generally unenforceable in the post-termination context. Other states will enforce a covenant not to compete provided that it is reasonable. The reasonableness of a covenant not to compete is generally determined on a case-by-case basis after balancing the franchisor’s business interest in the restraint, on the one hand, and the temporal, geographic and scope limitations imposed by the restraint, on the other hand.

In analyzing whether a covenant not to compete will be enforceable, the franchisor will also need to consider whether the state in which the franchisee does business will "blue pencil" an otherwise unenforceable covenant so as to make it enforceable. While some states will blue pencil a covenant not to compete, many states will not on the ground that the party seeking to enforce a covenant (and which presumably drafted the covenant) should be charged with the responsibility of making sure that the covenant is enforceable in the first instance.

The extent to which a franchisor will seek to enforce the covenant not to compete in the post-termination context varies greatly. In some cases, a franchisor may conclude that the benefits of preventing (or trying to prevent) a franchisee from competing are outweighed by the often significant costs of litigating the enforceability of the covenant. However, there are many franchisors who believe that a covenant not to compete is an essential part of the franchise system and will go to great lengths to enforce such a covenant. In either event, counsel and franchisor should discuss the enforceability and potential issues with respect to a post-termination covenant not to compete as part of the pre-termination due diligence.

4. Outstanding Royalties, Advertising Fees and the Like.

The terminated franchisee almost always owes the franchisor at least some, and often a great deal of, money. The notice of termination should, to the extent known by the franchisor, set forth the amount the franchisee owes and when it must be paid. This is the easy part. The difficult part is actually recovering the money owed. The franchisor will need to decide whether it makes sense to take the necessary steps to collect what is owed. In some instances it may not be cost-effective (*e.g.*, if the amount owed is relatively small and/or the franchise agreement does not include an attorneys' fees provision). In other instances, initiating a collection action or such other action as required by the franchise agreement may simply lead to a counterclaim by the franchisee which is usually best avoided. In all instances, the franchisor and counsel should discuss the various possibilities and likely outcomes up front.

II. FRANCHISOR ENFORCEMENT ACTIONS AND CAUSES OF ACTION

While claims based on the post-termination obligations in a franchise agreement are a frequent source of litigation, the scope of claims which a franchisor can raise is, not surprisingly, as broad as the scope of claims which a franchisee may assert. This section will address the fundamentals of some of the claims which typically arise after the termination or expiration of a franchise relationship, as well as some of the other claims that can arise during the term of the franchise relationship.

A. Typical Claims

1. Trademark Infringement

(a). The standards for relief under the Lanham Act

What happens if a franchise agreement has been terminated or has expired and the former franchisee (i) refuses to stop using the franchisor's trade names and/or trademarks, or (ii) adopts a trade name or trademark that is confusingly similar to the franchisor's name or mark. While state statutes may also afford relief, the primary means for stopping unauthorized trademark use is the Lanham Act, 15 U.S.C. § 1051, *et seq*. Bear in mind that a trademark does <u>not</u> need to be registered to be entitled to relief under the Lanham Act.[9]

The purpose of the Lanham Act is "to protect the public from deceit, to foster fair competition, and to secure to the business community the advantages of reputation and good will by preventing their diversion from those who have created them to those who have not."[10] The Lanham Act effects this purpose through two principal provisions: (i) Section 32(1), which proscribes trademark infringement by prohibiting the use of a reproduction of a registered mark; and (ii) Section 43(a), which prohibits false designations as to the source or origin of business establishments, services and goods. Under either Section, the Lanham Act "creates a claim for trademark infringement when a trademark holder can demonstrate that the use of its trademark by another is likely to confuse consumers as to the source of the product."[11]

This showing is easily made in most franchise cases, and is likely why franchisees that receive good counsel will usually not contest a franchisor's right to stop the unauthorized use of its marks (unless the franchisee is contesting the propriety of the termination). "Common sense compels the conclusion that a strong risk of consumer confusion arises when a terminated franchisee continues to use the former franchisor's trademarks . . . . Consumers automatically would associate the trademark user with the registrant and assume that they are affiliated."[12] It is therefore "well-settled doctrine that a terminated franchisee's continued use of its former franchisor's

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9 *USA Football Inc. v. Robinson*, 74 U.S.P.Q.2d 1646, 1651 (S.D. Tex. Sep 20, 2004).

10 *Truck Equip. Serv. Co. v. Freuhaud Corp.*, 536 F.2d 1210, 1215 (8th Cir.) (internal quotations omitted), *cert. denied*, 429 U.S. 861 (1976).

11 *Home Box Office v. Showtime/The Movie Channel, Inc.*, 832 F.2d 1311, 1314 (2nd Cir. 1987).

12 *Burger King Corp. v. Mason*, 710 F.2d 1480, 1492-93 (11th Cir. 1983), *cert. denied*, 465 U.S. 1102 (1984).

trademarks, by its very nature, constitutes trademark infringement."[13] In fact, one commentator has characterized such cases as "open and shut."[14]

(b). What if the franchisee disputes your right to terminate?

As a practical matter, claims for trademark infringement do not arise in a bubble. The fact that a former franchisee is continuing to use the franchisor's marks usually means either (i) that the franchisee believes that the franchisor itself acted improperly in its dealings with the franchisee, or (ii) that the franchisee is contesting the franchisor's right to terminate the franchise agreement. Each situation will have a different impact on the franchisor's ability to cease the unauthorized use of its marks.

The fact that a franchisee believes that it has counterclaims against the franchisor should have no bearing on a court's willingness to issue injunctive relief stopping the franchisee's use of the franchisor's marks. It is generally accepted that "a franchisor's right to terminate a franchisee exists independently of any claims the franchisee might have against the franchisor."[15]

What happens, however, if a franchisee believes that its franchise was terminated improperly? Does the franchisor need to show that its termination was proper to be entitled to injunctive relief? The case-law is not uniform on this issue. One line of cases holds that "a terminated franchisee's remedy for wrongful termination is an action for money damages, and not the continued unauthorized use of its franchisor's trademarks."[16] The other requires a franchisor to make some showing that its termination was proper before injunctive relief will issue. In *McDonald's Corp. v. Robertson*, the Eleventh Circuit held that "the Lanham Act's requirement that a franchisor demonstrate that unauthorized trademark use occurred to prevail on the merits of a trademark infringement claim against a franchisee necessitates some type of showing that the franchisor properly terminated the contract purporting to authorize the trademarks' use, thus resulting in the unauthorized use of trademarks by the former franchisee."[17] What that showing must likely depends on the standards applicable to preliminary injunction motions (*i.e.*, do you need to show a substantial likelihood of success on the merits, some likelihood of success on the merits, etc.).

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13 *Burger King Corp. v. Majeed*, 805 F. Supp. 994, 1006 (S.D. Fla. 1992); *see also McDonald's v. Robertson*, 147 F.3d 1301, 1010 (11th Cir. 1998).

14 3 J. McCarthy, Trademarks and Unfair Competition § 23.3.

15 *S & R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 375 (3rd Cir. 1992).

16 *Burger King Corp. v. Hall*, 770 F.Supp. 633, 638 (S.D.Fla.1991), *Dunkin' Donuts Incorporated v. Sharif, Inc.*, 2003 WL 24128052, *3 (D.N.M. Nov 20, 2003).

17 *McDonald's Corp. v. Robertson*, 147 F.3d at 1308.

2. Trade Secret Claims

Most franchise agreements contain provisions identifying certain elements of the franchisor's system as trade secrets. If, at the termination of the franchise relationship, a franchisee continues to use these elements, the franchisor needs to decide whether to sue to enjoin the use of those trade secrets and/or to recover the damages it has sustained as a result of the use of those secrets. The first question to be addressed in making this decision is whether the information at issue is, in fact, a trade secret.

What constitutes a "trade secret" varies from jurisdiction to jurisdiction. Some courts have viewed a franchisor's entire method of doing business as a trade secret. In *Tan-Line Sun Studios, Inc. v. Bradley*,[18] the franchisor gave the defendant, Bradley (a franchisor broker it hired to help it recruit franchisees) confidential information about Tan-Line's operating methods. Bradley then used the information to establish a competing sun tanning business. When Tan-Line brought suit to enjoin Bradley's use of its confidential information, Bradley argued that the information was not entitled to trade secret protection. The court disagreed:

> Through trial and error, research, and experience gained in the operation of their tanning studios, however, these individuals on behalf of Tan-Line developed a particular method of doing business that is peculiar to Tan-Line. This particular method of doing business is not generally known in the industry and it includes Tan-Line's methods of employee recruitment and training, studio layout, cash control, advertising, accounting, marketing, promotion, and site selection, among others. Tan-Line's particular method of business also incorporates knowledge and information gained concerning the success and value of different approaches to the various aspects of the indoor sun tanning business.
>
> Defendants assert that plaintiff has not sufficiently identified as trade secrets the individual, discrete aspects of Tan-Line's methodology about which Mr. Bradley has appropriated information. *I find, however, that Tan-Line's entire methodology for conducting a tanning studio constitutes a trade secret.*
>
> * * *
>
> [E]ven if defendants could discover independently the specific individual methodologies that make up Tan-Line's business approach, the defendants could only acquire the entire package of experience, knowledge and information after substantial time and the investment of much effort and money. Without using improper means, defendants would have had much difficulty in acquiring the information needed to start

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[18] 1986 U.S. Dist. LEXIS 27754 (E.D. Pa. Mar. 24, 1986).

> their businesses. . . . By using the information that Mr. Bradley appropriated, defendants significantly reduced the risk involved in starting their new businesses, as they eliminated any unprofitable trial and error.

Notwithstanding the approach taken in *Tan-Line*, franchisors that plan to bring suit based on the misuse of trade secrets should be prepared to identify each and every element of their system that they consider a trade secret.

In most jurisdictions, the definition of "trade secret" is premised on the Uniform Trade Secrets Act ("UTSA"), which has been adopted (in form or in substance) by 42 states. Under the UTSA, a trade secret means

> 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 generally 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.

UTSA § 1(4), 14 Uniform State Laws 437 (1990). Each element needs to be satisfied before something will be considered a trade secret. As a general rule, the fact that a party acknowledges that something is a trade secret will not, standing alone, satisfy the foregoing requirements.[19]

3. Specific Performance

Faced with a franchisee who refuses to comply with system standards, some franchisors have decided (either in lieu of or in advance of termination) to seek decrees of specific performance requiring a franchisee to comply with its obligations under the franchise agreement. In some cases, franchisors have been successful in these efforts.[20] Other courts have characterized franchise agreements as contracts for personal services, which are not amenable to a decree of specific performance.[21]

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19 *But see Gold Messenger, Inc. v. McGuay*, 937 P.2d 907 (Colo. Ct. App. 1997) (holding that a franchise agreement "was a contract for the protection of trade secrets" and relying, in reaching that conclusion, on the fact that the franchisee had acknowledged that the information in the franchisor's operations manual constituted a trade secret).

20 *See, e.g., Dunkin' Donuts Inc. v. Kashi Enters., Inc.*, 106 F. Supp. 2d 1325, 1327 (N.D. Ga. 2000).

21 *North American Financial Group, Ltd. v. S.M.R. Enters., Inc.*, 583 F. Supp. 691, 699 (N.D. Ill. 1984) ("there is absolutely no precedent for granting specific performance of a franchise contract . . . [because it] is at least partially a contract for personal services").

4. Declaratory Judgments

During the term of a franchise agreement, disputes may arise with respect to the meaning of certain contractual provisions or the effect of certain conduct. For example, the parties may dispute whether certain conduct constitutes a breach and, if so, whether that breach constitutes cause for termination. In such cases, the parties may be able to seek a declaration of their rights. Pursuant to the Declaratory Judgment Act, "[i]n a case of actual controversy within its jurisdiction . . . any court of the United States, upon the filing of an appropriate pleading, may declare the rights and other legal relations of any interested party seeking such declaration, whether or not further relief is or could be sought." 28 U.S.C. § 2201. And "[u]nder Rule 57 of the Federal Rules of Civil Procedure, the Court has the power to grant declaratory relief when another adequate remedy is available."[22] However, courts need not exercise that power. In determining whether to entertain a claim for declaratory judgment, courts will look to see "whether or not [another] remedy is more effective or efficient, and hence whether the declaratory action would serve a useful purpose." (*Id.*) Accordingly, "[w]hen declaratory relief and another remedy are substantially similar, the court may exercise its discretion to dismiss the declaratory judgment claim."[23] Therefore, if possible, a request for declaratory relief should be joined with a claim over which the court must exercise jurisdiction.

5. Non-competition covenants

As noted above, many questions factor into a decision to file suit to enforce a non-competition covenant. Further, the standards governing the enforceability of such covenants vary from State to State. Some States prohibit the enforcement of most non-competes.[24] In others, the enforceability of a non-compete is controlled (in whole or in part) by statute. For example, Texas Business and Commerce Code § 15.50 provides that a covenant against competition is enforceable if it: (1) is ancillary to an otherwise enforceable contract; and (2) contains reasonable limitations as to time, geographic area, and scope of activity to be restrained and does not impose a greater restraint than necessary to protect the goodwill or other business interest of the promisee.

In those jurisdictions where non-compete covenants are not governed by statute, courts usually apply a three-part test in assessing the enforceability of such covenants: (1) is the covenant reasonable in duration; (2) is the covenant's geographic scope reasonable; and (3) does the covenant protect a legitimate business interest. What is enforceable in one jurisdiction will not necessarily pass muster in another. Therefore, a

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22 *Cincinnati Ins. Co. v. Hertz Corp.*, 776 F. Supp. 1235, 1239 (S.D. Ohio 1991). There are similar statutes at the state level.

23 *The Pantry, Inc. v. Stop-N-Go Foods, Inc.*, 777 F. Supp. 713, 717 (S.D. Ind. 1991).

24 *See*, *e.g.*, Cal. Bus. & Prof. Code § 16600.

thorough analysis of the applicable law should be taken before commencing suit to enforce a non-competition covenant.[25] The following factors should guide your analysis:

(a). What is the legitimate interest you are seeking to protect

Courts have recognized the following as interests that support the enforcement of covenants not to compete:

- The franchisor's confidential and proprietary operating methods.[26]
- Protecting other franchisees from unfair competition.[27]
- Guarding against customer confusion.[28]
- Refranchising the territory at issue.[29]
- The goodwill developed at the location.[30]
- The health of its franchise system.[31]

(b). Is your covenant reasonable in terms of duration and geographic scope

Non-competition covenants which last for two years or less are common and generally enforced. The longer the duration of the covenant, the more the franchisor will need to prove to justify the length of the covenant.

There are no hard and fast rules governing what is reasonable in terms of geographic scope. In *Boulanger v. Dunkin' Donuts, Inc.*, the Supreme Judicial Court of Massachusetts enforced a covenant that prohibited a former franchisee from operating

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25 For a comprehensive state-by-state analysis of non-competition covenants in franchise cases, *see* P. Klarfeld, *Covenants against Competition in Franchise Agreements*, 2nd Edition (American Bar Association 2003).

26 *Tan-Line Sun Studios,* 1986 U.S. Dist. LEXIS 27754.

27 *Rita's Water Ice Franchise Corp. v. DBI Investment Corp.*, 1996 U.S. Dist. LEXIS 4551, *11 (E.D. Pa. Apr. 8, 1996).

28 *Domino's Pizza, Inc. v. El-Tan, Inc.*, 1995 U.S. Dist. LEXIS 20550, at *10-11 (N.D. Okla. Apr. 28, 1995).

29 *Id.*

30 *Jiffy Lube Int'l, Inc. v. Weiss Bros., Inc.*, 834 F. Supp. 683, 619, 692-93 (D.N.J. 1993).

31 *Gafnea v. Pasquale Food Co.*, 454 So. 2d 1366 (Ala. 1984).

a competing unit within a specified radius of every existing Dunkin' Donuts franchise.[32] An even broader covenant was enforced in *H&R Block Tax Services, Inc. v. Circle A Enterprises, Inc*.[33] There, the court held that a covenant that barred a franchisee from competing within 45 miles of its territory or any other H&R Block office was permissible.

Such covenants would likely not be enforced in Georgia, which requires the geographic scope of a covenant to be adequately identified at the time the parties enter into the covenant.[34]

(c). Will the Court blue pencil your covenant

Whether an unreasonable covenant is fatal to your ability to enforce the covenant depends on the law which governs your dispute. Some jurisdictions will "blue pencil" a covenant that is found to be unreasonable. In doing so, the court will either strike the provisions of the covenant that it deems unreasonable, or reduce those provisions so that the restrictions are rendered reasonable. Generally, a court will not blue pencil a covenant unless it is clear that the contract was intended to be severable.[35] Some jurisdictions have modified this willingness to blue-pencil by indicating that reformation is inappropriate if the covenant, as originally drafted, indicates "bad faith or deliberate overreaching."[36] Some jurisdictions will not blue pencil an overbroad covenant.[37] Finally, in some jurisdictions, the state legislature has imposed a duty on courts to reform unreasonable covenants.[38]

B. Potential Remedies

When considering what claims to bring, it is essential to consider what relief you want should you prevail. Many claims permit the recovery of different types of relief (for

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32 815 N.E.2d 572 (Mass. 2004).

33 693 N.W.2d 549 (Neb. 2005).

34 *New Atlanta Ear, Nose & Throat Assocs, P.C. v. Pratt*, 200 Ga. App. LEXIS 104 (Ga. Ct. App. 2002); *see also South Bend Consumers Club, Inc. v. United Consumers Club, Inc.*, 572 F. Supp. 209, 211 (N.D. Ind. 1983).

35 *See Snelling & Snelling, Inc. v. Dupay Enterprises, Inc.*, 609 P.2d 1062 (Ar. Ct. App. 1980 (enforcing provision which prohibited franchisee from competing within 35 miles of its territory, but striking provision which prohibited franchisee from competing within 35 miles of other franchisees).

36 *Durapin, Inc. v. American Products, Inc.*, 559 A.2d 1051, 1058 (R.I. 1989).

37 *Watson v. Waffle House, Inc.*, 253 S.E.2d 175 (Ga. 1985).

38 *See*, *e.g.*, Tex. Bus. & Com. Code Ann. § 15.51(c); Fla. Stat. § 542.335(1)(c).

example, injunctive relief and/or damages). The following is a synopsis of the relief that is available under typically asserted claims:

1. Contract Damages

Assuming a franchisee fails to pay royalties, the damages recoverable are easily calculated. The franchisor seeks the royalties the franchisee was required to pay and, if provided for in the agreement, the attorneys' fees and costs incurred in seeking the unpaid fees. But what if a franchisee abandons its franchise 2 years into a 10 year agreement. What damages, if any, may the franchisor recover?

The purpose of compensatory damages is to restore the injured party to the position it would have been in but for the other party's breach. These damages are usually characterized as benefit of the bargain damages (what you would have earned had the other party performed) or reliance damages (what you expended in an effort to perform). Punitive damages are usually not available on breach of contract claims.

Lost profits is the most common measure for "benefit of the bargain" damages. For a franchisor suing a terminated franchisee (or a franchisee who abandoned its franchise), these profits would generally consist of the royalties the franchisor would have earned had the franchisee performed for the full term of the franchise agreement, less any savings that resulted from the franchisee's abandonment or termination. The availability of these damages may depend on which law governs the dispute. For example, in *Postal Instant Press, Inc. v. Sealy*,[39] a California appellate court (applying California law) held that a franchisor was not entitled to any future royalty fees. The court based this ruling on its determination that the franchisor's decision to terminate the franchise (and not the franchisee's breach) was the proximate cause of its loss of the future fees. In most other jurisdictions, a franchisor is (subject to proof) entitled to recover future lost royalties.[40] Further, the principles announced in *Sealy* do not apply when the franchisee is the one who terminates the Franchise Agreement.[41]

Like all damage claims, a claim for lost profits must be reasonable, foreseeable, and reasonably certain. Mitigation principles may also impact the extent to which a franchisor can recover future royalties. For example, in addition to holding that the franchisor's decision to terminate was the proximate cause of its loss of future royalties,

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39 51 Cal. Rptr. 2d 365 (Cal. Ct. App. 1996).

40 *See*, *e.g*., *Burger King Corporation v. Hinton, Inc.*, 203 F. Supp. 2d 1357, 1366 (S.D. Fla. 2002) (rejecting *Sealy* as inconsistent with Florida law).

41 *See Sealy*, 51 Cal. Rptr. 2d at 369 n.2; *It's Just Lunch Franchise, LLC v. BLFA Enterprises*, LLC, 2003 WL 21735005, at *2 (S.D. Cal. Jul. 21, 2003).

the *Sealy* court held that the franchisor could obtain for itself "a full measure of 'reasonable' damages" by replacing the former franchise with a new franchise.[42]

2. Trademark Claims

A franchisor that sues for trademark infringement generally seeks two things: (i) injunctive relief; and (ii) damages.

(a). Injunctive Relief

While the test for injunctive relief is not entirely uniform among the federal Circuits, a party seeking injunctive relief is generally required to show: (1) a likelihood of success on the merits; (2) that it will be irreparably harmed if the injunction is not granted; (3) that the threatened injury outweighs any harm the preliminary injunction will cause the opposing party; and (4) that the preliminary injunction is not adverse to the public interest. As discussed above, the likelihood of success element is satisfied by showing that the franchisee's use of the franchisor's trademarks is likely to confuse consumers. If this element is shown, irreparable harm usually follows as a matter of course. That is because in trademark infringement cases, once a likelihood of confusion is established, irreparable harm is presumed.[43] Furthermore, the courts have regularly held that a franchisor's inability to control the nature and quality of goods and services provided under its marks irreparably harms the goodwill associated with those marks and devalues them and, as such, warrants the entry of injunctive relief.[44]

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[42] 51 Cal. Rptr. 2d at 373; *cf. Burger King Corp. v. Barnes*, 1 F. Supp. 2d 1367, 1370 (S.D. Fla. 1998) ("Mitigation is not an issue because the franchise agreement which is at the center of this case is a non-exclusive contract. When a non-exclusive contract is involved which would allow a plaintiff to enter into other similar contracts . . . there is no duty to mitigate or minimize losses.").

[43] *See S & R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 378 (3rd Cir. 1992).

[44] *See*, *e.g*., *McDonald's Corp. v. Robertson*, 147 F.3d at 1310; *S&R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d at 378. The third and fourth elements are generally not an impediment to the issuance of injunctive relief. "When considering the balance of hardships between the parties in infringement cases, courts generally favor the trademark owner." *Krause Int'l, Inc. v. Reed Elsevier, Inc.*, 866 F. Supp. 585, 587-88 (D.D.C. 1994). That is because "'[o]ne who adopts the marks of another for similar goods acts at his own peril'" since he has no claim to the profits or advantages derived thereby. *Burger King Corp. v. Majeed*, 805 F. Supp. 994, 1006 (S.D. Fla. 1992). Further, "it is in the public interest for the Court to prevent public confusion over the source or origin of products provided to the public." *Malarkey-Taylor Assocs., Inc. v. Cellular Telecommunications Indus. Ass'n*, 929 F. Supp. 473, 478 (D.D.C. 1996).

(b). Damages

Aside from injunctive relief, a franchisor that prevails on a claim of trademark infringement under the Lanham Act is entitled to damages. The damages available for trademark infringement are controlled by statute. Section 35 of the Lanham Act provides that "subject to the principles of equity," a plaintiff who prevails on a claim of trademark infringement is entitled to recover (i) the defendant's profits, (ii) actual damages, and (iii) its costs.[45] Additionally, treble damages and attorneys' fees are available in "exceptional" circumstances. (*Id*.)

Recovery of the defendant's profits does not require proof of actual damages.[46] Further, the Lanham Act does not require the plaintiff to show what the defendant's profits were. The Act provides that "in assessing profits the plaintiff shall be required to prove defendant's sales only; defendant must prove all elements of cost or deduction claimed."[47] "Actual damages," in contrast, can take many forms (such as damage to reputation and goodwill) and must be proven. (*Id*.)

3. Non-Competition Covenants

While damages may be obtained for breach of a non-compete, injunctive relief is generally the remedy sought for the violation of such covenants. As with claims for trademark infringement, getting injunctive relief will hinge on a franchisor's ability to show (i) that the covenant is enforceable and is being violated, and (ii) that it is suffering irreparable harm as a result of the violation of the covenant. In some jurisdictions, the latter element is presumed. In Texas, for example, "injury resulting from the breach of non-compete covenants is the epitome of irreparable injury."[48] Whether presumed or not, a franchisor seeking to enforce a non-compete should demonstrate why it is being harmed as a result of the breach of that covenant.

4. Liquidated Damages

Liquidated damage clauses are contractual provisions that specify the damages recoverable in the event of a contractual breach. The enforceability of such provisions generally depends upon (1) the reasonableness of the amount agreed upon, and (2) the difficulty of determining actual damages. Restatement (Second) of Contracts § 356. A liquidated damages clause that is unreasonably large will be deemed a penalty and unenforceable. Further, some state laws limit or prohibit liquidated damages clauses.

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[45] 15 U.S.C. § 1117(a).

[46] *Burger King Corp. v. Mason*, 855 F.2d 779, 781 (11th Cir. 1998).

[47] 15 U.S.C. § 1117(a).

[48] *Amerispec, Inc. v. Metro Inspection Servs., Inc.*, 2001 WL 770999, at *6 (N.D. Tex. July 3, 2001) (internal quotations omitted).

5. Attorneys' Fees

As a general rule, a party may not recover the attorneys' fees it incurs in connection with a lawsuit unless the parties' contract or a statute authorizes the recovery of fees. While a one-sided attorneys' fee provision is probably enforceable, that provision may be interpreted to provide both parties with the right to recover fees.[49] In California, for example, a contract which provides that one party may recover its fees if it prevails will be deemed to afford the other party to the contract the same right.[50]

C. Recurring Issues In Connection With Franchise Enforcement Actions And Causes Of Action

1. State Court or Federal Court

Once you have determined which claims to bring and the type of relief you want, you must decide where to file suit (*i.e.*, in federal court or state court). Whether to file suit in state or federal court is a decision that depends on a thorough analysis of several factors. If federal court is your preferred venue, you must make sure that the court will have subject matter jurisdiction over your dispute.

(a). Federal Jurisdiction

Unlike most state courts, which are courts of general jurisdiction, the United States District Courts are courts of limited jurisdiction. As a general rule, they only have subject matter jurisdiction over cases (i) arising under the United States Constitution or the laws of the United States, or (ii) where the matter in controversy exceeds the sum or value of $75,000, exclusive of costs, and is between citizens of different States or citizens of a State and citizens or subjects of a foreign state.[51] Jurisdiction may not be conferred by agreement. Nor can it be vested by inaction. "Any party or the court may, at any time, raise the issue of subject matter jurisdiction."[52]

In analyzing whether complete diversity exists (*i.e.*, whether the suit is between citizens of different states), you must consider each state in which an artificial entity may be deemed a citizen. For example, a corporation is deemed a citizen of "any State by which it has been incorporated and of the State where it has its principal place of business . . . ."[53] Also, like partnerships, which take the citizenship of each and every

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49 *Zeidler v. A&W Restaurants, Inc.*, 2001 WL 561367, at *2 (N.D. Ill. May 21, 2001).

50 *See* Cal. Civil Code § 1717(a).

51 28 U.S.C. §1332.

52 *GMAC Commercial Credit LLC v. Dillard Dept. Stores, Inc.*, 357 F.3d 827, 828 (8th Cir. 2004).

53 28 U.S.C. § 1332(c)(1).

general and limited partner, "limited liability companies are citizens of every state of which any member is a citizen."[54]

(b). Removal

Assuming you choose to file in State Court, under what circumstances may that matter be removed to federal court. A lawsuit may be removed to federal court as long as it is one over which the federal courts would have subject matter jurisdiction.[55] If removal is possible, the case will be removed to the District Court embracing the court where the action was originally filed. Several procedural points should be noted when a case is removed (or when you are considering removing a case):

- All defendants must join in removal.
- The notice of removal <u>must</u> be filed "within thirty days after the receipt by the defendant, through service or otherwise, of a copy of the initial pleading."[56]
- If a complaint that was not originally removable is amended, a party may file a notice of removal as to the amended complaint within thirty days after receipt of the amended pleading, except that no case may be removed more than 1 year after the action was commenced.
- The notice of removal must state the grounds for removal. Therefore, if a complaint does not demonstrate on its face that the amount in controversy is in excess of $75,000, for example, the party seeking to remove must establish that the amount in controversy is satisfied.
- Even if there is complete diversity, a lawsuit may not be removed if any of the parties properly served and joined as defendants are citizens of the State in which the lawsuit was filed.
- Once a lawsuit is removed to federal court, unless and until that lawsuit is remanded to state court, any action taken by the state court is a nullity.

If a case is removed improperly, the plaintiff may file a motion to remand the case. If granted, the case will be sent back to the state court in which it was originally filed. If the motion to remand is granted, the court may award costs to the plaintiff.

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54 *Belleville Catering Co. v. Champaign Market Place, LLC*, 350 F.3d 691, 692 (7th Cir. 2003).

55 28 U.S.C. §1441.

56 28 U.S.C. §1446(b).

2. Venue Issues

Most franchise agreements contain forum selection clauses, in which the parties agree that all or certain types of disputes will or may be resolved in a particular forum.

(a). Is the forum selection clause mandatory or permissive

When considering where to file, or in determining whether to seek to transfer or dismiss a lawsuit that was filed in another jurisdiction, first consider the terms of your forum selection clause. "A permissive clause authorizes jurisdiction in a designated forum but does not prohibit litigation elsewhere. A mandatory clause, in contrast, 'dictates an exclusive forum for litigation under the contract.'"[57]

Also, consider carefully the terms of the forum selection clause in deciding where to file. In *American Soda, LLP v. U.S. Filter Wastewater Group, Inc.*,[58] the court reviewed the effect of a forum selection clause which provided that all disputes would be settled in "the Courts of the State of Colorado." The Tenth Circuit Court of Appeals held that since the federal courts in the State of Colorado were not courts *of* the State of Colorado, but rather courts of the United States of America, the parties' agreement to limit venue to "the Courts *of* the State of Colorado" meant that the state courts were the exclusive venue for the resolution of the parties' disputes.

(b). Does clause encompass the claims at issue

Courts "looks first to the language of the parties contracts to determine which causes of action are governed by [a] forum selection clause."[59] Whether the claims at issue sound in tort or contract does not control this analysis. "Claims that arise out of the contractual relationship and implicate the agreement are subject to the forum selection clause" – regardless of the labels those claims are given.[60]

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[57] *Global Satellite Communication Co. v. Starmill U.K. Ltd.*, 378 F.3d 1269, 1272 (11th Cir. 2004) (internal quotations omitted). Such clauses "contain language such as 'exclusive' or 'only'." *Kachal, Inc. v. Menzie*, 738 F. Supp. 371, 373-74 (D. Nev. 1990).

[58] 428 F.3d 921 (10th Cir. Nov. 7, 2005).

[59] *Marinechance Shipping, Ltd. v. Sebastian*, 143 F.3d 216, 222 (5th Cir.), *cert. denied*, 525 U.S. 1055 (1998).

[60] *Kessmann & Assoc., Inc. v. Barton-Aschman Assoc., Inc.*, 10 F. Supp. 2d 682, 688 (S.D. Tex. 1997).

(c). Is the forum selection clause enforceable

Forum selection clauses are generally considered valid and enforceable unless the opposing party shows that enforcement would be unreasonable. A party seeking to avoid the effect of a forum selection clause usually needs to show one of the following:

> (1) that the incorporation of the forum selection clause into the agreement was the product of fraud or overreaching; (2) that the party seeking to escape enforcement will for all practical purposes be deprived of its day in court because of the grave inconvenience or unfairness of the selected forum; (3) that the fundamental unfairness of the chosen law will deprive the plaintiff of a remedy; or (4) that enforcement of the forum selection clause would contravene a strong public policy of the forum state.[61]

Federal law governs the enforceability of forum selection clauses in diversity cases.

(d). Do Other Considerations Impact The Enforceability Of The Forum Selection Clause

A number of states have enacted relationship and registration laws which impact the enforceability of certain provisions in franchise agreements. For example, California, Illinois, Michigan, Minnesota, and Rhode Island (among others) have enacted franchise statutes which render void any provision in a franchise agreement which requires a franchisee to litigate certain claims in any venue other than the state in which the franchisee does business. As a general rule, these statutes exempt agreements to arbitrate from their coverage, although Michigan's Franchise Investment Law purports to render void and unenforceable "[a] provision requiring that arbitration or litigation be conducted outside this state."[62]

3. Arbitration Agreements

(a). Does Your Agreement Have An Arbitration Clause And, If So, Is Your Dispute Encompassed Within That Clause

As discussed above, arbitration clauses have become increasingly prevalent in franchise agreements in recent years. One reason underlying the increased use of arbitration is that arbitration provides franchisors with greater ability to control the forum in which disputes must be resolved, even in the face of a relationship or registration law that would seem to require venue in the franchisee's state.

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61 *M/S Bremen*, 42 U.S. 1 (1972); *Carnival Cruise Lines, Inc. v. Shute*, 499 U.S. 585, 595 (1991).

62 Mich. Laws Ann. Section 445.1527(f). The Michigan law provides that this provision "shall not preclude the franchisee from entering into an agreement, at the time of arbitration, to conduct arbitration at a location outside this state." *Id*.

If your franchise agreement has an arbitration clause, the first question to be addressed is whether that clause encompasses the disputes at issue. Whether an issue is to be decided by an arbitrator is a matter of the parties' contractual intent.[63] When an arbitration agreement is encompassed by the Federal Arbitration Act – and most franchise agreements will be[64] – "[t]he court is to make this determination by applying the 'federal substantive law of arbitrability, applicable to any arbitration agreement within the coverage of the Act.'"[65] That body of law requires "'any doubts concerning the scope of arbitrable issues [to] be resolved in favor of arbitration, whether the problem at hand is the construction of the contract language itself or an allegation of waiver, delay, or a like defense to arbitrability.'"[66] Conversely, a court will narrowly construe any exceptions or carve-outs to an arbitration clause.[67]

If your lawsuit involves both arbitrable and non-arbitrable claims, the arbitrable claims will be severed and sent to arbitration, even if this leads to multiple and duplicative proceedings.[68]

(b). Where To Arbitrate

As noted above, forum selection clauses in arbitration agreements are often enforced in situations where ordinary forum selection clauses would fail. For example, a forum selection clause in an arbitration agreement may not be invalidated on the ground that a state statute requires all suits to be commenced in the state in which the franchisee resides.[69] However, like arbitration agreements in general, forum selection

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63 *AT&T Technologies, Inc. v. Communications Workers of Am.*, 475 U.S. 643, 648 (1986).

64 The FAA applies whenever there is an agreement to arbitrate contained in "a contract evidencing a transaction involving commerce." 9 U.S.C. § 2. The term "commerce" is broadly construed. *Prima Paint Corp. v. Flood & Conklin Mfg. Corp.*, 388 U.S. 395, 401-02 (1967). In fact, the Supreme Court has held that the FAA extends to the full reach of the Commerce Clause. *See Allied-Bruce Terminix Cos. v. Dobson*, 513 U.S. 265, 273-74 (1995). Since franchise agreements generally call for a continuous stream of products and funds to be exchanged between diverse parties, the FAA will usually apply.

65 *Mitsubishi Motors Corp. v. Soler Chrysler-Plymouth, Inc.*, 473 U.S. 614, 626 (1985) (quoting *Moses H. Cone Memorial Hospital v. Mercury Constr. Corp.*, 460 U.S. 1, 24 (1983)).

66 *Mastrobuono v. Shearson Lehman Hutton, Inc.*, 514 U.S. 52, 62 n.8 (1995) (quoting *Moses H. Cone Memorial Hosp.*, 460 U.S. at 24-25).

67 *Armijo v. Prudential Ins. Co.*, 72 F.3d 793, 800 (10th Cir.1995).

68 *Elias v. Superior Court*, 2005 WL 605716 (Cal. Ct. App. Mar. 16, 2005).

69 *Doctor's Associates, Inc. v. Hamilton*, 150 F.3d 157, 163 (2nd Cir. 1998); *Management Recruiters Int'l, Inc. v. Bloo*r, 129 F.3d 851, 856 (6th Cir. 1997).

clauses in those agreements are subject to generally applicable contract defenses (*i.e*., fraudulent inducement, unconscionability).

(c). Is Your Arbitration Agreement Enforceable

The fact that forum selection clauses in arbitration agreements are routinely enforced does not mean that those provisions (or arbitration agreements in general) are exempt from judicial review. Section 2 of the Federal Arbitration Act provides that "a written agreement to arbitrate in any contract involving interstate commerce or a maritime transaction 'shall be valid, irrevocable, and enforceable, save upon such grounds as exist at law or in equity for the revocation of any contract.'"[70] In *Perry v. Thomas*,[71] the Supreme Court explained this principle as follows:

> [T]he text of § 2 provides the touchstone for choosing between state-law principles and the principles of federal common law envisioned by the passage of that statute: An agreement to arbitrate is valid, irrevocable and enforceable, as a matter of federal law [citation omitted] "save upon such grounds as exist at law or in equity for the revocation of any contract." 9 U.S.C. § 2. Thus state law, whether of legislative or judicial origin, is applicable if that law arose to govern issues concerning the validity, revocability and enforceability of contracts generally.

Therefore, only "generally applicable contract defenses, such as fraud, duress or unconscionability, may be applied to invalidate arbitration agreements without contravening § 2."[72]

(d). Who determines arbitrability

Nearly 40 years ago, in *Prima Paint v. Flood & Conklin Mfg. Co.*, the Supreme Court determined who (the court or the arbitrator) decides challenges to arbitration agreements.[73] Establishing a "severability" principle, the Supreme Court held that a court will only address claims which go to the making of the arbitration agreement itself. Claims which go to the making of the contract generally (such as fraudulent

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70 *Volt Information Sciences, Inc. v. Board of Trustees of Leland Stanford Junior Univ.*, 489 U.S. 468, 474 (1989) (quoting 9 U.S.C. § 2).

71 482 U.S. 483, 492 n.9 (1987).

72 *Doctor's Associates, Inc. v. Casarotto*, 517 U.S. 681, 687 (1996).

73 388 U.S. 395 (1997).

inducement), and not just the arbitration clause, must be submitted to the arbitrator. This principle applies in the state and federal courts.[74]

Assuming the party contesting arbitrability has directed its attack to the arbitration agreement itself, who decides whether the arbitration agreement is valid and, if so, what issues fall within the scope of that agreement? The question of who (the arbitrator or the court) decides the validity of an agreement to arbitrate "turns upon what the parties agreed about that matter."[75] As a general rule, a court addresses any challenges to the validity of an arbitration agreement and, if there is a dispute, decides what issues fall within the scope of that agreement. However, the question of arbitrability should be referred to the arbitrator if there is "clear and unmistakable evidence" that the parties intended the issue of arbitrability to be decided by the arbitrator.[76]

When such evidence is present has been the subject of litigation in several recent cases. Many arbitration agreements provide that arbitration shall be conducted in accordance with the Commercial Arbitration Rules of the American Arbitration Association. Rule 7(a) of the AAA's Commercial Rules provides that "[t]he arbitrator shall have the power to rule on his or her own jurisdiction, including any objections with respect to the existence, scope or validity of the arbitration agreement." An increasing number of courts have held that when "parties explicitly incorporate rules that empower an arbitrator to decide issues of arbitrability, the incorporation serves as clear and unmistakable evidence of the parties' intent to delegate such issues to an arbitrator."[77]

4. What Law Will Govern Your Disputes

(a). General Principles

Assuming the parties have not agreed on the law that will govern their disputes, a court will need to determine what law applies. In making this determination, courts generally apply the "most significant relationship" test. Restatement (Second) of Conflict of Law § 188. This test takes into account a variety of factors, including where the contract was performed, where the contract was negotiated, and where the parties reside. A federal court will apply the conflicts of laws rules of the State in which it sits.

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[74] In February of this year, the Supreme Court reaffirmed and arguably expanded this severability principle. In *Buckeye Check Cashing, Inc. v. Cardegna*, No. 04-1254 (U.S. Feb. 21, 2006), the Court made clear that even if a party claims that a contract was void *ab initio*, that claim must be directed to the arbitrator.

[75] *First Options of Chicago, Inc. v. Kaplan*, 514 U.S. 938, 945 (1995).

[76] *First Options of Chicago*, 514 U.S. at 945.

[77] *Contec Corp. v. Remote Solution Co., Ltd.*, 398 F.3d 205, 208 (2nd Cir. 2005); *accord Terminix Int'l Co. v. Palmer Ranch Ltd. P'ship*, 432 F.3d 1327, 1332-33 (11th Cir. 2005).

(b). Choice-of-Law Clauses

i. The Fundamentals

Most franchise agreements contain clauses specifying the law that will govern disputes between the franchisor and the franchisee. The types of claims that will be encompassed by these clauses depends primarily on the language of the clause. For example, does the clause encompass claims "based on" the contract, "arising under" the contract, "related to" the contract, *etc*.? Choice-of-law clauses will generally be enforced unless (i) the chosen law has no reasonable relationship to the parties' agreement, or (ii) application of the chosen law would violate a fundamental public policy of the forum state. Restatement (Second) of Conflict of Law § 187.

ii. The Impact Of Franchise Relationship Laws on Choice-of-Law Clauses

The first basis for challenging a choice-of-law clause usually only comes into play if the parties chose the law of a State that has no ties to either the franchisor or the franchisee. The second basis for challenging choice-of-law clauses – the public policy issue – often comes into play in those States which have enacted franchise relationship or registration statutes. Most relationship laws contain provisions which address (either directly or indirectly) the enforceability of choice-of-law clauses. For example, many state relationship statutes provide that any provision in a franchise agreement which purports to require a franchisee to waive any of the protections of that statute is void.[78] Because application of another state's law would, in effect, cause a franchisee to lose the protections of the state statute, any clause which requires the application of another state's law is void with respect to any claims arising under that statute.

However, the impact of relationship laws must be considered even if the statute at issue does not directly or indirectly render choice-of-law clauses void. In *Grand Kensington, LLC v. Burger King Corp.*,[79] Burger King moved to dismiss a franchisee's claims under the Michigan Franchise Investment Law. The claim was barred, Burger King claimed, because the parties' Franchise Agreement provided that Florida law would apply to all disputes. While choice-of-law provisions were permissible under the Michigan Franchise Investment Law, the Court nevertheless denied Burger King's motion. The Court held that because applying Florida law "would substantially erode the protection plaintiffs enjoy under the Michigan law," application of Florida law would "be contrary to a fundamental policy of Michigan." *Id*. at 839.

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[78] *See*, *e.g.*, Illinois Franchise Disclosure Act, 815 ILCS 705/41; California Franchise Relations Act § 20010.

[79] 81 F. Supp. 2d 834 (E.D. Mich. 2000).

iii. Does The Franchise Statute Apply

Even if a state statute would seem to render void a choice-of-law clause, care must be taken to make sure that the franchise at issue is encompassed by the statute. The New Jersey Franchise Practices Act, for example, "applies only to a franchise (1) the performance of which contemplates or requires the franchisee to establish or maintain a place of business within the State of New Jersey, (2) where gross sales of products or services between the franchisor and franchisee covered by such franchise shall have exceeded $35,000.00 for the 12 months next preceding the institution of suit pursuant to this act, and (3) where more than 20% of the franchisee's gross sales are intended to be or are derived from such franchise."[80] Each element must be satisfied before the Act will apply.

Likewise, statutes may incorporate provisions which limit the scope of certain provisions of the statute. Section 19 of the Illinois Franchise Disclosure Act ("IFDA"), entitled "Termination of a Franchise," provides that "[i]t shall be a violation of this Act for a franchisor to terminate a franchise of a franchised business located in this State prior to the expiration of its term except for 'good cause' as provided in subsection (b) or (c) of this Section."[81] In *McDonald's Corp. v. C.B. Management Co., Inc.*,[82] the defendant-franchisee filed a counterclaim against McDonald's Corporation asserting, among other things, that McDonald's terminated the defendant's franchises without "good cause" in violation of the IFDA. Recognizing that the Illinois legislature had incorporated into the IFDA "specific language extending the statute only to businesses located in the State of Illinois," the court abided by "this manifestation of legislative intent" and dismissed the franchisee's claim for violation of the IFDA. *Id*. at 715.

Finally, what happens if a State statute seems inapplicable on its face, but your Franchise Agreement chose the law of that State as the law that would govern all disputes between the parties? For example, would the franchisee in the McDonald's case discussed above be entitled to sue under the IFDA (even though its franchise was not covered by the Act) if the franchise agreement provided that Illinois law would govern the parties' disputes? While the case law is not entirely uniform, the vast majority of courts have concluded that a franchise agreement's choice-of-law clause cannot supply the jurisdictional basis for the application of a franchise act if that basis is otherwise lacking.[83] This issue can also be dealt with when drafting the choice-of-law clause. An out-of-state franchisee's claim that Illinois law should apply, for example, would be weakened if the choice-of-law clause provided that the provisions of the IFDA

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80 *Instructional Sys., Inc. v. Computer Curriculum Corp.*, 614 A.2d 124, 133 (N.J. 1992) (citing N.J. Stat. Ann. § 56:10-4 (2004)).

81 815 ILCS § 705/19 (1998) (emphasis added).

82 13 F. Supp. 2d 705 (N.D. Ill. 1998).

83 *McDonald's Corp. v. C.B. Management Co.*, 13 F. Supp. 2d 705, 714 (N.D. Ill. 1998).

would not apply unless the Act's jurisdictional requirements were met independently, without reference to the choice-of-law provision.

III. FREQUENTLY ASSERTED FRANCHISEE CAUSES OF ACTION AGAINST FRANCHISORS

This final section addresses the claims which franchisees frequently assert and the contractual provisions which may pose obstacles to the assertion of those claims, and suggests various strategies for dealing with those provisions. Franchisors seek to limit their potential exposure to franchisees in several ways, including:

A. Limiting the scope of written disclosures and representations in the offering circular (and attempting to curtail pre-sale representations outside of the circular).

B. Limiting the scope of the franchisor's express and implied contractual duties in the franchise agreement.

C. Imposing a variety of substantive and procedural barriers to litigation by the franchisee.

Franchisors justify these drafting strategies as protecting the "system", which provides little solace to an aggrieved franchisee who was essentially asked to "check his legal rights at the door" when signing the franchise agreement.

However, despite all of the clever draftsmanship, franchisees continue to prevail (in actual cases or at the bargaining table) when the facts are in the franchisee's favor. For franchisee counsel, the following protocol is useful in case evaluation:

1. Gather all facts and all documents that might possibly bear on the dispute, from the franchisee's initial contact, to the present.
2. Review the UFOC to determine whether there has been any violation in the registration and disclosure process.
3. Review all pre-sale representations to determine whether any other claim of fraud or misrepresentation is possible.
4. Review the Franchise Agreement to determine if the franchisee can state a claim for breach of contract, either under the agreement's express terms, or by going beyond the written agreement with legal duties that are implied in fact or law.
5. Determine whether any other statutory or common law claims are available.
6. Consider the franchisor's possible justifications for its actions and all of the franchisor's available defenses (and possible counterclaims).

A. Claims Arising In The Franchise Sales Process

1. Registration And Disclosure Violations

Consideration of potential claims in franchising logically begins with the issue of whether there were registration or disclosure violations. *See* Garner (Editor), *Franchise Desk Book* (Selected State Laws, Commentary and Annotations) (American Bar Association) (2001) (hereinafter "Desk Book") for a summary of state franchise laws.

(a). The Federal Trade Commission Rule

In turn, the subject of disclosure violations begins with the Federal Trade Commission Franchise Rule, 16 C.F.R. §436. In enacting the Franchise Rule, the FTC determined, that as a matter of law, certain disclosures must be made, accurately and completely, in the sales process, including, e.g.: (i) the exact nature of the investment in the franchise, with specific ranges of estimated expenditures; (ii) the recurring funds required to be paid by the franchisee to the franchisor or its affiliates, including required inventory purchases; (iii) the number of franchises and company-operations that were planned to be opened in the following year; and (iv) the history of any failed or closed franchises or company-owned stores. The current FTC Franchise Rule permits, but does not require, the provision of earnings claims. There are numerous ways that a franchisor that elects to make earnings claims may violate the Franchise Rule.[84] The FTC Franchise Rule does not regulate franchisor conduct beyond pre-sale disclosures. The FTC is in the process of amending the Franchise Rule, but the anticipated amendments are not expected to extend into the areas of franchise relationships or terminations (and are disappointing to franchisee advocates).

Federal courts hold that the Franchise Rule does not create a private remedy. Enforcement at the federal level is left to the FTC, and while FTC enforcement can be vigorous, FTC enforcement is not common. *See FTC v. Minuteman Press*, 53 F. Supp. 2d 248, 258 (S.D.N.Y. 1998) (a franchisor's issuance of false earnings claims in violation of the FTC Rule subjected the franchisor to liability under the FTC Act).

(b). State Law Claims Under Little FTC Acts

Most, if not all, states have enacted sweeping "consumer fraud" or "deceptive business practice acts, commonly referred to as "Little FTC Acts", which may provide a means for private litigants to enforce the FTC Franchise Rule. Franchisee standing is a threshold issue, which will vary from state to state, but franchisees will usually win this debate, as Little FTC Act standing is usually conferred broadly.[85] Standing is

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84 A franchisor might provide false earnings information, provide undocumented information, provide earnings claims outside the UFOC, or even fail to provide a UFOC.

85 *See Avery v. State Farm,* 2005 Ill. LEXIS 959 (2005), observing that Section 10a(a) of the Illinois Consumer Fraud Act authorizes private causes of action for practices

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sometimes conferred on all “businesses” or “borrowers;”[86] or on “consumers” or under a “consumer nexus” test when the franchise is purchased from the franchisor, or where the trade practices are addressed to the market generally or [which] otherwise implicate consumer protection concerns.” (*Id*.)

The bridge between Franchise Rule violations and actionable claims under Little FTC Acts is found in the FTC Act, 15 U.S.C. §45. In *FTC v. Minuteman Press*, *supra*, a franchisor’s conduct was a concurrent violation of both the Franchise Rule and Section 5(a) of the FTC Act, which prohibits “unfair or deceptive acts or practices in or affecting commerce.”[87] The franchisor violated Section 5(a) by “making false gross sales and profitability claims to prospective… franchisees” which tend to bear directly on the economic viability of the transaction under consideration, [and which] are both likely to deceive and material.”[88] This same conduct violated the Franchise Rule governing earnings claims, and significantly, the earnings claim violation was actionable by the FTC under Section 5(a) of the FTC Act.[89] Consistent with *Minuteman Press*, violations

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proscribed by section 2. Section 10a(a) states, in pertinent part: “*any person* who suffers actual damage as a result of a violation of [the] act committed by any other person may bring an action against such person.” 815 ILCS 505/10a(a).

86 *See Sullivan’s Wholesale Drug Co., Inc. v. Farly’s Pharmacy, Inc.*, 214 Ill. App. 3d 1073, 1082, 573 N.E.2d 1370, 1376 (5th Dist. 1991) (also construing the Illinois CFA); and *Scotsman Group v. Mid-America Distribs.*, 1994 U.S. Dist. LEXIS 4127 **14-20 (N.D. Ill. Apr. 5, 1994) (dealers or distributors seeking to invoke the Illinois CFA need not prove that they were “consumers” or that the defendants’ practices had injured consumers generally). *See also People ex rel. Scott v. Cardet Int’l Inc.*, 24 Ill.App.3d 740, 321 N.E.2d 386, 391-92 (Ill. App. Ct. 1974); *Bixby Food Sys. Inc. v. McKay*, 985 F.Supp. 802, 807 (N.D. Ill. 1997); *cf. Peter v. Stone Park Enters.*, 1999 U.S. Dist. LEXIS 11385 *19 (N.D. Ill. July 22, 1999). *See also Kavky v. Herbalife Int’l of Am.*, 359 N.J. Super. 497; 820 A.2d 677 (N.J. Ct. App. 2003); *Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197 (N.J. Super. Ct. Law Div. 1986); *Diesel Injection Service Co. v. Jacobs Vehicle Equip. Co.*, 2002 Conn. Super. LEXIS 1227 (Conn. Super. Ct. 2002); *Cf. Bailey Employment, Inc. v. Clifford Hahn*, 545 F. Supp. 62 (D. Conn. 1982). *See also Athlete’s Foot Mktg. Assocs., Inc. v. Inner Reach Corp.*, Bus. Franchise Guide (CCH) ¶ 12,349 (N.D. Ga. 2003).

87 53 F. Supp. 2d 248 (S.D.N.Y. 1998).

88 *Id.* at 258.

89 *Id.* The court noted that the “Franchise Rule defines earnings claims to include any oral, written, or visual representations to a prospective franchisee which state specific actual or potential levels of sales, income, gross or net profits, or to make representations that state other facts that suggest such specific levels. 16 C.F.R. § 436.1(b), (c), (d); Final Interpretive Guides, 44 Fed. Reg. at 49,982.” In addition, the rule requires a franchisor that elects to make earnings claims to prospective franchisees to “have written substantiating documentation on hand, see 16 C.F.R. § 436.1(b)(2), (c)(2), and to furnish

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of the FTC's Franchise Rule should constitute *per se* violations of state Little FTC Acts, as these violations bear directly upon the economic viability of the franchise investment. Improper earnings claims, for example, would arguably be grounds for a private statutory claim under the same circumstances in which the FTC is empowered to bring an enforcement action.

(c). State Franchise Act Claims For Registration & Disclosure Violations

Where available, franchisees usually invoke state franchise statutes as their primary effort to state an actionable claim. These laws are not uniform. Sixteen states have enacted registration and disclosure acts.[90] Two other states require pre-sale disclosure without registration.[91] State franchise acts may apply where the sale is made within the state, although the franchise is located elsewhere. For example, while the registration provisions of the Illinois Franchise Disclosure Act (IFDA) apply only to franchises in Illinois, the anti-fraud provisions apply whenever "an offer to sell or buy a franchise is made within this State and accepted within or outside of this State."[92]

Often, a threshold issue is to determine whether a business arrangement is a "franchise."[93] Most, but not all, states require the payment of consideration to the

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supporting 'Earnings Claim Document[s]' to those individuals to whom representations were made. Final Interpretative Guides, 44 Fed. Reg. at 49,966, 49,982."

90 The states that have enacted registration and disclosure statutes are: *Arkansas* (Ark. Code Ann. §§ 4-72-201 to -210 (2001); *California* (Cal. Corp. Code §§ 31100-31516 (2001)); *Delaware* (Del. Code Ann. tit. 6, §§ 2551-2556 (2000)); *Hawaii* (Haw. Rev. Stat. §§ 482E-1 to -12 (2000); *Illinois* (815 Ill. Comp. Stat. Ann. 705/1 to /44 (2001)); *Indiana* (Ind. Code Ann. §§ 23-2-2.5-1 to -51 (2000)); *Iowa* (Iowa Code §§ 523B.1 to .3 (2001)); *Maryland* (Md. Code Ann. [Bus. Reg.] §§ 14-201 to -233 (2001); *Minnesota* (Minn. Stat. §§ 80C.01 to - 30 (2000)); New York (N.Y. Gen. Bus. Law §§ 680-695 (2001)); New Jersey (N.J. Stat. §§ 56:10-1 to -29 (2001)); *North Dakota* (N.D. Cent. Code §§ 51-19-01 to -17 (2000)); *Oregon* (Ore. Rev. Stat. §§ 650.005 to 650.085 (1999)); *Rhode Island* (R.I. Gen. Laws §§ 19-28.1-1 to -34 (2001)); *South Dakota* (S.D. Codified Laws §§ 37-25A-1 to -87 (2001)); *Virginia* (Va. Code Ann. §§ 13.1-557 to -574 (2001)); *Washington* (Wash. Rev. Code §§ 19.100.010 to .940 (2001)); and *Wisconsin* (Wis. Stat. §§ 553.01 to .78 (2000)). *See also* Fla. Stat. § 559.802(1) (2000), which "exempts franchises from filing as long as the franchisor files notice with the proper authority that the franchisor is in substantial compliance with the FTC Rule and pays the required fee."

91 *See* Mich. Comp. Laws § 19.854(8) (2000); and Ohio Rev. Code Ann. § 1334.02 (Anderson 2001).

92 *See* Illinois Franchise Disclosure Act, 815 Ill. Comp. Stat. §§ 705/1, /5, /6 and /10.

93 *See* Miller, "*Unintentional Franchising*", St. Mary's Law Journal, Vol. 36, No. 2 (2005).

franchisor to create a franchise. (*Desk Book*, *supra*) In *To-Am Equip. Co. v. Mitsubishi Caterpillar Forklift Am., Inc.*, the dealer's required payments for certain printed materials was an "indirect" franchise fee.[94] More recently, a national insurance company learned from a $2.3 million verdict that Connecticut requires only a prescribed marketing plan and the use of trademark to create a franchise.[95]

(d). Common Law Remedies For Disclosure Violations

Franchisees may assert common law misrepresentation for disclosure violations. *See Rodopoulos v. Sam Piki Enter.*, 570 So.2d 661 (Ala. 1990), where a franchisor's failure to comply with the FTC Franchise Rule on earnings claims was admissible to prove the franchisor's standard of care and its failure to adhere to that standard.

2. Fraud or Misrepresentation In The Franchise Sales Process

Beyond alleging a registration or disclosure violation, the franchisee might allege claims for misrepresentation in a variety of statutory and common law counts.

(a). Fraud Claims Under State Little FTC Acts

The scope of actionable conduct under state Little FTC Acts is quite broad. For example, the Illinois Consumer Fraud & Deceptive Business Practices Act ("ICFA"), 815 Ill. Comp. Stat. § 505/1 et seq., provides in pertinent part that:

> Unfair methods of competition and unfair or deceptive acts or practices, including but not limited to the use or employment of any deception, fraud, false pretense, false promise, misrepresentation or the concealment, suppression or omission of any material fact, with intent that others rely upon the concealment, suppression or omission of such material fact, … in the conduct of any trade or commerce are hereby declared unlawful whether any person has in fact been misled, deceived or damaged thereby. In construing this section consideration shall be given to the interpretations of the Federal Trade Commission and the federal courts relating to Section 5 (a) of the Federal Trade Commission Act [15 U.S.C. § 45].

The Texas Deceptive Trade Practices Act (the "TDTPA"), provides a cause of action against parties that engage in false, misleading, and/or deceptive acts or practices, including *e.g.*, the misrepresentation of the characteristics or benefits of a "service"; the misrepresentation that "services" were of a particular standard, quality or

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[94] 152 F.3d 658 (7th Cir. 1998).

[95] Conn. Gen. Stat. § 42-133e(b). A Connecticut jury recently awarded $2.3 Million to an insurance agent, where the agency was found to be a franchise under the state law. *See Alex Charts v. Nationwide Mutual Insurance*.

grade when they were of another; the misrepresentation that an agreement “conferred or involved rights, remedies or obligations which it did not so confer or involve”; or a failure to disclose information concerning goods and services which was known at the time of the transaction, with the intent of inducing the consumer into entering into the transaction, which the consumer would not have otherwise entered into; and failure to comply with filing and disclosure requirements established by the TDPTA, including those requirements of the Texas Business Opportunity Act.[96]

Even deception short of common law fraud, is arguably actionable under these types of statutes. In Illinois, the legislature’s express directive for courts to consider both judicial and FTC “interpretations” of the FTC act, arguably creates a private cause of action for violations of the Section 5(a) of the FTC Act, and Franchise Rule violations.[97] This result should be the same under the broad provisions of any comparable Act.

Plaintiffs under a little FTC Act usually need not prove intentional fraud by the franchisor or its sales agents. As the court in *Minuteman Press* held, “[i]f erroneous information is being disseminated in the marketplace, the availability of injunctive relief does not turn on whether the person or entity making the false claims is acting fraudulently as distinct from recklessly or due to sheer ignorance. The effect on consumers is the same in any event.”[98] The focus is on the effect on the consumer and not the intent of the seller, and even innocent deception would be actionable so long as there was intent to induce reliance (as opposed to intent to deceive).[99]

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96 Texas Bus. Com. Code § 17.50(a)(1).

97 In *Saunders v. Michigan Ave. Nat’l Bank*, 278 Ill. App. 3d 307, 662 N.E.2d 602 (1st Dist. 1996), the Illinois Appellate Court recognized the linkage to the FTC Act: “Illinois courts determine whether conduct [violates] the Consumer Fraud Act on a case-by-case basis. … In determining whether conduct [violates the ICFA], courts may rely upon interpretations of the Federal Trade Commission Act. 815 ILCS 505/2.”

98 53 F. Supp. 2d at 260. Illinois follows the same rule, as the franchisor or sales agent need not require proof of actual reliance or intentional fraud when bringing a claim under the state Little FTC Act, the Illinois Consumer Fraud Act (ICFA). The Illinois Supreme Court has repeatedly held that reliance is not needed to establish a consumer fraud claim. “[W]e must hold that a complaining party is not required to establish reliance, either actual or reasonable, to state a claim under the Illinois Consumer Fraud Act. This is in line not only with the Illinois Supreme Court’s statements regarding the absence of a reliance requirement, but also the liberal policy behind the Act.”98 Additionally, it has long been held that a showing of intentional fraud is not required in Illinois as well. “[A]n intent to deceive is not essential to a finding of unfair or deceptive conduct under section 2 of the Consumer Fraud Act.” *People ex rel. Hartigan v. Stianos*, 475 N.E.2d 1024, 1027 (Ill. App. Ct. 1985).

99 *See Carl Sandburg Village Condo. Ass’n No.1 v. First Condo. Dev. Co.*, 557 N.E.2d 246 (Ill. App. Ct. 1990). *Minuteman Press*, 53 F. Supp. 2d at 260-63; *Martin v. Heinhold*

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Consistent with *Minuteman Press*, Little FTC Act plaintiffs are generally not required to prove actual reliance.[100] Therefore, these claims are not defeated by disclaimers of reliance contained in the offering circular.[101] The usual test is whether a reasonable person would be likely be misled by the material misrepresentations or omissions. (*Id*.). However, in order to recover damages, plaintiffs will usually may be required to prove proximate causation, which effectively requires proof of reliance in order to establish that "but for" the deception, the plaintiff would not have entered into the transaction ("transaction causation").[102] In certain states, such as Illinois, further proof of "loss causation" is also required. (*Id*.). The deception must relate to the financial loss to support a damages claim. (*Id*.) Fraudulent inducement based on false earnings claims is likely to meet a loss causation test, while fraudulent inducement regarding a non-financial matter, such as the experience level of the franchisor's officers, may not be sufficient for this purpose.

(b). Fraud Claims Under State Franchising Acts

State franchising acts typically define and prohibit "fraudulent practices" In the franchise sales process. For example, the IFDA makes it unlawful to:

(a) employ any device, scheme or artifice to defraud.

(b) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statement made in the light of the circumstances under which they are made, not misleading.

(c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

(footnote continued from previous page)

Commodities, Inc., 162 Ill.2d 33, 76 (1994) (citations omitted) ("the test [under the Illinois act] is the effect the [deceptive] conduct *might have* on the consumer") (emphasis added).

100 *See Siegel v. Levy Org. Dev. Co.*, 153 Ill. 2d 534, 542-43, 607 N.E.2d 194 (1992).

101 53 F. Supp. 2d at 262-63. *See also Athlete's Foot Mktg. Assoc., Inc. v. Inner Reach Corp.*, Bus. Franchise Guide (CCH) ¶ 12,349 (N.D. Ga. 2003) (where the UFOC recited that: "[franchisor] and [franchisee] expressly acknowledge that [franchisor] has made no representations, projections or earning claims to [franchisee] with regard to the performance of or sales by each Store. It is expressly agreed between the parties that results and performance of each Store are matter strictly within the control of the [franchisee].") (emphasis added). The court held that where the franchisor made earnings claims (despite the disclaimers), the disclaimers were violative of the California Unfair Trade Practices Act, which was a fundamental public policy of California. *Id.*

102 *See Martin v. Heinhold*, 163 Ill. 2d 33, 39-40, 643 N.E.2d 734 (1994).

The degree of intent needed to state a fraud claim under state franchising laws varies among states and even within the statutes of some states, such as Indiana's, making generalization difficult.[103] Again using the Illinois Franchise Disclosure Act as an example, the Act's plain language indicates that while intent must be proven to establish "fraud" or "deceit" in subparagraphs (a) and (c), subparagraph (b) imposes strict liability for the "mak[ing] of any untrue statement of a material fact…" Scienter is not required.

Claims for promissory fraud are generally actionable under other state franchise acts, where the promises are made in bad faith and intent to deceive 9although proof requirements vary).[104] In contrast with Little FTC Acts, proof of actual and reasonable reliance is generally required to state a claim under the anti-fraud provisions of state franchising laws.[105] Thus, issues concerning integration and "no reliance" clauses permeate fraud claims brought under state franchising acts.

3. Common Law Claims

(a). Fraudulent Inducement

The elements of fraudulent misrepresentation are generally: (1) the making of a representation by defendant; (2) the representation was false; (3) the representation was material; (4) the defendant knew the representation was false; (5) defendant intended to deceive plaintiff; (6) plaintiff acted in reliance on the truth of the representation and was justified in relying on the representation; (7) the representation was a proximate cause of plaintiff's damages; and (8) the amount of damage.[106] In *Preferred RX, Inc. v. American Prescription Plan, Inc.*,[107] the Sixth Circuit explained a party's duty to disclose material facts. The court held:

> [A]n action for fraud and deceit is maintainable not only as a result of affirmative misrepresentations, but also for negative ones, such as a failure of a party to a transaction to fully disclose facts of a material nature where there exists a duty to speak...[A] party is under a duty to speak, and

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103 *See Motor City Bagels L.L.C. v. American Bagel Co.*, 50 F. Supp. 2d 460, 468 (D. Md. 1999).

104 *Healy v. Carlson Travel Network*, 227 F. Supp. 1080, 1092 (D. Minn. 2002). Proof of intent in cases of promissory fraud usually requires independent proof of a fraudulent scheme that goes beyond the mere making of the promise that was not kept. *See Houben v. Telular Corp.*, 231 F.3d 1066 (7th Cir. 2000).

105 *See e.g. Hardees v. Hardees Food System, Inc.*, 31 F.3d 573, 579 (7th Cir. 1994) (reasonable reliance required to state a fraud claim under the Indiana Franchise Act, Ind. Code § 23-2-2.5-1 et seq.).

106 *See Midwest Home Distrib., Inc. v. Domco Indus. Ltd.*, 585 N.W.2d 735 (Iowa 1998).

107 46 F.3d 535 (6th Cir. 1995).

therefore liable for non-disclosure, if the party fails to exercise reasonable care to disclose a material fact which may justifiably induce another party to act or refrain from acting, and the non-disclosing party knows that the failure to disclose such information to the other party will render a prior statement or representation untrue or misleading.[108]

(b). Negligent Misrepresentation

Generally, a claim for negligent misrepresentation requires "(1) that defendant made a misrepresentation of a fast or existing material fact; (2) that defendant had no reasonable ground for believing the statement to be true; (3) that defendant intended to induce plaintiff's reliance on the misrepresentation; (4) that plaintiff was ignorant of the true facts and justifiably relied on the misrepresentation; and (5) that plaintiff was damaged as a result."[109]

In Illinois, a defendant is not liable unless it is engaged in the "business of supplying information." *See First Midwest Bank, N.A. v. Stewart Title Co.*, 2005 WL 119802 (1st Dist. 2005) (whether a party is in the business of supplying information depends "upon the nature of the information at issue and its relation to the kind of business being conducted… 'The critical question is whether the information is an important part of the product offered. [A] business[] will be deemed to be in the business of supplying information if the information furnished along with the non-informational goods or services is central to the business transaction.") (Citations omitted).

4. Remedies For Pre-Sale Claims

Franchisees that prevail on a claim arising in the pre-sale process must generally elect between damages or rescission. Non-profitable franchisees often seek recessionary remedies, while profitable franchisees are more likely to claim lost profit damages. Franchisees seeking to avoid a post-termination non-competition clause are more likely to pursue rescission (or antecedent material breach by the franchisor).

B. Post-Sale Claims

1. Post-Sale Fraud Claims

Franchisees may claim to be defrauded after they sign a franchise agreement. They may allege that the franchisor made overly optimistic projections in support of a bank loan, or to persuade the franchisee to remodel or otherwise increase its investment. The elements of misrepresentation, stated above, apply after the sale.

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108 *Preferred RX*, 46 F.2d at 546 (*quoting Miles v. McSwegin*, 388 N.E.2d 1367, 1369 (Ohio 1979)).

109 *Maltz v. Union Carbide Chems. & Plastics Co.*, 992 F. Supp. 286 (S.D.N.Y. 1998) (applying California law).

State franchising acts do not provide remedies for post-sale fraud claims. However, post-sale fraud or misrepresentation is arguably actionable at common law or under a state Little FTC Act. In *Davis v. McDonald's Corp.*, the court held that a franchisor's post-sale statements about the future impact of additional stores in the area might constitute fraud if it had superior knowledge of the underlying facts.[110]

2. Post-Sale Statutory Protection

If available, the state franchise act must be examined to determine whether the franchisee is afforded any post-sale protection in connection with events such as transfers and renewals, terminations, territorial encroachment, discrimination, and retaliation.[111] Here, there is no substitute for researching the applicable state statute.

(a). Economic Discrimination Claims

Claims of economic discrimination among franchisees are potentially powerful claims on the right facts. In *Canada Dry Corp. v. Nehi Beverage Co., Inc.*, the Seventh Circuit held that under the Indiana franchise act, a franchisee could defend against termination if the franchisor had discriminated engaged in "arbitrary disparate treatment among similarly situated individuals or entities" (i.e., other franchisees).[112] In *General Aviation, Inc. v. Cessna Aircraft Co.*, the Sixth Circuit held that the anti-discrimination provisions of the Michigan franchise act required a franchisor to offer renewal to its franchisees on the same terms that were offered to similarly-situated franchisees.[113] Discrimination issues may also be challenged under the implied covenant of good faith and fair dealing.

(b). "Good Cause" For Termination

"Good cause" for termination is the most important post-sale statutory protection. Failure to pay royalties is the most obvious example of "good cause", and a franchisee that does not pay royalties will probably not be able to stop a termination. However, that franchisee may nonetheless have a damages claim if the franchisor's conduct was a cause of the franchisee's inability to pay royalties. In *Interim Health Care of Northern Illinois v. Interim Health Care*, the Seventh Circuit reversed a summary judgment for the franchisor on a claim that the franchisor breached the implied covenant of good faith

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110 *Davis v. McDonald's Corp.*, Bus. Franchise Guide (CCH) ¶ 11,387 (1998).

111 The Iowa Franchise Investment Act is probably the broadest relationship statute, as it addresses "relationship" problems such as transfer, termination, non-renewal, and also protects the franchisee from territorial encroachment resulting from the franchisor's subsequent sales. *See* Iowa Code §§ 523B.1 to .3 (2001).

112 723 F.2d 512 (7th Cir. 1984), citing Ind. Code § 23-2-2.7-2(5).

113 13 F.3d 178 (6th Cir. 1994), construing Mich. Comp. Laws, § 445.1527.

and fair dealing in invoking the termination clause after the franchisor had substantially damaged the franchisee by failing to refer national account patients to the franchisee.[114] "Good cause" for termination was not a complete defense to the lack of good faith.

(c). Termination "Strategery"

In examining a notice of termination, or notice of default preceding a termination, the franchisee's counsel must determine if the alleged violations are curable (under the agreement or a state statute); and if the franchisee has a factual defense. For terminations that might be defensible, in fact or law, the franchisee might seek an injunction against termination, in order to avoid the prospect of Lanham Act liability if the franchisee remains open after the date of termination declared by the franchisor. The disadvantage in taking this approach is a shifting of the burden of proof at the preliminary injunction stage, but the prospects of trademark infringement liability often compel the franchisee to assume that burden. Where a choice of forum battle is anticipated, "filing first" becomes more attractive for that reason as well.

Most often, the best strategy for a franchisee facing termination is to negotiate a period of time in which the franchise can be sold to preserve equity. To the extent that the franchisee can allege colorable defenses or counterclaims, the franchisee has obviously increased its leverage for this negotiation. The franchisee might also consider the prospect of surrendering the location, but reserving damages claims (or counterclaims). The most dangerous outcome, to be avoided at all costs, is to remain open post-termination without the protection of an injunction, thus risking trademark liability.

3. Claims For Breach of Contract

The most common post-sale claim is for breach of contract, including claims for breach of the express contractual term as well as for the implied covenant of good faith and fair dealing. In virtually every state, the implied covenant of good faith and fair dealing is implied into every contract as an aid to the interpretation of the parties' agreement, but not as an independent source of contractual duties.[115] The implied covenant imposes a duty of "good faith" and "fair dealing" in the performance of discretionary duties, or the exercise of discretionary rights, under the agreement. The key is whether the franchisor is "given wide discretion", leaving the franchisee to "hope that the discretion is exercised fairly" and "reasonably, and with proper motive", and not "arbitrarily, capriciously or in a manner inconsistent with the reasonable expectations of

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[114] 225 F.3d 876 (7th Cir. 2000).

[115] *See Martindale v. Lake Shore Nat'l Bank*, 15 Ill.2d 272, 286, 154 N.E.2d 683 (1958); and *Zeidler v. A&W Rests., Inc.*, 301 F.3d 572, 575 (7th Cir. 2002) ("'Bad faith' is a term of art in contract law; it refers to one party's manipulation of contractual terms in order to take commercial advantage of another party").

the parties."[116] This principle assures that parties do not try to take advantage of each other in a way that could not have been contemplated at the time that the contract was drafted or to do anything that would destroy the other party's right to receive the benefit of the contract."[117] The duty of good faith may also be invoked where there is some "gap" in the agreement, resulting from the fact that the drafters were not able to delineate every possible contingency that could arise over the term of the agreement.[118]

(a). Other Ways For Franchisees To Expand The Contract

As franchisee advocate Michael Dady has written, a contract arguably consists of all of the parties' various expressions of interest, not just the written agreement; and oral agreements that supersede the written agreement are enforceable.[119] Other ways for franchisees to attempt to expand a franchisor's duties include:

- Parol Evidence, which can be admitted to explain or clarify ambiguous writings in all jurisdictions.[120] If the language used in a contract is "reasonably susceptible of more than one meaning," it is ambiguous, and parol evidence may be introduced.[121]

- Custom and Practice, Course of Dealing. Evidence of the custom and practice in the industry with respect to franchise terminations and the course of dealing between the particular franchisor and franchisee is

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116 *Dayan v. McDonald's Corp.*, 125 Ill. App. 3d 972, 990, 466 N.E.2d 958 (1st Dist. 1984).

117 *Voyles v. Sandia Mortgage Co.*, 196 Ill.2d 288, 296, 751 N.E.2d 1126 (2001).

118 *See Original Great Am. Chocolate Chip Cookie Co. v. River Valley Cookie, Ltd.*, 970 F.2d. 273, 280 (7th Cir. 1992) ("Good faith is … the duty to avoid taking advantage of gaps in [a franchise agreement] in order to exploit the vulnerabilities that arise in performance"); *see also*, Fox and Su, *Franchise Regulation: Solutions In Search Of Problems*, 20 Okla. City U. L. Rev. 241, n. 17 (1995) ("A [franchise agreement] is relational to the extent that the parties are incapable of reducing important terms of the arrangement to well-defined obligations. Such definitive obligations may be impractical because of inability to identify uncertain future conditions or because of inability to characterize complex adaptations adequately even when the contingencies themselves can be identified in advance").

119 Caruso & Dady, citing *Darrell Dunafon v. Taco Bell Corp.*, Bus. Franchise Guide ¶ 10,919 (W.D. Mo. 1996). See also *Lindsey v. Jewels By Park Lane, Inc.*, 265 F.3d 1087; 2000 WL 254336.

120 *See e.g.*, *ICC Leasing Corp. v. Midwestern Mach. Co.*, 257 N.W.2d 551, 554 (Minn. 1977).

121 *See e.g.*, *Blattner v. Forster*, 332 N.W.2d. 316, 319 (Minn. 1982).

commonly admissible to assist the fact-finder in determining the agreement's terms.[122]

- Oral Modification. Contracts may also be modified, usually by oral agreements, after they have been entered into. In fact, contracts are sometimes subject to oral modification even where the written agreement provides that it can only be modified in writing. Courts allow agreements to be modified orally or by actual performance if such modification is done in good faith.[123]

- Promissory or equitable estoppel, which may also prevent a franchisor from invoking a clause in its written contract where the franchisor has, by its conduct, led its franchisee to believe it would not rely on the clause against that franchisee.[124]

- Recoupment, which may imply a minimum term to an at-will agreement (the length of time in which the franchisee can reasonably be expected to recoup its investment)[125] "has traditionally been confined to the recovery of preliminary expenses incurred in setting up a distribution system, such as sums expended for initial promotion and renting a facility."

- Unjust Enrichment: Typically, to satisfy a claim for unjust enrichment, a party must demonstrate the following three elements: (1) a benefit conferred upon one party by the other; (2) an appreciation or knowledge by the receiving party of the benefit; and (3) the acceptance or retention by the receiving party of the benefit under such circumstances as to make it inequitable for the receiving party to retain the benefit without the payment of its value.[126]

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122 *See* U.C.C. § 2-202; and *Anderson Tractor Sales v. Fiat Tractor North Am. Operations*, No. 14Y1990034594 (A.A.A. 1996).

123 *See* U.C.C. § 2-209; and *Kelly-Stehney & Assocs., Inc. v. MacDonald's Indus. Prods., Inc.*, 658 N.W. 2d 494 (Mich. Ct. App. 2003).

124 *See Central Microfilm Serv. Corp. v. Basic/Four Corp.*, 688 F.2d 1206 (8th Cir. 1982).

125 *See e.g.*, *Italian & French Wine Co. v. Negociants U.S.A., Inc.*, 842 F. Supp. 693 (W.D.N.Y 1993).

126 *Sensormatic Sec. Corp. v. Sensormatic Elecs. Corp.*, 249 F. Supp. 2d 703, 708 (D. Md. 2003); *see also Joan Hansen & Co. v. Everlast World's Boxing Headquarters Corp.*, 744 N.Y.S.2d 384 (N.Y. App. Div. 2002).

(b). Contract Clauses That Give Franchisees Trouble

i. Provisions That Expressly Negate A Claimed Legal Right

The most damaging clauses for franchisees are those that expressly negate a right that would otherwise exist by implication, *e.g.* a clause that expressly negates any territorial protection and which limits a franchise to the exact location (and which, in the case of a food franchise, would literally allow the franchisor to sell the exact product from a kiosk on the street in front of the franchised location, at half price)![127] These clauses are often the result of court decisions that were seen as expanding franchisee protection.[128] Recently, franchisor attorneys have advocated the total abolition of good faith and fair dealing through expansive disclaimers. *See* Schumacher, *Exercise of Discretion – Laws Affecting A Franchisor's Exercise of Discretion and Avoiding Claims In The Exercise Of Discretion* (IFA 2005). These proposals would literally, and by design, license a franchisor to behave unreasonably, and to act contrary to the parties' reasonable expectations at the time of contracting. Whether the courts will accept those proposals remains to be seen. Absent a standard of care by which to measure the adequacy of a franchisor's discretionary performance, the franchisor's promise is wholly illusory. *See Chodos v. West Publishing Co., Inc.*, 292 F.3d 992, 996-97 (9th Cir. 2002) (the obligation of good faith and fair dealing renders discretionary promises real and prevents the voiding of contracts for lack of mutuality).[129]

ii. Integration And "No Reliance" Clauses

It remains unsettled whether a provision that the written agreement is "complete" will bar a fraud claim. The Seventh Circuit case has held that if a contract was procured by fraud, an integration clause reciting that the written agreement was complete would not preclude a fraud claim arising from the parties' discussions before the contract was

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127 *Scheck v. Burger King Corp.*, 798 F. Supp. 692 (S.D. Fla. 1992) and *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999).

128 *See* Heller, "*Interim Health Care: The 7th Circuit applies The Implied Covenant*" (ABA 2000) (recommending that "the decision should prompt franchisors to review the language of their franchise agreements and redraft those provisions that a court may later conclude vest discretion in the franchisor.").

129 Closely related are clauses asserting that the agreement is complete as written and that there are no "implied agreements." Franchisors argue in litigation that a "no implied agreements" clause should be interpreted as negating the implied covenant of good faith and fair dealing in its entirety. That assertion arguably has no merit. Since the implied covenant of good faith and fair dealing is not typically viewed as an independent source of contract-in-fact duties, but rather is a contract-in-law aid in interpreting the existing agreement, the covenant's existence should not be affected by a clause stating that there are "no [independent] implied agreements."

signed; the integration clause "*would go down the drain with the contract of which it was a part.*"[130] The court explained that parties seeking to avoid fraud claims could still protect themselves by specifically providing that there was "no reliance" upon any oral or written representations not included in the final agreement.[131] Particularly problematic, however, is the argument that a "no reliance on prior representations" clause somehow precludes reliance on representations made in the Offering Circular. That application of an integration clause would arguably violate public policy, since franchisors provide Offering Circulars to comply with the FTC Franchise Rule and applicable state laws. "No waiver" clauses in state franchising acts, where applicable, arguably void these attempts.[132]

For contract claims, integration clauses are commonly enforced, leaving a party seeking to avoid its application to try to establish that the franchise agreement was incomplete (which is rare), ambiguous, or that the proposed additional term is separate from the subject matter of the agreement containing the integration clause.[133]

iii. Choice-Of-Law Provisions

Franchisors use choice-of-law clauses in an attempt to control the substantive law that will govern the parties' agreement. Courts review these clauses under a four-part test (or a close variation): (1) Did the parties agree to the choice of law in advance? (2) Are the contacts of the parties evenly divided between the chosen state and the plaintiff's state? (3) Are the parties of relatively equal bargaining strength? (4) Is the application of the chosen law repugnant to the public policy of the forum state?[134]

Serious problems arise when franchisors seek to use choice-of-law clauses to circumvent state franchising acts. With both the proliferation of state laws regulating the termination or substantial alteration of franchise relationships and the wide disparity in the nature and amount of regulation, enforceable choice-of-law provisions may

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130 *Vigortone AG Prods., Inc. v. AG Prods., Inc.*, 316 F.3d 641 (7th Cir. 2002) (*citing Olympia Hotels Corp. v. Johnson Wax Dev. Corp.*, 908 F.2d 1363, 1371 (7th Cir. 1990)).

131 *See e.g.*, *Healy v. Carlson Travel Network Assocs.*, 227 F. Supp. 2d 1080, 1094 (D. Minn. 2002), *citing Commercial Props, Inv., Inc. v. Quality Inns Int'l, Inc.*, 938 F.2d 870 (8th Cir. 1991).

132 As discussed above with respect to Little FTC Acts, franchisees might also turn to state consumer fraud or deceptive business practice laws to avoid the potential application of integration clauses in general, and as applied to UFOC disclosures in particular.

133 *See Miniasian v. Standard Chtd. Bank*, 109 F.3d 1212, 1215 (7th Cir. 1997) (if an integration clause is to have any application, the "subject matter" of the alleged false promises must be fully integrated into "an unambiguous contract provision").

134 *See Modern Computer Sys. v. Modern Banking Sys.*, 871 F.2d 734 (8th Cir. 1989). *See also TeleSave Merchandising Co. v. Consumers Distrib. Co.*, 814 F.2d 1120 (6th Cir. 1987).

dramatically affect the rights of those on both sides of the franchise relationship. Historically, state statutes regulating the conduct of parties to a franchise agreement have been viewed by courts as embodying the fundamental public policy of the state, and, as such, in the past, courts have consistently held that these statutes prevailed over conflicting language in the agreements between the parties.[135] Certain courts, however, have disregarded these statutory protections.[136]

Other problems may occur if a choice-of-law clause provides for the law of the state where the franchisor has its headquarters or principal place of business, but if the franchisor then relocates after the agreement is signed. In that situation, courts must determine whether the parties' rights were fixed at the time the contract was signed, or whether the choice of law floats with the franchisor.

Franchisees may use choice-of-law provisions offensively. For example, a California statute provides that non-compete clauses that would restrain a person from engaging in a "lawful profession, trade or business of any kind" are void.[137]

iv. Forum Selection Clauses

Forum selection clauses that would require a franchisee to litigate outside its home state are often void under state franchising acts.[138] Presumably, franchisees are protected in the registration process from approval of franchise agreements that would purport to require litigation in another state, in violation of a state law.[139] Franchisees are often well advised to be the "first to file" in their home state.

v. Jury-Trial Waivers

In federal cases, a contractual agreement can operate to waive the right to a jury trial, but, consistent with the status of jury trials as a constitutional right, such agreements are strictly and narrowly construed. Four factors courts use to consider contractual jury-trial waivers are: (1) the relative bargaining power of the parties; (2) the extent to which the party opposing the waiver understood that provision; (3) the extent

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135 *See Luis Rosario, Inc. v. Amana Refrigeration*, 733 F.2d 172, 173 (1st Cir. 1984); *Arnott v. American Oil Co.*, 609 F.2d 873 (8th Cir. 1979); *Cutter v. Scott & Fetzer Co.*, 510 F. Supp. 905 (E.D. Wis. 1981); *33 Flavors, Inc. v. Bresler's 33 Flavors*, 475 F. Supp. 217, 227 n.29 (D. Del. 1979).

136 *See* Caruso & Dady for further discussion of this point.

137 Cal. Bus. & Prof. Code § 16600. *See Budget Rent A Car Corp. v. G.M. Truck Rental*, 2003 U.S. Dist. LEXIS 11323 (N.D. Ill. June 26, 2003).

138 *See e.g.*, 815 Ill. Comp. Stat. § 705/4.

139 Item 17 of a UFOC requires disclosure of choice of law and choice of forum provisions in an agreement.

to which the provision was negotiated; and (4) the conspicuousness of the provision. Courts place the burden of establishing these factors on the party seeking to enforce a waiver provision. Franchisees can argue against these provisions with success.[140]

vi. Damage Limitations And Exclusions

The agreement might provide for limitations on the right of either party to seek punitive damages from the other. Arguably, these provisions should be given no effect, since punitive damages are rarely (if ever) available in contract actions, and if the claim is based on fraudulent inducement, then damage limitations should be stricken as part of the fraud. There is, however, no broad rule striking down these clauses.[141]

Similarly, there is no broad rule to strike down the exclusion of consequential damages or lost profits. The argument may be, however, that if the combined effect is to deprive the franchisee of any effective remedy, the agreement is unconscionable.

vii. Waiving The Right To Bring A Class Action

Federal courts permit contractual waivers of the right to seek class-wide relief.[142]

viii. Shortened Limitations Periods

These clauses are usually upheld, even in the Ninth Circuit (although it remains possible for the authors to conceive of provisions that would be so short as to arguably become unconscionable).[143] Moreover, fraudulent concealment and/or the discovery rule should continue to apply even where the franchisor has imposed a shortened period.

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140 *See MZ Ventures v. Mitsubishi Motor Sales of Am., Inc.*, 1999 U.S. Dist. LEXIS 14421 (C.D. Cal. August 30, 1999) (holding that franchisor failed to establish the effectiveness of a jury trial waiver).

141 *See Gannon v. Circuit City Stores*, 262 F.3d 677, 681-82 (8th Cir. 2001) (observing that the district court had refused to enforce a waiver of punitive damages in an employee's dispute resolution agreement, where the employee alleged the intentional tort of sexual harassment, but noting that the employer did not appeal the issue, and there was a lack of precedent on the issue).

142 *See Arnold v. Goldstar Fin. Sys., Inc.*, 2002 U.S. Dist. LEXIS 15564 (N.D. Ill. August 20, 2002) (rejecting the contention that an arbitration agreement was void because it would have required the prospective plaintiff to waive its right to file a class action under a federal consumer protection law). For a discussion of class actions in franchising, *see Broussard v. Meineke Discount Mufflers*, 155 F.3d 331 (4th Cir. 1998), where the court of appeals overturned a verdict for a combined class of current and ex-franchisees, finding that the two sub-classes had distinct interests in the survival of the system.

143 *See Soltani v. W. & S. Life Ins. Co.*, 258 F.3d 1038, 1042 (9th Cir. 2001).

C. RICO Claims

The federal Racketeering Influenced & Corrupt Organizations Act, 18 U.S.C. § 1961 *et seq.*, provides a comprehensive remedy for serious fraud claims, complete with treble damages and attorneys' fees. Detailed discussion of RICO is beyond the scope of this paper. However, for franchising:

- The most important predicate acts are mail fraud or wire fraud. (18 U.S.C. § 1341 and 18 U.S.C. § 1343).
- The pattern of racketeering activity may be present where the alleged violations are system-wide.
- Franchisors can be "persons" that violate the RICO statute in relationship to an "enterprise", which can be the franchise system, or some portion of that system (as an association-in-fact). *See Lee v. General Nutrition Cos., Inc.*, where the franchisee stated a RICO claim under Section 1962(a), alleging that the franchisor engaged in a fraudulent scheme to drive GNC franchisees out of business and to retake the stores.[144]

D. Anti-Competitive Conduct

1. Antitrust Claims

Exhaustive antitrust discussion is beyond the scope of this paper. However, successful antitrust claims by franchisees are not common, since franchisors usually do not have sufficient market power for their conduct to be deemed anti-competitive under the Rule of Reason (which governs vertical non-price restraints).[145]

2. Robinson-Patman Act Claims

Price discrimination claims under the Robinson-Patman Act, 15 U.S.C. § 13, remain viable for franchisees. This Act comes into play when franchisees purchase goods from the franchisor or from third-parties that the franchisor may designate.[146] The Supreme Court's 2005 decision in the *Volvo* dealers' case is beyond the scope of this paper. The difficulty in proving price discrimination is built into § 13(b) of the Act, which

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[144] 2001 U.S. Dist. LEXIS 24739 *7 (C.D. Cal. November 21, 2001).

[145] *See* B. Bruckman and H. Hillman, *Problems of Dual Distribution Systems*, ABA Forum on Franchising (October 2002) (separate papers). *See also Maris Distrib. Co. v. Anheuser-Busch, Inc.*, 302 F.3d 1207 (11th Cir. 2002), for an illustration of the difficulty of establishing actionable Sherman Act claims under the rule of reason.

[146] Third-party supplier cases may involve claims of illegal brokerage payments in violation of 15 U.S.C. § 13(c).

contains three express affirmative defenses, including “due allowance” for cost differentials, “changing market conditions”, and “meeting the competition.” Two cases in which franchisees stated viable claims are noted below.[147]

3. Contract Challenges To Anti-Competitive Conduct

Anti-competitive conduct by a franchisor may breach a duty of good faith and fair dealing, even if it is not possible to state an antitrust claim. In *Matthis v. Exxon Corp.*, fifty-four (54) franchised gasoline dealers alleged that their franchisor had attempted to drive them out of business by imposing a low price setting, where “price” had been an open term of the contract that had been left to Exxon’s discretion, and where Exxon allegedly intended to replace them with lower price jobbers.[148] Only the contract claims survived to trial. Examining the franchise agreement to mount challenges to the arbitrary exercise of discretion has particular relevance in the context of dual distribution.

E. Civil Rights Claims

California provides statutory protection to minorities from discrimination in franchising.[149] At the federal level, racial minorities (but not women or other minorities) are protected from discrimination in franchising by a Reconstruction era law, 42 U.S.C. § 1981, which provides that “all persons” shall have the same right as “white persons” to “make and enforce contracts.” Civil rights claims turn on “direct” or “indirect” proof of discriminatory intent — *i.e.*, that the color of the plaintiff’s skin caused the adverse action and keep the franchisor’s stated reasons for its actions were phony.[150] The Seventh Circuit has held that plaintiffs may present “a mosaic of evidence which, taken together, would permit a jury to infer discriminatory intent.”[151] *See also Home Repair, Inc. v. Paul W. Davis Sys., Inc.,* where a “mosaic” of proof included evidence of suspicious timing, inconsistent behavior, racist statements and/or evidence of “racial steering” of minority franchisees to minority communities.[152]

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147 *Schwartz v. Sun Co.*, 276 F.3d 900, 903-04 (6th Cir. 2002); and *Inomed Labs LLC v. Aza Corp.*, Bus. Franchise Guide (CCH) ¶ 12,465 (S.D.N.Y. 2002). .

148 302 F.3d 448 (5th Cir. 2002).

149 Cal. Civil Code, §51.8 and 84.

150 *Troupe v. May Dept. Stores Co.*, 20 F.3d 734, 736 (7th Cir. 1994).

151 *Id.*; and *Kennedy v. Schoenberg, Fisher & Newman, Ltd.*, 140 F.3d 716, 724-25 (7th Cir. 1998).

152 2000 U.S. Dist. LEXIS 929 (N.D. Ill. Jan. 31, 2000).