International Franchise Association
52nd Annual Legal Symposium
May 5-7, 2019
Washington, D.C.

BASICS TRACK: FRANCHISE LITIGATION

Panelists:
Stacy Howard
McDonald's Corporation
Chicago, Illinois

Christopher A. Mair
Greenberg Traurig, LLP
Chicago, Illinois

Table of Contents

Page

I. INTRODUCTION 1
II. PRE-SUIT CONSIDERATIONS 1
 A. Lawsuit vs. Arbitration 1
  1. Benefits of Arbitration 2
  2. Benefits of Litigation 4
 B. State Court vs. Federal Court 5
  1. Jurisdiction 5
   (a) Personal Jurisdiction 6
   (b) Subject Matter Jurisdiction 7
   (c) Removal 8
III. PRE-SUIT DISPUTE RESOLUTION 8
 A. Mediation 8
 B. Arbitration 9
  1. Enforcement Issues 9
   (a) Arbitrability 9
   (b) Non-Signatory Challenges 11
  2. Emergency Interim Relief in Arbitration 13
IV. SUBSTANTIVE CLAIMS AND DEFENSES 14
 A. Common Franchisee Claims 14
  1. Common Law Fraud Claims 14
  2. Statutory Misrepresentation and Omission Claims 15
  3. Breach of Contract 15
   (a) Breach of Good Faith and Fair Dealing 16
   (b) Encroachment Claims 16
   (c) Wrongful Termination Claims 17
   (d) Transfer or Assignment Claims 18
   (e) Failure to Provide Training and Support 18
   (f) Marketing Fund Mismanagement 19
 B. Third-Party Claims Asserted Against Franchisor 19

(a) Vicarious Liability Claims 19
(b) Liability Under the FTC Act 20

C. Common Franchisor Claims 21

1. Breach of Contract 21

(a) Monetary Default/Failure to Pay 22
(b) Wrongful Termination/Abandonment 22
(c) Violation of System Standards 23

2. Post-Termination Claims 23

(a) Trademark Infringement 24
(b) Covenant Not to Compete 24
(c) Confidential Information and Protection of Trade Secrets 25

V. PROVING DAMAGES 25

I. INTRODUCTION

Like any other area of commercial litigation, franchise law can range in complexity depending on, among other things, the parties involved, the claims at stake, the level of factual development, and the procedural posture of the case. Regardless of the level of complexity, it is important that both franchisors and franchisees alike understand the key issues surrounding the topic of franchise litigation. This paper aims to provide all readers with a helpful reference that touches on subjects that most frequently may arise in franchise litigation.

Section II examines the considerations that a party contemplating franchise litigation should consider before commencing an action. Section III discusses options available for parties that would like to seek resolution of the dispute through mediation and/or arbitration. Section IV identifies and discusses claims and defenses commonly asserted by franchisees, third-parties, and franchisors in franchise litigation. Finally, Section V examines the type of relief that parties usually seek in franchise litigation.

II. PRE-SUIT CONSIDERATIONS

Preparation for franchise litigation should begin long before commencement of an action and often starts with a thoughtful consideration of the contractual terms governing the dispute resolution process. To maximize the chances of success in a franchise dispute that has advanced to the point of litigation or alternative dispute resolution, a party should take advantage of every opportunity to craft favorable and fair conditions for adjudication of the dispute. One of the first decisions that a franchisor or franchisee encounters is determining the best forum in which to litigate. Before initiating a franchise action, a party—regardless off their position as franchisor or franchisee—should have a well-developed understanding of the options available for commencing a lawsuit. Depending on the language of the franchise agreement, or other operative agreement granting rights and/or obligations to the parties that is at issue, a franchisor/franchisee might have important pre-lawsuit considerations to evaluate before filing.

A. Lawsuit vs. Arbitration

Choosing between initiating litigation in court or commencing arbitration is the first major pre-suit consideration that a franchisor/franchisee party should contemplate. Whether a franchisor or franchisee chooses to sue in court or in an arbitral forum depends in part on the language of the franchise agreement governing the relationship between the parties. If the franchise agreement (or other operative contract) already establishes where disputes must be brought, then a franchisor or franchisee's choice is more limited. But this is not always the case. Some contracts are silent on such provisions. Thus, it is important to examine and understand any dispute resolution provisions that may contractually bind the parties. While opinions may vary about which forum provides the best benefit to its participants, there is no dispute that both options contain unique and distinctive advantages and disadvantages. It is also worth noting that a party's perspective can play an important role in evaluating the choice between litigation and arbitration. What might be seen as a benefit to a party initiating a franchise law claim could just as likely be viewed as a detriment to a party defending a franchise law claim.

1. Benefits of Arbitration

Time. The age-old idiom "time is money" is as relevant to the legal practice as any other industry. A long and drawn out dispute period requires, among other things, the allocation of finite resources that could be utilized or directed towards alternative tasks or goals. Whether a dispute lasts for a series of months or years can have a significant impact on a party's financial bottom line and overall willingness to assert or defend its rights given the costs associated with pursuing a franchise law claim. Consequently, it might be in a party's best interest to choose a dispute resolution forum that allows for a prompt and efficient administration and adjudication of the franchise issue at hand. Here, arbitration may be better than state and federal court litigation. Between litigation and arbitration, for those matters that are likely to proceed to a full hearing, disputes that are taken to arbitration can often be resolved faster than a lawsuit in state court or in federal court.[1] According to a recent study conducted by the economic research firm Micronomics, United States District Court cases take more than twelve months longer to get to trial than cases adjudicated by an arbitration hearing.[2]

Thus, if a party's primary consideration for choosing a forum hinges on reaching a final hearing on the merits as soon as possible, then arbitration should be the preferable choice. If on the other hand, the length of time it takes to resolve the matter is less important, then it may be that party's best interest to keep the franchise dispute in federal or state court.

Flexibility. Another benefit to arbitration relates to the parties' flexibility in determining how the proceeding should be conducted. In arbitration, parties can schedule hearings and deadlines to meet their objectives and convenience.[3] Arbitration allows franchisors to craft custom dispute resolution procedures designed to control their cost and exposure, particularly for recurring and anticipated claims, which in turn benefits the franchise system as a whole.[4] Arbitration gives the parties the power to choose, among other things:

- the entity tasked to administer the arbitration;

---

[1] Brenton D. Soderstrum, *Litigation v. Arbitration: Pros and Cons*, https://www.bestlawyers.com/Content/Downloads/Articles/4379_1.pdf (2005).

[2] American Arbitration Association, Measuring the Costs of Delays in Dispute Resolution (2017).

[3] Edna Sussman & John Wilkinson, *Benefits of Arbitration for Commercial Disputes*, ABA Dispute Resolution, http://www.americanbar.org/content/dam/aba/publications/dispute_resolution_magazine/March_2012_Sussman_Wilkinson_March_5.authcheckdam.pdf.

[4] Hon. Jeffrey Keyes (Ret.), Melissa Durso, et al., *A Litigator's Perspective on Arbitration—A Practical Session*, 51st Annual Legal Symposium Panel Paper, May 2018.

- the location where the arbitration proceeding should commence and a final hearing be held;

- the number of arbitrators required to adjudicate the proceeding;

- what qualifications an arbitrator must have to be selected;

- how much discovery each party is entitled to conduct; and

- the form of the award that should be issued by the arbitrator(s).

Further, the likelihood that courts will intervene to limit the parties' agreed arbitration terms is rare. Because the decision to arbitrate is a matter of contract, courts generally provide great deference to the arbitration terms that the parties agreed to at the time of contract formation. Or, if an issue regarding procedure arises, it is typically dealt with quickly by the arbitrator or arbitral forum under the governing arbitration rules. Given these facts, a party that seeks and values flexibility in dispute resolution would likely prefer arbitration over litigation for the above reasons.

Cost. Asserting franchise law claims can quickly become expensive, whether in court or in arbitration. But when comparing the two, arbitration often is less costly than court litigation largely because arbitration is likely to involve a contracted schedule for the completion of discovery and trial. Arbitration should contain numerous cost advantages relative to litigation, and generally:

- permits less discovery than litigation and, partly as a result, give rise to fewer discovery disputes and motions;

- eliminates almost all pretrial motions to dismiss and for summary judgment;

- eliminates detailed pretrial orders and move promptly to a final evidentiary hearing;

- permits evidence to be presented in a simpler, less technical manner; and

- acts as a final movement, with very limited bases for appeal.[5]

Pre-trial expenses are also narrowed in arbitration in certain areas, such as broad motion practice, evidentiary issues, qualification of experts, *voir dire*, jury charges, proposed findings of fact, authentication of documents, and cumulative witnesses. Court litigation, on the other hand, usually involves the expenditure of significant expenses related to pre-trial discovery. Parties can further narrow what is and what is not permitted by including such provisions in the contracts governing their business relationship.

---

[5] E. Norman Veasey, *The Conundrum of the Arbitration vs. Litigation Decision*, September 19, 2018, https://www.americanbar.org/groups/business_law/publications/blt/2015/12/07_veasey/.

Expertise. Arbitration allows the parties to select a decision-maker with experience in franchising, making the process more efficient and reducing the likelihood of error that could be committed by a judge or jury lacking such specialized experience.[6] This requirement can be written into the parties' contract.

Party Control. Because arbitration is created through contracting, parties can by agreement design the dispute resolution process to accommodate their respective needs and can continue to do so as the proceeding moves forward.[7]

2. Benefits of Litigation

Discovery. In general, the Federal Rules of Civil Procedure and state rules of civil procedure allow for broad and expansive discovery. In addition to document requests, written interrogatories, and requests to admit, parties in federal and state court litigation can seek depositions. Parties are not limited to discovery of the parties, but can also seek information from non-parties to the lawsuit.

Appellate Rights. Unlike arbitration, a party that has not prevailed in court and believes that the trial court committed an error is provided the right to appeal its decision to a higher court for review.

Depending on the type of claim that is being asserted and the position of the party initiating a claim, having a less certain chance for appeal could be a benefit. Under the FAA and its similarly situated state counterparts, arbitration awards are appealable only on the following narrow grounds: (a) where the award was procured by corruption, fraud, or undue means; (b) where there was evident partiality or corruption by the arbitrators; (c) where the arbitrators are guilty of misconduct in refusing to postpone the hearing, upon sufficient cause shown, or in refusing to hear evidence pertinent and material to the controversy, or guilty of any other misbehavior prejudicing a party's rights; or (d) where the arbitrators exceeded their powers, or so imperfectly executed them that a mutual, final and definite award upon the subject matter submitted was not made.[8]

In most jurisdictions, the precise grounds upon which an arbitration award may be vacated is set forth specifically by statute.[9] According to the statutory schemes in place in some jurisdictions, a party may attack an arbitration award upon a finding that the rights of a party were prejudiced by "partiality of an arbitrator appointed as a neutral."[10] Some statutes provide that such partiality may take two forms -- actual bias, which must be

[6] Keyes, *supra* note 4.

[7] Sussman, *supra* note 3.

[8] Federal Arbitration Act, 9 U.S.C.A. § 10(a).

[9] George L. Blum, *Setting aside arbitration award on ground of interest or bias of arbitrators -- commercial, business, or real estate transactions*, 67 A.L.R. 5th 179.

[10] *See* Conn. Gen. Stat. Ann. § 52-418 (Lexis 2018); Ohio Rev. Code Ann. § 2711.10 (Lexis 2019); N.Y. C.P.L.R. 7511 (Lexis 2019); Cal. Civ. Proc. Code § 1286.2 (Lexis 2019).

proven by clear and convincing evidence, and the appearance of bias, from which a conflict of interest may be inferred.[11]

Publicly Accessible Filings. The lack of confidentiality associated with state and federal court proceedings can be either a benefit or disadvantage, depending on the perspective of the party initiating the claim. A party may view the openness of court as unfavorable, due to the risk of negative publicity. For a franchisee that is seeking to exert pressure or leverage against a franchisor, the threat of having the matter decided in public and having all filings made public could be viewed as an advantage.

B. State Court vs. Federal Court

If the decision to arbitrate has been ruled out—either because the operative document at issue (a) does not contain an applicable arbitration provision or (b) references an arbitration provision that lacks the appropriate scope to capture the claims being asserted by the initiating party —certain pre-suit considerations must still be made. Without a contractual agreement that sets the arbitral forum, the decision to commence a suit requires a determination as to the appropriate litigation forum. Whether a franchisor or franchisee chooses to sue in state or federal court largely turns on the substantive claims being asserted as well as the parties' residence. But there are strategic considerations that must also be evaluated. Regardless of the party's position of franchisor or franchisee, it is important that counsel thoughtfully consider the benefits and disadvantages associated with pursuing a claim in state or federal court. For example, a party may perceive a state court forum to be more favorable to its positions because the jury pool would be more receptive than a jury pool that would be constituted in federal court. Further, a party may view a particular jurisdiction less or more likely to grant dispositive motions or injunctive relief. Depending on the position of the parties and the claims being asserted in the litigation, a particular state or federal court could lead to differences in how the litigation may proceed. As such, the plaintiff franchisor or franchisee should seek out and accumulate as much information as possible about the jurisdiction being considered. Those selections can be impacted depending on the facts and particulars of the parties involved in the case, as well as the type of dispute.

If the parties are residents of the same state, then the decision is made for the party initiating litigation, and the case must proceed in state court unless the case involves a federal question. However, if the parties reside in different states, and the amount in controversy exceeds $75,000, then the case may proceed in federal court, as diversity-jurisdiction has been established.

1. Jurisdiction

In order to adjudicate a lawsuit, in either state or federal court, the deciding court must first have the authority over the substantive claim at issue (commonly referred to as "subject-matter jurisdiction") and authority over the parties (commonly referred to as

[11] *Kay v. Kaiser Found. Health Plan, Inc.*, 119 Haw. 219, 226 (App. 2008).

personal jurisdiction).[12] If an adjudicating court lacks either subject matter jurisdiction or personal jurisdiction, the case at issue likely will be subject to venue transfer or dismissal, depending on the forum and governing law.

(a) Personal Jurisdiction

Personal jurisdiction is a court's jurisdiction over the parties to a lawsuit. It is a constitutional requirement; the United States Constitution requires that the party has certain minimum contacts with the forum in which the court sits.[13] More specifically, a plaintiff must demonstrate that the defendant has sufficient "minimum contacts" with the forum such that requiring the litigant to litigate in the forum "does not offend traditional notions of fair play and substantial justice."[14] Generally, questions of personal jurisdiction can arise in the franchise context because it is not uncommon for a franchisor to be based in a different state from where the franchisee is operating.

In *Burger King v. Rudzewicz*, the United States Supreme Court considered the issue of personal jurisdiction in a franchise dispute. The defendants, residents of Michigan, entered into an agreement with Burger King, a Florida corporation, to open and operate a Michigan-based franchise. The defendants fell behind in their franchise payments to Burger King, and Burger King sued in federal district court in Florida for breach of contract and trademark infringement under the Lanham Act. The defendants challenged the Florida court's exercise of personal jurisdiction. The Court held that sufficient minimum contacts existed for the defendants to be required to litigate the dispute filed in Florida. As the basis for its decision, the Court found that the franchisee's communications and payments to Burger King in Florida were sufficient to constitute a "substantial and continuing" relationship with Florida so that due process would not be violated. The Court stated that there was or should have been a reasonable anticipation by the franchisee that it would be summoned into court in Florida for claims arising out of the franchise agreement.

Since the Supreme Court's decision in *Burger King*, other personal jurisdiction cases in the franchise context have been decided by state and federal courts throughout the United States.[15]

---

[12] 1 Weinstein, Korn & Miller CPLR Manual § 3.02

[13] *International Shoe v. Washington*, 326 U.S. 310 (1945).

[14] *Id*.

[15] *Precision Franchising LLC v. Dist. Heights CCS LLC*, No. 1:18-cv-582, 2018 U.S. Dist. LEXIS 166437, at *2-3 (2018) (Defendants in franchise dispute subject to Court's personal jurisdiction on presence of forum selection clause); *Get in Shape Franchise, Inc. v. TFL Fishers, LLC*, 167 F. Supp. 3d 173, 194 (D. Mass. 2016) (holding that court had personal jurisdiction over the franchisee where she had deliberately reached out to the franchisor in the forum state to negotiate for purchase of a long-term franchise, and the instant dispute over the franchise agreement and trademark grew out of a contract with substantial connections to the forum state); *A Love of Food I, LLC v. Maoz Vegetarian USA, Inc*., 795 F. Supp. 2d 365, 370 (personal jurisdiction valid on basis that franchisee negotiated and finalized franchise agreement in forum state).

(b) Subject Matter Jurisdiction

Subject matter jurisdiction is the authority of a court to hear cases of a particular type or cases relating to a specific subject matter. Unlike the case of personal jurisdiction, the requirements needed to establish subject matter jurisdiction vary between state and federal law. Most state courts maintain general jurisdiction and may hear nearly any type of claim that arises under state or federal law, except for those claims that are exclusive to the jurisdiction of the federal courts.

Determining whether subject matter jurisdiction exists in federal court is more limited and requires a much more rigorous analysis. This is because federal courts are courts of limited jurisdiction and do not have jurisdiction over a claim unless the statutory requirements have been met. In the context of a franchise dispute, a case can only be brought in a federal court if (a) it involves a federal cause of action (also referred to as "federal question" jurisdiction); or (b) there is a diversity of citizenship.

Federal Question Jurisdiction. Federal question jurisdiction is the subject matter jurisdiction of United States federal courts to hear a civil case because the plaintiff has alleged a violation of the United States Constitution, federal law, or a treaty to which the United States is a party. U.S. Code, 28 U.S.C. § 1331, requires that the action "aris[e] under the Constitution, laws, or treaties of the United States" in order for federal question jurisdiction to be conferred. For purposes of federal question jurisdiction, a claim "arises under" federal law only if "a right or immunity created by the constitution or laws of the United States is an essential element of the plaintiff's cause of action."

Claims of trademark infringement under the Lanham Act is one of the most common federal questions to arise in the context of franchise disputes, largely because the termination of a franchise agreement also terminates the franchisee's license to use the franchisor's trademark.

Diversity Jurisdiction. Under federal law, in accordance with 28 U.S.C. § 1332, if the franchisor and franchisee reside in different states (or if either party resides in a foreign country) and the amount at issue in the case exceeds $75,000, exclusive of costs, a federal court will have subject matter jurisdiction over the case based on diversity of citizenship. The complaint must clearly set forth the grounds for federal jurisdiction. For purposes of determining the citizenship of parties, a corporation is deemed to be a citizen "or any state by which it has been incorporated and of the state where it has its principal place of business." Limited liability companies ("LLCs") are citizens of every state in which any individual member is a citizen. With respect to diversity jurisdiction, it is important to note that "complete diversity" is necessary; all plaintiffs must be from states that are different than all defendants.

In the context of franchise disputes, most are litigated in federal court and not state court, because these disputes often involve monetary claims or demands for the adjudication of legal rights that are valued at more than $75,000, and they arise between franchisors and franchisees that are typically located in different states.

(c) Removal

Although the party initiating the case in a franchise dispute has the right to initiate their cause of action in state court (to the extent that there is no contractual language in the governing document requiring that the claim be brought in a different forum), a defendant maintains certain removal rights under U.S. law. If a case is filed in state court, it may be removed to federal court, in accordance with 28 U.S.C. § 1441, as long as the case is one over which the federal court would have original subject matter jurisdiction and the defendant has not waived the right to remove.

III. PRE-SUIT DISPUTE RESOLUTION

A. Mediation

Before filing a lawsuit or arbitration demand, a party should first look to their franchise agreement or operative document to determine whether mediation is a pre-requisite to initiating a claim for relief. Some franchise agreements require a party attempt to mediate their claims prior to litigation, while other franchise agreements are silent on the issue. Mediation is a dispute resolution procedure in which the parties discuss their disputes with the assistance of a trained impartial third person. The goal is to assist in reaching a settlement. Depending on the type and size of the claims at issue, mediation can be a cost-effective approach to dispute resolution. It is generally the final step that stands between the parties and the commencement of new litigation. The range of potential solutions in any mediated dispute is limited only by the parties' imagination and individual interests.[16] As such, the threat of impending litigation and the "last hope" posture of the mediation can sometimes lead the parties to an agreed resolution of claims. It is important to note however, that mediation is not binding, and if the parties do not reach an agreement then they are not required to adhere to any of the mediator's decisions or conclusions. Some franchise agreements require mediation prior to commencing litigation for claims or disputes arising out of the franchise relationship.

Mediation poses a variant of the principal-agent problem.[17] Mediators do not represent parties in a mediation, but they can play an important role in the shaping, guiding, and facilitating of the mediation.[18] As such, the quality of the mediator can be vital to arriving at a mutually acceptable, voluntary, self-determined solution to a given dispute. Selecting the right mediator is one of the most important components for achieving a successful mediation conference. But the "right mediator" is not universal and may in fact vary depending on the circumstances of the case; the status of the parties; and the parties' claims and defenses. In general, there are two types of mediator "personalities" that can impact the way in which the mediation conference is conducted:

---

[16] Andrew K. Niebler, *Getting the Most Out of Mediation: Toward a Theory of Optimal Compensation for Mediators*, 4 Harv. Negotiation L. Rev. 167 (1999).

[17] *Id*.

[18] *Id*.

- **The Facilitative Mediator** assists the parties in reaching accord without passing judgment as to positions or outcomes.[19] The mediator that adopts this style of mediation is less likely to push the parties to come to an agreement, and functions more as a conduit to resolution. The parties are tasked with determining the control and speed of negotiations, while the mediator is simply there to assist the parties in the mediation process from a neutral perch.

- **The Evaluative Mediator** plays a much more involved role in facilitating the mediation.[20] The mediator with this "personality" is much more aggressive, will not hesitate to identify the strengths and weaknesses of a party's position in hopes of guiding the parties to settlement, and will not hesitate to aggressively push the parties when needed.

B. Arbitration

An arbitrator's role differs greatly from that of a mediator. Unlike a mediator, who seeks to help the parties resolve their disputes on their own, an arbitrator becomes the finder of fact and law and imposes a solution by himself or herself based on the claims and defenses that have been advanced by the parties. Arbitration is a matter of contract; unless the parties agree to arbitrate, any dispute will be resolved in court.[21] Arbitration can be used as tool to efficiently and effectively resolve disputes and eliminate risks. Relative to state and federal forums, arbitration offers numerous advantages.

1. Enforcement Issues

Under most circumstances, when an arbitration clause exists, the franchisee is the party seeking to challenge or avoid asserting or defending its claims in arbitration. Whether the franchisee has brought claims in court and is opposing the defendant-franchisor's motion to compel arbitration, or seeking to stay the arbitration that has been initiated by the claimant-franchisor, the same arguments are likely to be raised.

(a) Arbitrability

"Arbitrability" refers to whether or not arbitrators have the authority to rule on a dispute. It is most often raised when one party disputes the enforceability of the parties'

[19] Alan Burger, Mediation and Franchise Relationships, Industry Insights, https://mcdonaldhopkins.com/Insights/Blog/Industry-Insights/2018/08/08/Mediation-and-franchise-relationships (2018).

[20] *Id*.

[21] Christopher Drahozal, *Arbitration Clauses in Franchise Agreements: Common (and Uncommon) Terms*, 22 Franchise L.J. 81 (2002).

agreement.[22] It is usually the first issue raised in opposition to arbitration to prevent the dispute from reaching an arbitrator in the first place.

Determining who decides the arbitrability of a dispute is a nexus question that is frequently raised in franchisee disputes challenging the applicability of an arbitration provision. A franchisee may oppose arbitration by arguing that the arbitration agreement itself is unenforceable because the franchise agreement as a whole was the product of fraudulent inducement, adhesion, unconscionability, or some other inequity.[23] It is on these bases that franchisees may argue that the court should decide arbitrability in the first instance. Whether the arbitration clause covers the dispute at issue is generally a question for the court to decide unless the parties have "clearly and unmistakably" delegated that issue to the arbitrator.[24]

Some courts have attempted to reject delegation clauses, despite their language and clear inclusion in arbitration agreements on the basis of the "wholly groundless" exception. According to the Federal Circuit, "the 'wholly groundless' standard applies when an arbitration agreement clearly and unmistakably refers the issue of arbitrability to the arbitrator."[25] The Federal Circuit applied the standard in *Evans v. Bldg. Materials Corp. of Am.* to uphold a district court's denial of a motion to compel arbitration, despite a valid delegation clause, when the claims were "so plainly outside the arbitration provision that a contrary argument is wholly groundless."[26]

Just recently, the United States Supreme Court has provided more instruction and guidance on how clauses delegating arbitrability should be interpreted in commercial contracts, while wholeheartedly rejecting the Federal Circuit's wholly groundless exception approach. In *Henry Schein, Inc. v. Archer & White Sales, Inc.*, the Supreme Court interpreted the text of the Federal Arbitration Act ("FAA") strictly to exclude the "wholly groundless" exception previously adopted by the Fourth, Fifth, Sixth, and Federal Circuits. *Schein*, 139 S. Ct. at 528-29. Under *Schein*, "the courts must respect the parties' decision as embodied in the contract." 139 S. Ct. at 531. Accordingly, a party seeking to ensure arbitration and arbitrability remains with the arbitrator can do so if the parties' choice is clearly and unmistakably articulated in the language of the operative arbitration agreement at issue. This is so regardless of the perceived merit or lack of merit of the parties' claims.

But recent guidance from the Supreme Court on this issue does not necessarily mean that a party will no longer raise an opposition to an arbitrator's arbitrability, even though challenges to well-drafted delegation clauses are the exception—and not the norm. Those attacks are expected to continue, even if less likely to succeed post- *Schein*.

---

[22] Keyes, *supra* note 3.

[23] *Id*.

[24] *T3 Enters. v. Safeguard Bus. Sys.*, 435 P.3d 518, 527 (Idaho 2019) (finding that there was not a "clear and unmistakable" delegation of authority in the arbitration provision).

[25] *Evans v. Bldg. Materials Corp. of Am.*, 858 F.3d 1377, 1381 (Fed. Cir. 2017).

[26] *Id.* at n.1.

In *Mohamed v. Uber Techs., Inc.,* the Ninth Circuit upheld a delegation clause notwithstanding challenges to its clarity and conscionability, holding that "[t]he delegation provisions clearly and unmistakably delegated the question of arbitrability to the arbitrator."[27] Similarly, in *Doctor's Assocs. v. Kirksey*, the District Court in Connecticut granted a franchisor's motion to compel arbitration on the basis that the Franchise Agreement's delegation provision was valid and enforceable.[28] The court stated, in no clearer words, that the parties "unmistakably agreed to send questions of arbitrability to the arbitrator."[29]

This trend has not been confined to federal courts. In fact, many states have adopted similar holdings to *Mohamed* in recent years. For example, in *Regions Bank v. Rice*, the Alabama Supreme Court affirmed the enforceability of a delegation clause on the basis that the party did not specifically "challenge the delegation provision," which "clearly and unmistakably delegates questions of substantive arbitrability to the arbitrator."[30] Similarly, in *Family Dollar Stores of W. Virginia, Inc. v. Tolliver*, the West Virginia Supreme Court enforced an arbitration agreement on the basis that the party challenging the agreement failed to "specifically address the delegation provision."[31]

(b) Non-Signatory Challenges

There is no dispute that signatories to a franchise agreement are required to adhere to and perform their agreed-upon obligations. If a signatory fails to do so, it risks exposure and potential liability under a breach of contract cause of action. Franchisors and franchisees should always act with the presumption that they can enforce a franchise agreement's arbitration provision against one another if the parties are in fact signatories to the agreement at issue. Issues arise, however, when individuals and/or entities are involved in the franchise relationship (whether through operation or management), yet not signatories to the operative agreement. From familial relationships to business associates and employees, a franchisee may find themselves in a position where a franchisor is attempting to assert claims against a non-signatory to the franchise agreement on the basis that they are sufficiently involved in the business and should be held responsible for their conduct (or lack thereof) under the franchise agreement. The issue can become even more complex when there are multiple individuals or entities who have signed some, but not all of the many agreements involved in the franchise relationship, such as guarantees, licenses, or leases, among others.

In these situations, the case law confirms that arbitration often can be enforced against these non-signatories if certain facts are present. Courts generally recognize five

[27] 848 F.3d 1201, 1209 (9th Cir. 2016) ("The delegation provisions were not procedurally unconscionable . . . .").

[28] 2018 U.S. Dist. LEXIS 197515, at *20 (D. Conn. Nov. 19, 2018).

[29] *Id*. at *14.

[30] 209 So. 3d 1108, 1111 (Ala. 2016) ("Pursuant to the delegation provision, the arbitrator must resolve the disputed issue whether Rice's claim is arbitrable under the arbitration provision.").

[31] 2018 WL 1074947, at *1 (W. Va. Feb. 27, 2018).

circumstances where signatories to an agreement are entitled to compel non-signatories to arbitration: 1) incorporation by reference; 2) assumption; 3) agency; 4) veil-piercing/alter ego; and 5) estoppel.[32] Estoppel theory is frequently used by franchisors who aim to bind a non-signatory to arbitration. Under the "direct benefits" estoppel theory, a party can be estopped from relying on its nonsignatory status to avoid arbitrating under an agreement if the nonsignatory "knowingly exploits the agreement containing the arbitration clause."[33] Texas courts have clearly embraced estoppel theory to prevent a non-signatory to rely on its status to avoid arbitration. The Texas Supreme Court provided such clear language in *In re Weekley Homes*, stating "when a nonparty consistently and knowingly insists that others treat it as a party, it cannot later 'turn its back on the portions of the contract, such as an arbitration clause, that it finds distasteful.' A nonparty cannot both have his contract and defeat it too." This position is not unique to Texas, either. In *Half Dental Franchise, LLC v. Houchin*, the Nevada Supreme Court denied a challenge to the arbitrator's authority to bind a non-signatory because they "provided 'colorable justification' for their estoppel theory."[34] The *Houchin* decision is an example of how fact dependent these inquiries are. In *Torres v. Simpatico, Inc.*, the Eighth Circuit stated that "the language of the Agreement is sufficiently broad and inclusive to express an intent to benefit not only the actual signatories and named beneficiaries, but also the other Non–Signatory Parties, all of whom are owners, operators, agents, officers, or employees of the master franchisers."[35]

Non-signatories may also be able to compel signatories to arbitration, often under a third-party beneficiary theory, which requires the agreement to evidence a clear intent to benefit the third-party.[36] In *Melendez v. Horning*, the North Dakota Supreme Court granted a non-signatory's petition to compel a signatory to arbitration because the allegations at issue in the case involved "intertwined conduct by the non-signatories and related signatories."[37] Further, in *Bridgestone Americas Tire Operations, LLC v. Adams*, the Alabama Supreme Court allowed a non-signatory company affiliated with a signatory to compel another signatory to arbitration.[38]

---

[32] *See Arthur Andersen LLP v. Carlisle*, 556 U.S. 624, 631 (2009); *Crawford Prof'l Drugs, Inc. v. CVS Caremark Corp.*, 748 F.3d 249, 257 (5th Cir. 2014); *CD Partners, LLC v. Grizzle*, 424 F.3d 795, 799 (8th Cir. 2005); *Zurich Am. Ins. Co. v. Watts Indus., Inc.*, 417 F.3d 682, 687 (7th Cir. 2005); *Denney v. BDO Seidman*, L.L.P., 412 F.3d 58, 71 (2d Cir. 2005); *Trippe Mfg. Co. v. Niles Audio Corp.,* 401 F.3d 529, 532 (3d Cir. 2005); *Javitch v. First Union Securities, Inc.*, 315 F.3d 619, 6280–29 (6th Cir. 2003); *Employers Ins. Of Wausau v. Bright Metal Specialties*, 251 F.3d 1316, 1322 (11th Cir. 2001); *Int'l Paper Co. v. Schwabedissen Maschinen & Anlagen GMBH*, 206 F.3d 411, 416-17 (4th Cir. 2000); *Thomson-CSF, S.A. v. Am. Arbitration Ass'n*, 64 F.3d 773, 776 (2d Cir. 1995).

[33] *Bridas S.A.P.I.C. v. Government of Turkmenistan*, 345 F.3d 347, 361-62 (5th Cir. 2003).

[34] 2017 WL 3326425 (Nev. Aug. 3, 2017).

[35] 781 F.3d 963, 971 (8th Cir. 2015).

[36] *Ex parte Stamey*, 776 So.2d 85, 92 (Ala. 2000)

[37] 908 N.W.2d 115, 120 (2018).

[38] 2018 WL 1355966, at *2 (Ala. Mar. 16, 2018)

Franchisors and franchisees should keep in mind, however, that there are limits to the availability of arbitration for disputes with non-signatories. For example, under the First Circuit standard established in in *Oudani v. TF Final Mile, LLC*, independent contractors are not "agents" that can be compelled to arbitration.[39] Further, in *White v. Sunoco, Inc.*, the Third Circuit denied a non-signatory's motion to compel arbitration because of the absence of "concerted conduct" between the non-signatory and signatory or reliance necessary to establish estoppel.[40]

Prevailing on contractual enforcement against non-signatories is a substantially fact dependent and fact driven exercise. If a franchisor wants to maximize the scope of an arbitration clause to include potential non-signatories, it is of primary importance that it explicitly identify third-party beneficiaries that the agreement intends to cover, such as the franchisee's subsidiaries, affiliates, employees, and investors. This can be accomplished by incorporating by reference other agreements that are signed by third-parties, among other things. In the end, franchisors and franchisees should stay updated and aware of the law in their operative jurisdiction.

2. Emergency Interim Relief in Arbitration

Like litigation, parties should be able to seek emergency interim relief in arbitration on an expedited basis. Because the rules may vary depending on the dispute resolution organization that is administering the arbitration, it is particularly important that the party seeking emergency relief carefully read and understand the dispute resolution organizations rules, preferably before including them in the contract. Minor differences can have major consequences on the availability of the interim relief.

On October 1, 2013, the American Arbitration Association ("AAA") adopted new Commercial Arbitration Rules that now allow parties to seek emergency relief from specially designated arbitrators.[41] Commercial Rule 38 only applies to "arbitrations conducted under arbitration clauses or agreements entered on or after October 1, 2013." This provision requires that a party seeking emergency carefully examine the operative document at issue that contains the arbitration clause. If the parties entered into the agreement prior to October 1, 2013, they cannot seek relief under the AAA's emergency rules.

For those contracts that can take advantage of the AAA's emergency relief, the process is straightforward. In accordance with the Commercial Rules, "[a] party in need of emergency relief prior to the constitution of the panel shall notify the AAA and all other parties in writing of the nature of the relief sought and the reasons why such relief is required on an emergency basis. The application shall also set forth the reasons why the party is entitled to such relief." Following the appropriate notice being made to all necessary parties, the AAA must, within one day, "appoint a single emergency arbitrator

---

[39] 2017 WL 5587648 (1st Cir. Nov. 21, 2017)

[40] 2017 WL 3864616 (3d Cir. Sept. 5, 2017).

[41] American Arbitration Association, *Commercial Arbitration Rules*, https://www.adr.org/sites/default/files/Commercial%20Rules.pdf

designated to rule on emergency applications." Within two business days of the emergency arbitrator's appointment, the emergency arbitrator is required to establish a schedule for consideration of the emergency application for relief.

The International Centre for Dispute Resolution ("ICDR"), which is the arm of the AAA tasked with administering international dispute resolution/arbitration, also provides procedures for seeking emergency interim relief. Upon application, an emergency arbitrator may be appointed within one business day and must establish a schedule for consideration of the emergency relief within two business days of appointment.[42]

Such emergency procedures are not tied exclusively to the AAA and the ICDR. JAMS' Emergency Relief Procedures provides for the appointment of an emergency arbitrator within 24 hours of a request made by the parties.[43] The language of the JAMS Rule is similar to that of the AAA, and states that "[a] Party in need of emergency relief prior to the appointment of an Arbitrator may notify JAMS and all other Parties in writing of the relief sought and the basis for an Award of such relief. This Notice shall include an explanation of why such relief is needed on an expedited basis." The emergency arbitrator retains jurisdiction over the dispute until an arbitrator or a panel is appointed. Like the AAA Rule, the emergency arbitrator must establish a schedule for the consideration of the request for emergency relief, within two days.

IV. SUBSTANTIVE CLAIMS AND DEFENSES

A. Common Franchisee Claims

1. Common Law Fraud Claims

Common law fraud is defined as the intentional misrepresentation of a material fact presented to and relied upon by another party to its detriment. It is one of the most common claims that franchisees assert against franchisors in litigation or arbitration. Across jurisdictions, the elements of a common-law claim for fraud are: (1) a material misrepresentation of the presently existing or past fact; (2) knowledge or belief by the defendant of its falsity; (3) an intention that the other person rely on it; (4) a reasonable reliance thereon by the other person; and (5) resultant damages.[44]

Franchisees will often assert claims of common law fraud against a franchisor as it relates to the franchisor's alleged failure to provide accurate or truthful financial performance representations. Claims of negligent misrepresentation are often asserted

[42] International Centre for Dispute Resolution Rules, https://www.icdr.org/sites/default/files/document_repository/ICDR_Rules.pdf

[43] JAMS Comprehensive Arbitration Rules, https://www.jamsadr.com/files/Uploads/Documents/JAMS-Rules/JAMS_comprehensive_arbitration_rules-2014.pdf

[44] *Intarome Fragrance & Flavor Corp. v. Zarkades*, 2009 U.S. Dist. LEXIS 48350, at *14-*15 (D. N.J. June 9, 2009).

against a franchisor, particularly when there may be certain issues relating to the "intentionality" of the fraud claim.

There are, however, certain statements that a franchisor can make and are definitively not considered to be financial performance representations. General statements regarding sales without providing specific details does not rise to a claim of a financial performance representation. Additionally, suggestions of potential success are also not sufficient to give rise to a franchisee financial performance representation claim.

In addition to defending against FPR claim on the basis that the representations made do not meet the definition of a FPR, franchisors often defend against FPR claims by relying on certain provisions found in the franchise agreement, including integration, "no representation", and "no reliance" clauses.[45] The legitimacy of these defenses can vary depending on the jurisdiction governing the dispute at issue. As example, certain state disclosure statues have anti-waiver provisions which prohibit franchisors from relying upon the protections of contractual provisions.[46]

2. Statutory Misrepresentation and Omission Claims

Most states have enacted extensive statutes which allow private actors to assert claims for conduct giving rise to "consumer fraud" or "deceptive business practices. These laws are commonly referred to as "Little FTC Acts" and can pose major headaches for a franchisor that has not fully adhered to the FTC Amended Franchise Rule because violations of the FTC Rule have been found to be per se violations of state Little FTC Acts, including but not limited to, the Texas Unfair and Deceptive Trade Practices Act and the Massachusetts Little FTC Act.[47]

3. Breach of Contract

---

[45] *Interim Healthcare v. Care@home*, 2019 U.S. Dist. LEXIS 61996, at *40 (S.D. Fla. 2019) (finding that franchisees Franchise Act claim failed because "the FA contains a detailed disclaimer and encouraged HCH to perform its own due diligence and independent investigation.")

[46] See, e.g., *Governara v. 7-Eleven, Inc.,* 2014 U.S. Dist. LEXIS 130205, at *13 ("the anti-waiver provision of the NYFA has been interpreted to provide a statutory exception to this common law rule. Under <u>§ 687(4)</u>, "[a]ny condition, stipulation, or provision purporting to bind any person acquiring any franchise to waive compliance with any provision of this law, or rule promulgated hereunder, shall be void." N.Y. Gen. Bus. Law § 687(4). Furthermore, under § 687(5), "[i]t is unlawful to require a franchisee to assent to a release, assignment, novation, waiver or estoppel which would relieve a person from any duty or liability imposed by this article."); *Hanley v. Doctors Express Franchising*, LLC, No. ELH-12-795, 2013 U.S. Dist. LEXIS 25340, at *81 (D. Md. Feb 25, 2013) (finding the anti-waiver provision of Minnesota's franchise statute to be quite similar to Maryland's); (*Cousin Subs Sys. Inc. v. Better Subs Dev. Inc.*, No. 09-C-0336, 2011 WL 4585541, at *8 (E.D. Wis. Sept. 30, 2011) ("no reliance" clause not sufficient to bar claims under the anti-fraud provisions of the Wisconsin Franchise Investment Law and the Indiana Franchise Disclosure Act); *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071, 1089 (D. Minn. 2007) (holding that "[f]ranchisors cannot use contractual provisions to protect themselves from being sued for misrepresentation under the Minnesota Franchise Act").

[47] *Texas Cookie Co. v. Hendricks & Peralta, Inc*., 747 S.W.2d 873, 877-79 (Tex. App. 1988); *Brennan v. Carvel Corp*., 929 F.2d 801, 811-14 (1st Cir. 1989).

Because nearly all litigation between franchisors and franchisees result from the parties' franchise agreement or affiliated contracts, it should come as no surprise that a breach of contract claim is one of the most widely used causes of action in a franchisee's litigation arsenal. The elements of a claim for breach of contract are: (1) the existence of a valid and enforceable contract; substantial performance by the plaintiff; (3) breach of contract by the defendant; and (4) resultant injury to the plaintiff. *Avila v. CitiMortgage, Inc.*, 801 F.3d 777 (7th Cir. 2015); *Interim Healthcare v. Care@home*, 2019 U.S. Dist. LEXIS 61996, at *22 (S.D. Fla. 2019).

(a) Breach of Good Faith and Fair Dealing

With every breach of contract claim that a franchisee asserts, a claim for breach of the duty of good faith and fair dealing is undoubtedly to follow because of its deep-rooted association in every contract.

While the definition of the duty of good faith and fair dealing may vary among states, it often provides that parties to all contracts, and in the context of franchise litigation—franchise agreements, are expected to behave honestly, fairly, and in good faith in connection with their contractual rights, obligations, and responsibilities. For example, under Ohio law, "[i]nherent in every contract is a duty of good faith and fair dealing by each of the parties in performing and enforcing the contract."[48] Because of this, "there can be no breach of the implied covenant of good faith and fair dealing absent a breach of contract."[49]

The implied covenant of good faith and fair dealing seeks to ensure that the parties adhere to the express contract terms in accordance with the party's reasonable expectations. The reasonable expectations of the parties may be determined by the language of the contract, the purpose of the contract and other facts and circumstances known to the parties.[50]

A franchisee may assert this claim in a series of different factual circumstances, including by alleging that the franchisor has acted in bad faith as a result of the franchisor's course of performance as it relates to the franchise agreement or associated agreement. In order to defend against such claims, a franchisor is likely to show that there was no deliberate bad faith in its decision-making as it relates to the franchisee. In order to do so, a franchisor may rely on documentary evidence and communications between the franchisee and the franchisor to establish that its course of performance changed within the ambit of a business decision.

(b) Encroachment Claims

A franchisor's grant of rights to a franchisee typically involves the provision of certain territorial rights and "protected territories" to the franchisee. When those territorial

[48] *Maher v. City of Akron*, 2018-Ohio-4310, at *P19 (App. 2018).
[49] *Peterbrooke Franchising of Am., LLC v. Miami Chocolates, LLC*, 312 F. Supp. 3d 1325, 1343 (S.D. Fla. 2018).
[50] *See, e.g.*, *Sons of Thunder, Inc. v. Borden, Inc.*, 148 N.J. 396, 690 A.2d 575 (N.J. 1997)

protections are violated or infringed upon, franchisee-initiated lawsuits are likely to result. Franchise encroachment claims usually stem from the opening of new and competing franchises near the geographic territory of an existing franchise location. A franchisee will often predicate an encroachment claim on one of two bases: (a) the language of the franchise agreement; or (b) the implied covenant of good faith and fair dealing.

The most effective way to defend against a franchisee's encroachment claim is to clearly and unmistakably state in the franchise agreement that the franchisee has no exclusive rights to any territory and that the franchisor retains the right to open or authorize any other franchisee to open new franchise locations in the territory where the current franchisee operates.

Even though franchisors choose to expressly disclaim that a franchisee does not have exclusive territorial rights, some courts have allowed franchisees to assert allegations of encroachment against franchisor's who include such statements in their franchise agreements. In *Barnes v. Burger King Corp.*,[51] the United States District Court for the Southern District of Florida denied Burger King's defenses to the franchisee's claims of encroachment, and held that Burger King did not have complete discretion in opening new franchise locations in the geographic area near the franchisee if such growth could affect franchisees that were already existing in the territory, despite the specific contractual language in the franchisee's franchise agreement that denied territorial exclusivity.

(c) Wrongful Termination Claims

By their nature, franchise agreements contain finite terms for the relationship between franchisor and franchisee. Some franchise agreements may include a term that lasts for five years, while others may include longer terms of 10 years, and sometimes even 20 years in length. Termination of these agreements occur when the relationship ends prior to the natural term expiration of the contract. If the termination was initiated by the franchisor, and the dispute proceeds to litigation, it is almost without doubt that the franchisee will assert, either as a claim or a defense, that the franchisor's decision to terminate was either wrongful or improper. Franchise agreements often define the circumstances under which termination is permitted. To successfully establish that a franchisor's decision to terminate the franchise agreement or relationship was wrongful, a franchisee has to show that the franchisor's decision to terminate does not fall within the enumerated provisions for termination. Franchisees commonly argue that the franchisor failed to follow the notice and cure provisions contained in the franchise agreement, which must be met prior to termination.

Depending on the state that the franchisee is operating in, there may be certain statutory notice and cure periods that go beyond what is contemplated by the franchise agreement and additional termination requirements that the franchisor must adhere to. There are eighteen states that statutorily prescribe notice and cure periods for termination of a franchise agreement: Arkansas, California, Connecticut, Delaware, Hawaii, Illinois,

[51] 932 F. Supp. 1420.

Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Washington, Wisconsin, and Virginia. Two U.S. territories, Puerto Rico and the Virgin Islands, also prescribe notice and cure periods for franchise agreement termination.

(d) Transfer or Assignment Claims

Often, franchise agreements include provisions that describe the process and obligations of both the franchisor and franchisee for transferring ownership or assigning interest in the franchise location at issue to another third-party individual or entity. Many, if not all modern franchise agreements provide the franchisor with the discretion to approve or deny the transfer that is being sought by the franchisee. And that discretion may vary depending on the language of the franchise agreement. For example, some franchise agreements provide broad discretion to franchisors to approve or deny a transfer, while others are more restrictive, and state that the franchisor cannot unreasonably withhold or delay consent. Despite this discretion, franchisees will frequently threaten or initiate litigation (asserting breach of contract, tortious interference with business relationships, or breach of the implied covenant of good faith and fair dealing) against a franchisor after their request to transfer or assign their interest has been denied. Disputes generally arise when a franchisee is under the impression that the franchisor's decision to grant consent to transfer was unreasonably withheld or delayed, and the franchisee suffered economic damages by way of the franchisor's denial.

In order to defend against these type of "unreasonable withholding" claims, a franchisor should always ensure that its basis for denying a franchisee's transfer or assignment clearly comports with the discretion it is afforded by way of the franchise agreement. Being able to show a business justification for denying the transfer to the intended third party can also insulate against a franchisee claim of bad faith decision-making.

(e) Failure to Provide Training and Support

Almost all franchise agreements contain language that requires the franchisor to provide a level of training and support to its franchisees. Whether that training is only provided on an initial basis, or continues throughout the franchise relationship, depends on the language of the franchise agreement and the terms agreed to by the parties. Within any franchise relationship, however, there is an expectation that franchisees will be trained in the franchisor's particular business and supported to sell the products and/or services associated with the franchise brand. If a franchisee does not receive this coveted training and support, or believes that the training and support that it has received is inadequate, a cause of action against the franchisor could result.

At times, a franchisee's expectations may not align with the obligations that a franchisor must adhere to per the terms of the franchise agreement. A franchisor is under no obligation to ensure the franchisee succeeds, or provide "general support" whenever needed by the franchisee, unless the parties' contractual language specifically requires such support. To the contrary, most franchise agreements are drafted to provide limited and specific training and few, if any, support obligations. To the extent that any such support obligations are provided for in a franchise agreement, they are often stated in broad language and usually reserves the franchisor's right to exercise its "sole discretion" in deciding whether and in what ways to provide support.

(f) Marketing Fund Mismanagement

Most franchise systems feature a marketing and advertising fund, which is used to further the brand and promote the franchisees across the system. Often, the marketing and advertising fund is maintained through monthly or weekly contributions from each of the franchise locations operating in the system, as well as contributions from the franchisor-entity. The intent of the fund may vary depending on the language of the franchise agreement, but it should be used for the common good of the franchisees in order to conduct system advertising. Franchisors run into potential liability problems when they exercise control over the fund and direct expenditures for purposes other than advertising and marketing. This conduct may give rise to breach of contract and breach of fiduciary claims. To avoid such claims, franchisors should ensure that marketing funds are kept separate from corporate funds, and that marketing fund expenditures are being conducted in full compliance with the expenditure obligations articulated in the operative franchise agreement.

B. Third-Party Claims Asserted Against Franchisor

(a) Vicarious Liability Claims

Due to the unique relationship between a franchisor and franchisee, a third-party—allegedly injured by the franchisee—will often assert a claim against the franchisor for the franchisee's purported conduct on the basis that the franchisor is responsible for the acts or omissions of their franchisees (or their franchisees' employees) or due to events occurring on the premises of the franchised business. In most jurisdictions, a plaintiff may hold a franchisor vicariously liable by establishing the franchisor had an actual or apparent agency relationship with its franchisee.[52] In order to establish actual agency between a putative franchisor and franchisee, a plaintiff must show the franchisor has the right to control the franchisee's business.[53]

These types of claims typically turn on the question of "control."[54] But this question creates a dilemma for franchisors in a practical sense. Among franchisors, there is a

---

[52] *Patel v. Sunvest Realty Corp.*, 2018 Del. Super. LEXIS 441 at *12 (Oct. 15, 2018).

[53] *Id*.

[54] Whether in any given case the level of "control" crosses a line so as to result in vicarious liability is not a simple question. *Compare Wise v. Kentucky Fried Chicken Corp.*, 555 F. Supp. 991, 995-96 (D.N.H. 1983) (holding that a jury could hold franchisor vicariously liable for injuries suffered by franchisee's employee because the parties had a "sophisticated system for selecting, approving, testing . . . and maintaining quality control") *with Allen v. Choice Hotels Int'l Inc.*, 276 Fed. Appx. 339, 343 (4th Cir. 2008) (holding that the franchisor was not vicariously liable for its franchisee's actions because the franchisor's policies "simply ensure[d] uniformity" among its franchisees); *Allen v. Greenville Hotel Partners, Inc.*, 409 F. Supp. 2d 672, 677 (D.S.C. 2006) (noting that "operational standards and inspection

strong business interest to ensure quality and consistency of a franchisors trademarks and franchise operations. Failing to control a franchisee's use of the franchisor's Marks and system requirements may result in the loss of a positive and uniform image for the brand. On the other hand, the more detailed and extensive a franchisor's requirements are on the franchisee (with respect to control, operations, and safety standards), the more it appears that the franchisee is acting as the franchisor's actual or apparent agent instead of an independent business entity. Such a finding could lead to a determination of vicarious liability. A franchisor' challenge is to reach the delicate balance between controlling only the franchisee aspects that must be controlled in order to ensure adequate protection of the brand and its Marks, and encouraging the franchisee to perform in a manner that is consistent with brand identity and quality standards without controlling the manner in which the work is performed. In most cases, the focus on the franchisee's conduct will be on whether the franchisor has the right to control the way the work is performed or the day to day activities of the franchisee.[55] Operating standards relating to marketing, quality and operating standards could be inadequate to impose vicarious liability.[56]

(b) Liability Under the FTC Act

Under the FTC Amended Franchise Rule (the "FTC Rule"), a financial performance representation is defined as "[a]ny representation . . . to a prospective franchisee . . . that states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits." Further, Under the FTC Rule,[57] it is an unfair or deceptive practice in violation of not only the FTC Rule but also Section 5 of the Federal Trade Commission Act,[58] for any franchise seller to make any claim or representation that contradicts the information presented in the FDD, or to misrepresent that any person purchased a franchise from the franchisor or operated a franchise similar to the franchise offered by the franchisor. A franchisor's failure to comply with the FTC Rule for financial performance representations or Amended Franchise Rule for disclosure violations can have serious negative ramifications for the franchise agreements and relationships that were entered into upon a franchisee's reliance of any such representations.

While there is no private right of action for violating the FTC disclosure rules, a franchisor may endure litigation initiated by the FTC on behalf of impacted franchisees.[59]

---

rights of control contained in the franchise agreement do not establish a franchisor's control or right of control over the franchisee," to impose vicarious liability); *Thornton v. Ford Motor Co.*, 297 P.3d 413, 425 (Okla. Civ. App. 2012) (holding that the franchisor was not liable under the state's consumer protection act or responsible for protecting customers from its undercapitalized and inexperienced franchisees).

[55] *Depianti v. Jan-Pro Franchising International, Inc.*, 465 Mass. 607, 617 (2013) (holding that "a franchisor is vicariously liable for the conduct of its franchisee only where the franchisor controls or has a right to control the specific policy or practice resulting in harm to the plaintiff."

[56] *Id*.

[57] 16 C.F.R. 436.1 et seq.

[58] 15 U.S.C. § 45

[59] *JTH Tax, Inc. v. Hines*, 2018 U.S. Dist. LEXIS 34811, at *11 (E.D. Va. March 1, 2018).

Pursuant to the FTC Rule, if a franchisor declines to make financial performance representations in Item 19 of its FDD, then it is not permitted to provide information about the actual or potential financial performance of its franchise outlets.[60] A franchisor that fails to disclose, but nevertheless makes financial performance representations may be found liable for committing a statutory disclosure violation. It is also important to keep in mind that the violation is irrespective of whether the disclosure is fraudulent, negligent, or innocent. The failure to adhere to the FTC Rule can have significant consequences for the non-disclosing franchisor.

One such example is apparent in *FTC v. Minuteman Press*. In Minuteman, the court found that the franchisor's conduct—involving the provision of undisclosed earnings claims and projections—constituted a violation of the FTC Rule. The FTC issued a press release soon after the federal court's ruling, highlighting two distinctions made by the court:[61]

> The first distinction is that where a franchisor makes earnings claims to prospective purchasers, an enforcement action is not barred because the franchisor provides written disclaimers indicating that no earnings claims were made and that no officer, director or employee of the franchisor was authorized to make such claims. In fact, a contradiction between a franchisor's actual practices and its written disclaimers is a violation of the FTC's Franchise Rule. The second distinction is that in an enforcement action, injured consumers are entitled to redress under the FTC Act, even if they signed a franchise agreement containing an acknowledgment that the franchisor did not make earnings claims. Applying this principle to the facts of this case, the court found that individuals who purchased franchises from Minuteman and Speedy would have the "common-sense net impression" from the actions of Minuteman, Speedy and their representatives that the prospective purchaser was being furnished important specific earnings claims information to assist in the decision-making process, notwithstanding the general disclaimers about earnings claims.

The FTC's success in *Minuteman* and other cases since shows that franchisors need to be cautious with respect to any statements it is making to prospective franchisees on the issue of earnings, sales, and profits. To fail to do so could risk exposure, liability, and government investigation.

C. Common Franchisor Claims

1. Breach of Contract

[60] *Relo Franchise Servs. v. Gilman*, 2019 U.S. Dist. LEXIS 12335, at *9 (S.D. Ohio Jan. 25, 2019).

[61] https://www.ftc.gov/news-events/press-releases/1998/10/ftc-wins-landmark-case-against-national-franchisor

(a) Monetary Default/Failure to Pay

Generally, franchise agreements are set up to provide the franchisor monthly revenues based on the franchisee's sales. It is also not uncommon for franchisees to pay advertising fees and purchase other products and services from the franchisor. When a franchisee fails to make such payments, a franchisor may decide to initiate litigation against the franchisee for their failure to pay amounts owed to the franchisor. The most common claim that is asserted by franchisors against franchisees is for monetary defaults.

Although a franchisor is well within its right to file suit every time a franchisee fails or refuses to make his royalty or fee payments, it is neither an efficient nor cost-effective strategy to do so. Because most franchise agreements contemplate cure periods for a franchisees failure to pay, a franchisor should carefully examine and understand the steps that must be taken prior to terminating the franchise relationship and initiating an action for monetary default. The first step that is often required is issuing a notice of default to the franchisee. That notice should also provide the amount of time that the franchisee has to cure their default and pay the franchisor what is owed. If payment is not made within that cure period, then the franchisor may move to terminate the franchise agreement. Depending on the language of the franchise agreement, there may be certain timeframes that a franchisor must adhere to prior to termination.

In the event that a franchisee defaults and is unable to cure, termination is not the only option that a franchisor has at its disposal. In certain circumstances, a franchisor may use their franchisee's default as a way to gain additional consideration from the franchisee, presuming the franchisee is seeking an accommodation for their default. For example, a franchisor may request that a franchisee sign a release in connection with granting the accommodation that is being provided due to the franchisee's default. To ensure proper enforcement of the new rights provided to the franchisor by virture of the franchisee's accommodation, a franchisor should, among other things, (a) document all concessions and disallow oral agreements; (b) reserve all rights and include express anti-waiver language in all correspondence sent to the franchisee; and (c) condition any and all accommodations on continued compliance with the franchise agreement at issue, along with other agreements.

(b) Wrongful Termination/Abandonment

Franchisors also frequently assert claims against franchisees when franchisees make the decision to cease operating and abandon their franchise locations. Most franchise agreements provide that a franchisee that abandons their franchise location is not entitled to a cure period.

When a franchisee abandons a franchise location, it also loses the ability to rely on common procedural arguments to delay the case. To a factfinder, a franchisee's affirmative decision to cease operating their business may create the impression that the franchisee no longer wants to be in the franchise system. Thus, subsequent challenges to a franchisor's termination, such as the lack of proper notice to the franchisee, will likely fail because of the franchisee's conduct. Under these circumstances, the narrative of the franchisee being unfairly or wrongfully pushed out of the system is much harder to establish since the franchisee initiated the departure from the system through their abandonment of the location. That is not to say that franchisors will always be able to undercut these procedural arguments. If the franchisee can prove that the franchisor's conduct created the conditions that left the franchisee with no other choice but to abandon the location, then the franchisee is in a better argumentative position.

(c) Violation of System Standards

In most franchise systems, ensuring that all individual franchisees are adhering to the system standards established by the franchisor is a paramount concern. Unsurprisingly, it is in a franchisor's economic interest to maintain a consistent and uniform system for brand awareness and customer satisfaction, among other things.

It is extremely important that a franchisor enforce adherence of its system standards to its franchisees uniformly because of the risk that a franchisor's inconsistent enforcement of system standards can be used against it by a franchisee to argue that the relevant standard is either not material or that the franchisor's enforcement of the standard is being used to harass the franchisee.

2. Post-Termination Claims

When a franchisee continues to operate in violation of its post-termination covenants, including by competing with the franchisor, using the franchisor's marks, or disclosing confidential trade secret information, major issues can arise, including significant risks to brand value and customer trust. Not surprisingly, franchisors take such improper use of its marks very seriously, and will almost always immediately seek to enforce its rights against the infringing franchisee. Moving for a preliminary injunction is the often-used approach to prevent a franchisee's continued infringement and damage to the brand.

Most courts analyze the same factors in determining whether a preliminary injunction is appropriate. The moving party must prove that: (1) it has a substantial likelihood of success on the merits; (2) irreparable injury will be suffered unless the injunction issues; (3) the threatened injury to the movant outweighs whatever damage the proposed injunction may cause the opposing party; and (4) if issued, the injunction would not be adverse to the public interest.[62]

In *The Maids Int'l, Inc. v. Maids on Call, LLC*, the defendant was a previous franchisee of four "The Maids" franchise locations, which provided household maintenance and cleaning services to residential properties in the United States. Upon investigation of defendants' sales and reporting practices, plaintiff-franchisor found that defendants were providing services to customers outside of their assigned territories, as provided for in the franchise agreements. Defendants failed to cure their breaches, and

[62] *IHOP Rests. LLC v. Moeini Corp.*, 2018 U.S. Dist. LEXIS 19707, at *13 (S.D. Ala. Feb. 7, 2018).

plaintiff terminated the Franchise Agreements. After defendants were terminated, however, a new entity that was in privity with defendants began operating a competing residential maintenance and cleaning service business under the name “Two Sisters.” Plaintiff sought a preliminary injunction against defendants to prohibit defendants from (a) infringing on plaintiff’s trademarks, trade names, service marks, and related marks; (b) operating a competing business in violation of the non-compete, non-solicitation, and post-termination provisions; and (c) violating article 18 of the franchise agreement, which required the franchisee to return all manuals and confidential information.

(a) Trademark Infringement

Most often, a franchisor will assert trademark infringement claims against an infringing franchisee under the Lanham Act, which can be brought in either state or federal court. To establish a claim for trademark infringement under the Lanham Act, §§ 1114 or 1125, the franchisor must show "that it has ownership or rights in the trademark and that the defendant has used the mark in connection with goods or services in a manner likely to cause consumer confusion as to the source or sponsorship of the goods or services."

(b) Covenant Not to Compete

“Whether called ‘non-compete clauses,’ ‘covenants not to compete,’ ‘restrictive covenants,’ or some other term, their purpose is plain: to restrict the covenantor from engaging in a business that competes with the covenantee, either during the parties' contract term or for a specified time after termination.”[63] Because of their anticompetitive nature, restrictive covenants are usually heavily scrutinized by courts, and enforcement of these claims are never certain; jurisdiction matters, as well as the facts and circumstances surrounding the conditions of the non-compete.

Finding irreparable injury where a former franchisee is competing against a franchisor is not difficult in many jurisdictions.[64] The reasons is often framed in a resource/goodwill perspective: Because the franchisor has trained the new franchisee (who may otherwise have had no experience in the business), it would be

[63] Robert W. Emerson, *Franchising Covenants Against Competition*, 80 Iowa L. Rev. 1049, 1050 (1995).

[64] *Goddard Sys. v. Gondal*, 2018 U.S. Dist. LEXIS 52945, at *72 (D. Del. March 29, 2018) (Finding that courts in the Third Circuit “regularly hold in franchisor/franchisee cases that "[i]rreparable injury results when a former franchisee competes against a franchisor in breach of a restrictive covenant contained in the parties' franchise agreement.") (citing *Athlete's Foot Mktg. Assocs. v. Zell Inv., Inc.*, No. CIV.A. 00-186, 2000 U.S. Dist. LEXIS 22906, 2000 WL 426186, at *11 (W.D. Pa. Feb. 17, 2000); *see also Soft Pretzel Franchise Sys., Inc. v. Taralli, Inc.*, Civil Action No. 13-3790, 2013 U.S. Dist. LEXIS 144305, 2013 WL 5525015, at *10 (E.D. Pa. Oct. 4, 2013); *Rita's Water Ice Franchise Co., LLC v. S.A. Smith Enterprises, LLC*, No. CIV. A. 10-4297, 2011 U.S. Dist. LEXIS 2595, 2011 WL 101694, at *8 (E.D. Pa. Jan. 11, 2011)).

unjust for the franchisee (absent an injunction) to then be permitted to use the benefits of that very training to serve former and potential customers of the franchisor.[65]

Thus, the key question that courts are faced with is whether the language of the non-competition provision reasonably restricts the franchisee's freedom to work. To survive a challenge to its enforceability, a franchisor must show in most jurisdictions that the non-competition covenant that the franchisee entered into is reasonable. There must be a protectible interest recognized by the law.[66] One of the most easily recognizable protectible interests is the one which permits the buyer of a business to burden his seller with an anticompetitive covenant, so that the buyer might fully realize the benefits of the business and the goodwill which he has purchased.[67]

Recent case law has embraced the enforceability of a franchise agreement's non-compete provision under Florida law. In *Peterbrooke*, the parties entered into a franchise agreement to open a chocolate shop in the city of Miami.[68] The franchise agreement contained a non-compete clause which prohibited the franchisee upon termination from operating any competitive business within 25 miles of the former franchise location for a period of two-years following termination. When the relationship broke down and the plaintiff franchisor initiated a suit against the defendant franchisee seeking to enforce the terms of the non-compete, the defendant challenged the provision as unenforceable. The court ruled in favor of the franchisor, and found that the limitations imposed in the non-compete provision was reasonable and thus, enforceable.

(c) Confidential Information and Protection of Trade Secrets

Most franchise agreements contain provisions that require the franchisee to return, upon expiration or termination of the franchise agreement, all confidential and proprietary information in the franchisee's possession that is related to the franchisor's system. Because a franchisor has developed and markets its confidential methods, practices, and procedures, a former franchisee that utilizes said information to compete or harm the franchisor's business can have a substantial impact. As such, courts generally hold that a provision that requires a franchisee to return such information designated as confidential by the parties during the franchise relationship, is enforceable.

V. PROVING DAMAGES

With breach of contract claims in the franchise context, damages can be recovered for the lost profits that the franchisor would have gained for the remainder of the franchise term but for the franchisee's wrongful breach, if the jurisdiction provides for such a damage calculation. Some courts allow the franchisor to seek such damages where there

---

[65] *Maaco Enters., Inc. v. Bremner*, 1998 U.S. Dist. LEXIS 15174, at *2, *5 (E.D. Pa. Sept. 29, 1998) ("Maaco invested significant time, money and resources in training and assisting [franchisees] in its business system to open, establish and develop their Center as a Maaco franchise.").

[66] 14 A.L.R. Fed. 473

[67] *Id*.

[68] *Supra*, note 49.

is no contractual language expressly barring damages for lost profits.[69] Conversely, other jurisdictions preclude a franchisor from recovering future royalties if it terminates a franchisee for nonpayment of past due royalties, based on the legal theory that the franchisor elected the termination remedy and that the proximate cause of the franchisee's nonpayment of royalties in the future is the franchisor's decision to terminate the franchise.[70] What is certain, across all jurisdictions, is that the fact finder has to have a basis upon which to award damages to the party seeking relief. Often, that requires the assistance of an expert.

Franchisees frequently employ damage experts to calculate and prove (1) lost profits, (2) the value of a business that has been partially or completely destroyed, or (3) the value of a terminated franchise agreement.[71] Conversely, franchisors typically offer damage experts to rebut the franchisee's experts' damage projections or to support their claims for unpaid past or future royalties.[72]

When a jurisdiction does allow lost profits damages, a franchisor can use creative methods to prove such damages. For example, in *Coldwell Banker Real Estate, LLC v. Brian Moses Realty, Inc.*, the plaintiff franchisor asserted claims against defendant franchisees for breach of two franchise agreements.[73] The court found that defendants breached one of the agreements when they abandoned the second franchise office before the second franchise agreement expired. On the topic of ascertaining the damages that plaintiff was entitled to, the court stated plaintiff could rely on a knowledgeable employee to testify as to profitability as it relates to the abandoned restaurant in question:

> To establish lost profits due to [defendants'] abandonment, [plaintiff] may call an employee whose work makes him or her familiar with the Salem franchise's past profit margins and knowledgeable of other comparable [of plaintiff] franchises' profitability. *See Von Der Ruhr v. Immtech Int'l, Inc.*, 570 F.3d 858, 862-63 (7th Cir. 2009) (describing circumstances when lay witnesses can testify about lost profits); *see also Wallace Motor Sales, Inc.*, 780 F.2d at 1062 (allowing lost profit damages to be based on an internal financial statement without any expert testimony); *Jay Edwards, Inc. v. New England Toyota Distrib.*, 708 F.2d 814, 820 & n.4 (1st Cir. 1983) (permitting corporate officer to testify as to lost profits). The jury can then weigh that evidence against all the other evidence to determine whether to award damages and, if so, how much to award. *See Seahorse Marine Supplies, Inc.*, 295 F.3d at 81 (explaining credibility and weight of evidence are within the jury's province). The fact that damages are not now determinable is irrelevant to the grant of

---

[69] *Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, 423 Fed. Appx. 274 (4th Cir. 2011)

[70] *Postal Instant Press v. Sealy*, 51 Cal. Rptr. 2d 365 (Ct. App. 1996).

[71] Robert W. Emerson, *The Neutral Factfinder as a Pathway to Legal Reform: Examples from Franchising*, 10 Va. L. & Bus. Rev. 63 (2015).

[72] *Id*.

[73] 752 F. Supp. 2d 148, 167 (D. N.H. 2010).

> summary judgment on [defendants'] liability for abandoning the Salem franchise in breach of the Second Franchise Agreement**.**

If the franchise agreement at issue includes a liquidated damages provision, the analysis can become much simpler. The fundamental purpose of a liquidated damages provision is to provide a reasonable measure of compensation in the event a breach occurs where, at the time the provision is agreed to, the damages are indeterminable or will be otherwise difficult to prove.[74] Generally, a liquidated damages provision will be enforced if (1) it appears that the parties intended to liquidate damages; (2) at the time of contracting, the amount of damages specified was a reasonable estimate of the presumed actual damages that would result from a breach; and (3) at the time of contracting, it was difficult to ascertain the amount of damages that would result from a breach.[75] If a court finds the liquidated damages provision to constitute a penalty, they will find the provision invalid. Thus, a franchisor must craft the language of a clause carefully; articulate the damages amount; consider the reasonableness of the contemplated recovery amount; and think about the specific law of the state that governs the provision.

In addition to monetary damages, franchisees will often seek rescission of the franchise agreement. Rescission is an equitable remedy that unwinds the contract and annuls the franchise relationship, and is available in most jurisdictions that have promulgated state franchise disclosure statutes.[76] Rescission can also be sought under the common law as well. To do so, a party seeking the relief must prove that there is a valid reason to rescind the franchise agreement, such as fraud, mistake, impossibility of performance or frustration of purpose. In sum, if a franchisee is seeking to remove itself from the franchise relationship and be placed in its original position, obtaining relief for rescission is its best bet.

---

[74] Paul J. Ferak and Christopher A. Mair, *Liquidated Damages Provisions: Best Practices & Key Considerations*, 50th Annual Legal Symposium Panel Paper, May 2017.

[75] Deborah S. Coldwell, Altresha Q. Burchett-Williams, and Melissa L. Celeste, *In this Issue, Liquidated Damages*, 29 FRANCHISE L.J. 211 (2010).

[76] Rochelle Spandorf Julianne Lusthaus, Theresa Koller, *Rescission: The Annulment of a Franchise Marriage*, American Bar Association 38th Forum on Franchising.