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BASICS TRACK: FRANCHISE LITIGATION

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Introduction

Franchising involves relationships that create opportunities for great success as well as the risk of bitter disputes. When reality falls short of expectations and the parties are unable to resolve their disagreements by themselves, franchise litigation is the result.

Franchise litigation is unique in the breadth of procedural, substantive, and thematic issues that can arise. Procedures for resolving disputes include courts, arbitration, mediation, and settlement. Claims arise under both law and equity, involving statues, contracts, and business torts. Parties often have very different stories to tell based on their sense of disparate resources and bargaining power.

This paper will introduce you to franchise litigation by covering the lifecycle of a franchise action from start to finish. Section I provides an overview of litigation strategy for franchise systems. Sections II and III highlight procedural options available to franchise litigants, including venue, forum selection, and ADR. Sections IV to VI review common motions, substantive claims, defenses and remedies, and discovery issues that arise in franchise litigation. Finally, Section VII discusses unique aspects of settling franchise disputes.[1]

I. Litigation Strategy for Franchise Systems

In many ways, franchise disputes are no different from other commercial disputes. However, there are a few unique considerations that arise in litigation between franchisors and franchisees, including the impact of federal and state franchise laws, the effect of litigation on the franchise system, required disclosure of certain disputes, the parties' relative means, and their ongoing relationship.

A. Federal and State Franchise Laws

Franchising is regulated by both federal and state laws. At the federal level, the Federal Trade Commission's ("FTC") Franchise Rule requires that franchisors provide a prospective franchisee with a franchise disclosure document ("FDD") that contains information about the franchise opportunity. The Franchise Rule identifies twenty-three items of information that a franchisor must provide to a prospect before offering and selling a franchise. In addition, fourteen states mandate that the FDD be registered in the state before a franchise can be offered or sold. The FTC's Franchise Rule, and many state registration laws, do not contain a private right of action for violations, although state

[1] This paper focuses on disputes between franchisors and franchisees arising out of the offer or sale of the franchise, the franchise agreement between the parties, or the parties' ongoing franchise relationship. However, franchise litigation can encompass an even broader range of disputes. For example, franchise litigation may also include whether the parties' relationship is in fact one of employer and employee under certain statutes, whether the franchisor is the joint employer of the franchisee's employees, whether customers or other third parties can hold the franchisor liable for the franchisee's conduct, and whether state or federal regulatory authorities may obtain injunctive or monetary relief against franchisors for violations of statutes regulating the franchise disclosure and sales process.

laws may be enforced by attorneys general. The FTC's Franchise Rule and state registration laws will be discussed in more detail in Section V below.

In addition to registration laws, approximately twenty states and territories have enacted franchise relationship laws that govern various aspects of the parties' relationship, including termination and renewal. Generally, these laws require written notice to the franchisee and good cause before a franchisor can terminate or fail to renew a franchise. The statutes vary in their definitions of good cause, but a franchisee's failure to comply with the material provisions of the franchise agreement, becoming insolvent, or voluntarily abandoning the franchise are generally considered good cause for termination. State relationship laws and their applicability to franchise terminations will be discussed in more detail in Section V below.

State franchise statutes also often contain a prohibition on misrepresentations, omissions, or misleading actions taken during the franchise sales process. Claims under these statutes will be discussed in more detail in Section V below. Some state franchise statutes also contain provisions limiting the use of releases or waivers of forum selection clauses and choice of law provisions, or requiring the buyback of inventory upon termination or nonrenewal.

Because state laws vary, in some cases widely, the choice of which states' law applies is an important strategic decision. Choice of law issues are discussed in more detail in Section II below.

B. Effect of Litigation on the Franchise System

The parties should consider the effect of their lawsuit on other franchisees or the franchise system as a whole. A case against one franchisee might set a precedent (good or bad) for similar cases brought by other franchisees. In particular, the determination by a court that a standard franchise agreement provision is unenforceable will likely be noticed by other franchisees in the system. For example, if a noncompete is found to be unenforceable, that could lead other franchisees to break away from the system and open competing businesses. Or, if a court determines that certain design elements of a product or store are not protectable trade dress, other franchisees may feel emboldened to use those design elements.

The entire franchise system benefits from consistent enforcement of standards, protection of intellectual property, and prevention of unfair competition. It is easy for former franchisees to lose sight of the fact they agreed to limit their rights to protect the system they joined. When franchisors are enforcing their rights, it is sometimes helpful to explain how they are not only acting in the interest of themselves but also their franchisees, who expect them to protect the system.

The effect of litigation on the franchise system may also inform settlement decisions. If a franchisor is worried about receiving an unfavorable decision about a franchise agreement provision, it may decide that the best course of action is to settle litigation and avoid the unfavorable decision. On the other hand, a franchisor may be unwilling or unable to compromise in a particular case if it is worried about setting a precedent. It may not want to signal to its other franchisees that it is willing to pay out money, for example, for certain types of claims.

C. Required Disclosure of Litigation, Arbitration, and Settlements

A related consideration is whether the dispute must be disclosed in Item 3 of the franchisor's FDD. Item 3 requires a franchisor to disclose pending and recent material civil litigation—formal lawsuits and arbitrations—and settlement agreements resulting from prior actions, including some confidential settlements.[2] It also requires disclosure of litigation involving certain types of claims that result in adverse findings, for the past 10 years. The disclosure requirement may also inform settlement decisions, as franchisors may be hesitant to disclose settlement terms that they view as unfavorable or may seek to avoid settlement on terms that would require disclosure for the 10-year period. Settling disputes short of litigation offers the incentive of avoiding their disclosure in the FDD.

D. The Relative Means of the Parties

The parties' relative means may play a role in the course of the litigation. Some franchisees who are individuals may find it difficult to fund lawsuits against a corporate franchisor. On the other hand, franchisees may join together in class or mass actions, or in associations, to sue a franchisor.

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[2] Specifically, 16 C.F.R. § 436.5(c) states that a franchisor must disclose if it:

(i) Has pending against [it]:

(A) An administrative, criminal, or material civil action alleging a violation of a franchise, antitrust, or securities law, or alleging fraud, unfair or deceptive practices, or comparable allegations.

(B) Civil actions, other than ordinary routine litigation incidental to the business, which are material in the context of the number of franchisees and the size, nature, or financial condition of the franchise system or its business operations.

(ii) Was a party to any material civil action involving the franchise relationship in the last fiscal year. For purposes of this section, "franchise relationship" means contractual obligations between the franchisor and franchisee directly relating to the operation of the franchised business (such as royalty payment and training obligations). It does not include actions involving suppliers or other third parties, or indemnification for tort liability.

(iii) Has in the 10-year period immediately before the disclosure document's issuance date:

(A) Been convicted of or pleaded nolo contendere to a felony charge.

(B) Been held liable in a civil action involving an alleged violation of a franchise, antitrust, or securities law, or involving allegations of fraud, unfair or deceptive practices, or comparable allegations. "Held liable" means that, as a result of claims or counterclaims, the person must pay money or other consideration, must reduce an indebtedness by the amount of an award, cannot enforce its rights, or must take action adverse to its interests.

Moreover, some state franchise laws contain provisions that shift attorneys' fees to the prevailing party. Fee shifting provisions are also common terms in franchise agreements. The prospect of a large award of attorneys' fees may impact the decision to pursue litigation in the first place, or to settle it along the way.

The relative size of the franchisee to the franchise system will also play a role. Franchisees who own a number of units in a small franchise system might have particular leverage in a franchise dispute. Conversely, a franchisee who owns a single store in a system with thousands of franchised locations will probably have less sway over the franchisor. A smaller franchisee may also be less sophisticated or experienced in litigation, whereas a larger franchisee may have significant litigation experience and greater resources to hire experienced franchise litigation counsel.

E. The Ongoing Relationship Between the Parties

Finally, the long-term nature of most franchise agreements complicates franchise disputes. Sometimes a dispute arises between two parties that have contractually agreed to do business with each other for 10 or 20 years. If a dispute becomes particularly acrimonious, it can be difficult for parties to agree to continue doing business together for another decade or two, even if that might make the most sense from a financial perspective. An action to enjoin the termination of a franchise might force the parties to reluctantly continue their relationship.

The length of most franchise agreement terms can also affect the calculation of damages that arise from a franchise dispute, as both parties likely expect the franchisee to run their franchised business for the entire length of the franchise term.

Even after franchise agreements terminate, franchisees often remain bound by post-termination obligations that require indemnification, return of confidential information and other property interests, deidentification, nondisclosure, and noncompetition. These are important settlement considerations, as discussed below in Section VII.

II. Jurisdiction, Venue & Forum Selection

A. Jurisdiction

One of the first decisions a plaintiff must make is the court in which it will initiate the lawsuit. There are several strategic considerations: is a certain state's law more favorable? Is it a convenient forum given the location of the parties, their lawyers, and the witnesses? But ultimately the plaintiff must choose a court that has both subject matter jurisdiction over the dispute and personal jurisdiction over the parties.

i. Subject Matter Jurisdiction

A lawsuit may be initiated in either state or federal court. But many franchise disputes meet the requirements for federal subject matter jurisdiction, in that either the case involves a question of federal law and thus satisfies federal question jurisdiction,[3] or the requirements for diversity jurisdiction are met, *i.e.*, the parties are citizens of different states and the amount in controversy exceeds $75,000.[4]

As a practical matter, many disputes between a franchisor and franchisee involve citizens of different states. The citizenship of individuals is fairly straightforward—they are generally citizens of the state in which they reside. A corporation is a citizen of the states in which it is incorporated and in which its principal place of business is located. The citizenship of pass-through entities (LLCs, LPs, etc.) is more complicated. Those entities are citizens of every state of which their members are citizens. Because many businesses run through a series of LLCs in which the members of an LLC are themselves LLCs, citizenship can at times be difficult to determine, particularly at the outset of a case.

The $75,000 amount in controversy threshold is generally clear-cut in cases that seek damages. It can be difficult to determine whether the threshold is met if the dispute involves only equitable relief. In these cases, courts will look to the value of the right being protected.

Disputes between franchisees and franchisors also often have federal question jurisdiction. For example, disputes that involve claims under the Lanham Act, for trademark infringement, dilution, or unfair competition involve questions of federal law. Claims under the federal Defend Trade Secrets Act also satisfy federal question jurisdiction.[5]

If federal jurisdiction exists then a defendant can remove the lawsuit to federal court if the plaintiff brings it in state court, so long as no defendants are citizens of that state. Many parties favor federal courts, as there is a perception that the federal judiciary has more resources to devote to pretrial procedures, and thus the likelihood of obtaining injunctive relief or a judgment on a dispositive motion is higher. On the other hand, the local party may prefer a state court where a hometown advantage may be greater than in federal court. For this reason, state courts may also seem friendlier to the plaintiff or franchisee.

ii. Personal Jurisdiction

Personal jurisdiction is another requirement that must be satisfied before a court can hear a matter.[6] In general, a plaintiff must demonstrate that the defendant has

[3] 28 U.S.C. § 1331.
[4] 28 U.S.C. § 1332.
[5] *See* Section V, *infra.*
[6] There are two types of personal jurisdiction—general and specific. General personal jurisdiction exists in the state where a party is "fairly regarded as at home," and gives a court jurisdiction over the defendant regardless of where the actions at issue in the case occurred. *See Goodyear Dunlop Tires Operations, SA v. Brown*, 564 U.S. 915, 924 (2011). Specific jurisdiction, the more commonly-applied type, is discussed more fully in this Section.

sufficient minimum contacts with a forum such that requiring the defendant to litigate in the forum does not offend traditional notions of fair play and substantial justice.[7]

In franchise disputes, it is not uncommon for franchisors and franchisees to reside in different locations, which increases the likelihood of personal jurisdiction issues. However, in the seminal case *Burger King v. Rudzewicz*,[8] the U.S. Supreme Court found that a franchisee had sufficient minimum contacts with the franchisor's home state to warrant the exercise of personal jurisdiction over the franchisee in that state. Specifically, the franchisee's communications and payments to the franchisor in Florida were sufficient to constitute a "substantial and continuing" relationship with Florida such 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. In addition, the court relied on the fact that the contractual language specified that the franchisor was located in Florida, that the franchisee would continually conduct business with the Florida-based franchisor, and that Florida law would govern the contract, noting that the franchisee "entered into a carefully structured 20-year relationship that envisioned continuing and wide-reaching contacts with [the franchisor] in Florida."[9]

A more recent case, *Baskin-Robbins Franchising LLC v. Alpenrose Dairy, Inc.*,[10] also found personal jurisdiction in a franchisor's home state of Massachusetts under more attenuated circumstances. The franchise agreement in *Alpenrose* originally contemplated that the franchisee would conduct business with the franchisor in California because that was where the franchisor was originally located. More than 30 years into the parties' relationship, the franchisor moved its headquarters to Massachusetts. The parties continued their relationship, with the franchisee twice sending notices of intent to renew the agreement to the franchisor's headquarters in Massachusetts, and continuing its interactive business relationship with the franchisor in Massachusetts. The first circuit found that the two notices of intent to renew, by themselves, were not enough to satisfy the minimum contacts requirement, but that the franchisee's repeated contacts with the franchisor in Massachusetts, as required for the continuation of the franchisor-franchisee relationship, did show that the franchisee purposefully availed itself of the privilege of doing business in Massachusetts such that it could be haled into court there.

When issues with personal jurisdiction arise at the outset of a case, they are often fact intensive and time consuming, and distract from the merits, which can be good or bad depending on your perspective. Parties can avoid these issues by consenting to a particular jurisdiction in their venue and forum selection clauses, which are typically enforced.

[7] This standard is required under the Due Process Clause of the Fourteenth Amendment. The power of a court to hear cases against a defendant from another state is determined by the state long-arm statute. The Due Process Clause sets the constitutional outer limits of a state's ability to exercise personal jurisdiction, and most state long-arm statutes provide courts with personal jurisdiction over out of state defendants to the same extent as the Due Process Clause.
[8] 471 U.S. 462 (1985).
[9] *Id.* at 480.
[10] 825 F.3d 28 (1st Cir. 2016).

B. Venue and Forum Selection

The plaintiff must also consider the language of the contract when deciding where to initiate its lawsuit. It is very common for franchise agreements to include a forum selection clause. Forum selection clauses may be mandatory—meaning that they require a case to be brought exclusively in a particular forum—or permissive—meaning that the parties agree that a case may be brought in a particular forum.

i. Motions to Transfer Venue

In most instances, those clauses will be enforced. A defendant may move to transfer a case from one federal district court to another on the basis that the receiving court is a more appropriate forum. In general, under 28 U.S.C. § 1391, an action may be brought in a district where any defendant resides, a district where the events that gave rise to the claim occurred, or a district where the property that is the subject of the claim is located. If none of these apply, then venue is proper in any district that has personal jurisdiction over a defendant. Venue is often proper in more than one federal district court, and in those cases, a court may transfer the case to another district court "for the convenience of parties and witnesses, in the interest of justice."[11]

In *Atlantic Marine Construction Co. v. United States District Court for the Western District of Texas*,[12] the U.S. Supreme Court held that a valid forum selection clause provides conclusive evidence that the parties' interests favor transfer in accordance with the clause. Thus, when parties have agreed to a forum selection clause, a motion to transfer under 28 U.S.C. § 1404(a) should be denied "only under extraordinary circumstances unrelated to the convenience of the parties."

However, some state franchise statutes prohibit provisions that require a franchisee to waive the application of state laws or their ability to bring a lawsuit in a certain forum. In total, twenty-six states and Puerto Rico have statutes that govern the use of forum and venue provisions in their franchise or business opportunity laws.[13] For example, some state statutes state make void forum selection clauses that require claims arising under the franchise agreement to be brought outside of the state.[14]

In addition, even if a party brings a claim in its chosen out of state forum, state franchise statutes often contain provisions preventing parties from waiving application of the statutes.

III. Alternate Dispute Resolution

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[11] 28 U.S.C. § 1404(a).

[12] 571 U.S. 49 (2013).

[13] *See* Earsa Jackson and Jim Meaney, *Forum Selection Clauses After Atlantic Marine*, ABA 37TH ANNUAL FORUM ON FRANCHISING (Oct. 2014), available at https://www.americanbar.org/content/dam/aba/administrative/franchising/materials2014/w4.authcheckdam.pdf.

[14] *See* Cal. Bus. & Prof. Code § 20040.5; 815 Ill. Comp. Stat. Ann. 705/4; Iowa Code Ann. § 523H.3; Mich. Comp. Laws Ann. § 445.1527; N.C. Gen. Stat. Ann. § 22B-3; 19 R.I. Gen. Laws Ann. § 19-28.1-14.

A. Mediation

Mediation is a common tool for dispute resolution that may be used at any point during the dispute. It is typically one of the least expensive and fastest ways to resolve a dispute if it is successful, but there is no guaranty of success. Even if a mediation is unsuccessful, it can provide the parties with an objective evaluation of their claims and defenses and possibly move them closer towards a future settlement, On the other hand, mediation still involves time and expense with the possibility of forgoing an opportunity to take an aggressive litigation posture. Mediation is generally a confidential process that is focused on finding a mutually acceptable negotiated resolution to a dispute rather than adjudicating the merits of the dispute.

Because of the possibility of a quick resolution, the parties may decide to mediate a dispute at its onset in order to save litigation expenses. On the other hand, if there are facts in dispute it may be beneficial for the parties to engage in some discovery before mediating. This allows both parties to realistically assess the risks of a lawsuit when attempting to settle the dispute.

When deciding to mediate a dispute, the parties may decide to enter into a standstill agreement that effectively pauses time while the parties mediate. If mediation is occurring at the outset of a dispute before an action is filed, the parties may agree to toll the applicable limitations period, be it contractual or statutory. If the mediation is taking place after the action has been initiated, the parties may agree to pause court or arbitration deadlines so that they do not have to incur the expense of proceeding with litigation while they are trying to resolve the dispute. As part of the mediation process, before the parties meet, the parties will often send the mediator confidential written statements outlining their respective likelihoods of success in the case and their settlement posture.

During a mediation, a third party neutral—a mediator—will typically engage in shuttle diplomacy, travelling back and forth between the parties to discuss their positions. There are two different approaches to mediation—facilitative and evaluative. In a facilitative mediation, the mediator will ordinarily present one party with the other party's offers and counter-offers, discuss the potential expense and risk of proceeding with arbitration or litigation, and may endeavor to explain the other side's view of the issues in dispute or any business realities that need to be addressed in the resolution. But the mediator will generally avoid providing their own analysis of the factual or legal merits of the dispute. On the other hand, in an evaluative mediation, the mediator will provide each party with an assessment of the strengths and weaknesses of its position. The mediator may also provide an analysis of the damages likely to be recovered by the parties. This tactic can be particularly useful if one or both parties have an unrealistic view of the case. Even the end of an unsuccessful mediation session does not necessarily mean the end of the process. A mediator can stay involved, exchanging offers and proposals, so long as the parties chose to continue the engagement.

Mediation is generally voluntary, although some franchise agreements require the parties to mediate before they may litigate their claims. Although case law is scant, such provisions are generally enforceable.[15] More and more courts are also requiring parties to engage in mediation or early dispute resolution at the outset of a case.

B. Arbitration

Arbitration is a binding procedure in which the parties submit their dispute to an arbitrator or a panel of arbitrators who fully and finally adjudicate factual and legal issues, and issue an award that the winner may enter and enforce as a judgment in court. Whether a dispute is adjudicated in court or in arbitration is entirely a matter of contract.

i. Arbitration Procedure

Arbitration may involve an abbreviated process compared to litigating in court, especially in discovery, and that may save on attorneys' fees. But arbitrations increasingly are costing nearly as much as or more than litigating in court, because the discovery process in arbitration is sometimes nearly as fulsome as discovery in court. The fee structure of arbitration renders it more expensive than the fees associated with court filings, because parties must pay higher fees to the arbitral forum and must also pay an hourly fee for the arbitrators' time. Because the parties typically select the arbitrators, parties to a franchise dispute may be more likely to have factfinders with significant experience in franchise law. Arbitrations may provide a faster path to a final judgment, but if a party is seeking interim relief like a preliminary injunction, arbitration is likely slower than a court. Courts can generally only review and vacate arbitration decisions on limited grounds specified by statute such as fraud, corruption, misconduct, or arbitrators exceeding their powers,[16] so appeals are rarely successful. Perhaps in part because there is no jury, arbitrators generally seem unlikely to grant dispositive motions, preferring instead for the parties to have the opportunity to present their evidence and arguments at the hearing.

The stages of arbitration are in many respects similar to those in a court action—the arbitration is commenced by filing an arbitration demand and paying a filing fee. The demand must then be served on the other party, although the rules for service are generally much more relaxed than those that apply in court proceedings. Once the demand is served, the defending party may respond to the demand and assert counterclaims. The parties will also need to select a mutually acceptable arbitrator, or a panel of arbitrators, who will act as neutrals. The parties will typically then meet with the arbitrator to discuss case logistics and set a schedule and procedure for discovery, any motion practice, and the arbitration hearing. At the arbitration hearing, the parties may present fact witnesses, documentary evidence, and expert witnesses using a process similar to that used in a trial, although the rules of evidence are typically relaxed or not

[15] *See, e.g., Bank of Am., N.A. v. SFR Investments Pool 1, LLC*, No. 2:15-CV-0693-GMN-VCF, 2016 WL 389981, at *2 (D. Nev. Jan. 31, 2016); *Getchell v. Suntrust Bank*, No. 6:15-CV-1702-ORL-TBS, 2016 WL 740603, at *3 (M.D. Fla. Feb. 25, 2016).
[16] 9 U.S.C. § 10.

strictly applied. The arbitrator may issue subpoenas to compel witnesses, including third parties, to testify at the hearing.[17] Following the hearing, the arbitrator will issue a decision and award.

In order to enforce an arbitration award, a party must first have it confirmed by a state or federal court. The process for confirming an award is fairly straightforward. If the franchise agreement provides for a confirmation process, the parties must follow that process. Otherwise, they will generally follow the process in the Federal Arbitration Act.[18] Section 9 of the FAA provides that the party seeking confirmation file a motion in court to confirm the arbitration award, within one year of the issuance of the award.[19] A party has three months from the issuance of the award in which to move to modify or vacate it,[20] so the winning party will typically wait until those three months have passed before moving to confirm the award. Once a court has confirmed the arbitration award, it has the same force and effect as a court judgment, and can be enforced in the same manner.[21]

Arbitration provisions are common in franchise agreements, although many agreements also contain carve outs that exempt certain types of claims from arbitration. Common examples are situations where a party is seeking an injunction, especially to protect intellectual property, or cases involving simple claims of unpaid fees.

Although many arbitral forums have their own rules and procedures, the process of arbitration is also governed by the contract between the parties. Therefore, the parties may determine in their contract the location for the arbitration, which forum to use, which rules apply, how many arbitrators to have, how much discovery to allow, and almost any other feature of the arbitration. Contracts typically provide that the parties will share the cost of arbitration, including filing fees and arbitrators' fees, equally.

ii. Enforcement of Arbitration Provisions

Under Section 2 of the FAA, arbitration provisions are broadly enforced.[22] Upon a party's motion, a court may dismiss or stay a lawsuit that should have been brought in arbitration, and compel the parties to arbitrate. In doing so, the court is essentially enforcing the parties' agreement to arbitrate, finding that court is the improper venue or that the court lacks jurisdiction, and transferring the case to an arbitrator. A party seeking to enforce an arbitration agreement should bring a motion to compel arbitration immediately at the outset of a lawsuit because it can waive its right by proceeding in court.[23]

A court may invalidate an agreement to arbitrate if it finds that the agreement is procedurally or substantively unconscionable, which are often difficult standards to

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[17] *Id.* § 7.
[18] *Id.* §§ 1, *et seq.*
[19] *Id.* § 9.
[20] *Id.* § 12.
[21] *Id.* § 13.
[22] *Id.* § 2.
[23] *See e.g., St. Agnes Medical Center v. PacifiCare of California*, 31 Cal.4th 1187 (Cal. 2003).

satisfy. Procedural unconscionability refers to problems with the formation of the arbitration agreement. For example, if a court finds that a party's waiver of its right to litigate in court was not "knowingly and voluntarily" made, it may not enforce the arbitration agreement. Similarly, if a party can demonstrate that the agreement to arbitrate was made under fraud or duress, a court may not enforce it.

A court may also decline to enforce an arbitration agreement that it finds to be substantively unconscionable. Substantive unconscionability refers to the content of the arbitration agreement. For example, if a party has waived its right to pursue certain statutory remedies, a court may find the arbitration provision substantively unconscionable and unenforceable.

Another issue that may arise is whether a court will enforce an arbitration provision against a nonsignatory to the agreement. This issue may arise when a third party (e.g., managers or business partners) is not a signatory to the franchise agreement, but is so highly involved in the franchise relationship that the other party (typically the franchisor) feels that aspects of the agreement should be enforced against that third party. For example, a franchisor may wish to enforce a post-termination noncompete against a spouse and franchisee employee who was not a signatory to the franchise agreement. In such instances, courts will often compel nonsignatories to arbitrate claims along with the signatories to the agreement.[24] The theories under which courts do this include: (1) incorporation by reference; (2) assumption; (3) agency; (4) piercing the corporate veil; and 5) estoppel.[25]

IV. Motion Practice

A few different types of motions commonly arise in franchise cases. Motions to transfer venue and motions to compel arbitration, which were both discussed above, are common motions. Another common motion at the outset of a case is a motion for preliminary injunctive relief. Finally, many franchise cases will involve a dispositive motion such as a motion to dismiss at the outset of a case, or a motion for summary judgment after the conclusion of discovery. Those motions depend on pleading and substantiating the substantive claims discussed in Section V below.

Motions for preliminary injunctions arise frequently in franchise litigation. A franchisor may seek a preliminary injunction if it terminates a franchise agreement but the franchisee continues to operate under the franchisor's trademark or operates a competing business in violation of a post-termination noncompete provision. Or one party may seek an injunction to prevent the other party from terminating the franchise agreement. The grant of an injunction may sometimes effectively end the litigation if the plaintiff seeks no monetary remedies in the lawsuit. On the other hand, losing a motion for a preliminary injunction at the outset of a case can result in findings that take the wind out of its sails.

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[24] *See e.g., Doctor's Assocs., LLC v. Tripathi*, 794 F. App'x 91, 94 (2d Cir. 2019).
[25] *See e.g., Bentley v. Control Grp. Media Co., Inc.*, No. 19-CV-2437-DMS-RBB, 2020 WL 3639660, at *2 (S.D. Cal. July 6, 2020).

In considering a motion for preliminary injunctive relief a court will weigh four factors: (1) the moving party's likelihood of success on the merits of its claims; (2) whether the moving party is likely to suffer irreparable harm in the absence of preliminary injunctive relief; (3) the balance of equities; and (4) whether an injunction is in the public interest.[26] No factor is dispositive and a court will balance all of the factors. But courts typically spend the most time examining the likelihood of success and irreparable harm prongs.

There are some well-established circumstances under which motions for preliminary injunctions will generally be granted. For example, if a franchise agreement is validly terminated due to a franchisee's breach but the franchisee continues to operate the franchise as a holdover franchisee, a court will grant an injunction requiring the franchisee to stop operating the business and deidentify it from the franchisor's proprietary marks. This is true even if the franchisee alleges that the franchisor also breached the franchise agreement.[27] Similarly, if a franchisee's operation violates serious health and safety requirements, franchisors will generally be successful in obtaining preliminary injunctions to require the franchisee to stop operating while they address the health and safety concerns.

Parties may also seek preliminary injunctions to enforce or prevent the enforcement of noncompetes and enjoin the disclosure of trade secrets and confidential information. As discussed more fully below in Section V, those claims very much depend on the facts of the case, as well as the applicable state law.

V. Common Claims, Defenses, and Remedies

There are many types of claims that franchisees and franchisors may raise when issues arise concerning the franchise relationship. This section provides an overview of some of these claims—focusing on those that are most often the subject of litigation—along with the defenses commonly used to address them.

A. Frequent Franchisee Claims and Franchisor Defenses

i. The "Accidental" Franchise

Parties can create a business relationship through a variety of arrangements, including license agreements, distributorships, joint ventures, capital investments and consulting agreements. If the business relationship has all the definitional elements of a "franchise"—irrespective of whether the business self-identifies as a franchise or whether the parties considered it to be a franchise when they entered into the relationship—it will be treated as a franchise under the law, subject to applicable regulations, and the franchisor may be held liable for violations of applicable franchise laws.

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[26] *Winter v. Nat. Res. Def. Council, Inc.*, 555 U.S. 7, 20 (2008).
[27] *S & R Corp. v. Jiffy Lube Int'l, Inc.*, 968 F.2d 371, 375 (3d Cir. 1992) ("[A] franchisor's right to terminate a franchisee exists independently of any claims the franchisee might have against the franchisor.").

While franchises are regulated and defined by both federal and state law, there is no uniform definition of a “franchise.” Definitions are found in the FTC’s Franchise Rule providing “Disclosure Requirements and Prohibitions Concerning Franchising,” state franchise disclosure and registration statutes, and many state relationship statutes.[28] Notwithstanding the lack of a uniform definition, essentially all franchise laws define “franchise” using the same three main elements.

First, one must grant authority to use its trademark, service mark, or name in offering, selling, or distributing goods or services. This would necessarily include any trademark license agreement.

Second, the trademark licensor must have significant control of, or provide significant assistance to, a licensee. Significant control exists where a licensor approves or restricts the business location or sales territory, specifies design or appearance requirements, prescribes operating hours, establishes production methods or standards, or restricts the products a franchisee may sell. Certain states refer to this element as a marketing plan, where the trademark owner governs how the trademark is to be used. Training programs, recipes, employment and operating manuals, and sales assistance all satisfy the significant assistance aspect of this element. Some other state franchise statutes instead analyze whether there is a "community of interest" between the franchisor and franchisee.[29]

Third, the licensee must directly or indirectly pay a franchise fee for the right to operate the business. A franchise fee can include payments such as license fees, ongoing royalty payments, consulting fees, training fees, or site assistance fees.[30]

If all three elements are present, then the relationship is a franchise.[31] In such a case, the label the parties attach to their business relationship has little bearing on determining if the relationship constitutes a franchise. Whether the parties even intended to create a franchise relationship is irrelevant; they may have created a “hidden” or an “accidental” franchise. The protections afforded by franchise laws generally cannot be waived, and the benefits of any applicable statutes will control,[32] despite any contractual language to the contrary. As such, and as noted above, a franchisor must provide a prospective franchisee with an FDD and, in states that require registration, the franchisor must also register the FDD before the business may be offered for sale.[33]

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[28] *See, i.e.,* 16 C.F.R. § 436.1.
[29] Hawaii, Minnesota, Wisconsin and New Jersey are examples of states that take the community of interest approach.
[30] Notwithstanding, each of the franchise laws exempts payments for goods purchased for resale in reasonable quantities and at bona fide wholesale prices.
[31] Some states have adopted different definitions of a “franchise.” For example, New York requires that only two elements be satisfied: the required payment element and either the trademark element or the marketing plan element.
[32] As discussed above and below, while such protections vary by state, some state statutes require good cause for termination, prohibit misrepresentations, omissions, misleading sales, and may award attorneys’ fees.
[33] *See* Section I, *supra.*

Accordingly, for a trademark licensor who does not want to be caught up in a "franchise" relationship, it is important to set quality controls that are sufficient to retain the rights to enforce the trademark (and to avoid the other extreme of insufficient quality controls resulting in a "naked" license and loss of rights to enforce the trademark) while not imposing other requirements on the licensee that satisfy the definition of a franchise under applicable state law.

ii. Disclosure and/or Registration Violations

In order to offer and sell franchises in the United States, franchisors must comply with the FTC's pre-sale disclosure requirements, contained in the FTC's Franchise Rule, as well as applicable state franchise statutes. Although the FTC's Franchise Rule creates no private cause of action, a franchisor's failure to comply with these regulations can give rise to claims by its franchisee under various state statutes, as discussed below.

The FTC's Franchise Rule requires franchisors to prepare and provide to a prospective franchisee a document containing specific information about the franchisor and the franchise opportunity in the form of an FDD. The FTC's Franchise Rule describes the form and content of the FDD and requires the franchisor to disclose 23 "items" of financial and business information.[34] These disclosures include information such as the franchisor's background, current and recent litigation involving the franchisor, bankruptcy filings of the franchisor or its officers, the costs involved in starting or operating a franchise, trademarks that the franchisor will license to the franchisee, and financial statements about the franchisor. Franchisors are not required to disclose potential earnings, but they can if they follow certain guidelines. The FDD also includes copies of the form agreements the franchisor will require the prospective franchisee to sign in connection with the franchise opportunity, including the franchise agreement, any applicable leases, technology licenses, and purchase agreements.[35] A franchisor must provide a prospective franchisee with the FDD at least fourteen days before it signs any contract or pays any money to the franchisor.[36] The FTC's Franchise Rule applies in all states and creates a minimum standard of disclosure that franchisors nationwide must comply with. States are allowed to provide greater protections and require further disclosures. The FTC's Franchise Rule only pre-empts state franchise statutes to the extent the statute does not provide a franchisee with equal or greater protections as the FTC.[37]

The FTC's Franchise Rule has no requirement that the franchisor register the FDD with any government agency and the FTC has no mechanism for filing or registering FDDs. Nevertheless, in order to offer and sell franchises in certain states, a franchisor must comply with state franchise statutes, which may require registration with a state agency. These statutes range from requiring the filing of an annual notice, to

[34] *See* 16 C.F.R. § 436.5.
[35] *Id.* § 436.5(v).
[36] *Id.* § 436.2(a).
[37] *Id.* § 436.10(b).

comprehensive review of franchise registration applications, and renewal registration applications on an annual basis. For example, fourteen states have statutes requiring a franchisor to register its FDD with the appropriate state regulatory authority, or obtain an exemption from registration, prior to the offer or sale of franchises in the state.[38]

There is no federal private right of action created by a franchisor's failure to comply with the FTC's Franchise Rule. However, a franchisor's failure to abide by state franchise statutes in disclosure and registration states does provide the franchisee with a private right of action under state law against the franchisor to recover damages caused by the statutory disclosure and/or registration violations, and often against the franchisor's "control persons," e.g., officers, directors, and managers, who assisted in the violations as well.[39] Many of these state franchise statutes also contain anti-fraud provisions that prohibit the sale or offer of a franchise if the FDD contains untrue statements or omits statements necessary to prevent any statements made from being misleading. Remedies may include actual damages (e.g. recovery of the franchisee's investment and operational losses) or rescission and restitution, which involves the cancellation of the franchise agreement and restoration of the franchisee to its economic position prior to the execution of the franchise agreement.[40] Some state statutes also provide for punitive damages and attorneys' fees.[41]

A franchisor faced with a claim that it committed a disclosure or registration violation should look closely at the applicable state statute under which the violation is claimed to ensure that the requirements for disclosure and/or registration were indeed triggered. It should also look at the disclosures it made or allegedly omitted, including analyzing whether they were mandatory disclosures and whether they were material to the franchisee's investment decision. Some state statutes provide limited periods of time for a franchisee to rescind a franchise agreement as a result of a registration or disclosure violation, and thus a franchisee's continued operation of the business notwithstanding the fact it knew or should have known of the violation may prevent rescission.[42] Finally, a franchisor should determine whether any technical violation of a registration statute actually caused the franchisee to suffer any damages, and research whether any authority precludes the franchisee's claims in the absence of such causation or damages.[43]

iii. Misrepresentation and Unauthorized FPRs

[38] The states that require registration are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Michigan, often times referred to as a registration state, does not require the registration of a disclosure document; instead, franchisors are only required to submit a prescribed notice. Indiana, South Dakota, and Wisconsin simply require the filing of a disclosure document for registration, while the remainder of the states review and approve the disclosure document before registration, including requesting or requiring changes before approval.

[39] *See, e.g.*, Minn. Stat. § 80C.17(2); N.Y. Gen. Bus. Law § 691.

[40] *See, e.g.*, *id.*

[41] *See, e.g.*, Haw. Rev. Stat. Ann. § 482E-9.

[42] *See, e.g.*, Va. Code Ann. § 13.1-565.

[43] *See Morris v. Int'l Yogurt Co.*, 729 P.2d 33, 35 (Wash. 1986) ("Thus, the franchisee must show that the violation actually caused him to suffer damages, not merely that a violation occurred.").

Before investing in a franchise, most prospective franchisees will ask the franchisor or its representatives how much money they can make if they buy a franchise. Important to the response a franchisor can give, there are regulations governing the circumstances by which a franchisor may give financial performance information to a prospective franchisee prior to its purchase of a franchise. A franchisor's failure to comply with these regulations can give rise to a franchisee's claims under state statutes that prohibit making false or misleading representations, as well as for omitting material information.

Financial performance representations ("FPRs") include representations from which a prospective franchisee can infer a specific level or range of income, sales, or profits, including "break-even" points, and are broadly defined by the FTC to include:

> [A]ny representation, including any oral, written, or visual representation, to a prospective franchisee, including a representation in the general media, which states, expressly or by implication, a specific level or range of actual or potential sales, income, gross profits, or net profits. The term includes a chart, table, or mathematical calculation that shows possible results based on a combination of variables.[44]

The FTC's Franchise Rule makes disclosure about financial performance optional. If a franchisor wants to make FPRs in connection with the sale of its franchises—including discussing historical performance and future performance projections with prospective franchisees—the franchisor must include them in Item 19 of its FDD. Item 19 disclosures must comply with certain requirements, including reasonableness and written substantiation requirements. Franchisors may disclose FPRs in many permissible formats that present various types of information.

If a franchisor does not include FPRs in Item 19 of its FDD, then the FTC's Franchise Rule prohibits the franchisor from discussing financial performance information with prospective franchisees and from providing *any* written materials to them that concern financial performance (even as informally as on a piece of scrap paper or cocktail napkin). The franchisor's sales representatives, along with other employees of the franchisor responsible for selling franchises, are likewise prohibited from having such discussions with prospective franchisees or providing any written materials concerning financial performance to them. Assisting a prospective franchisee in preparing a pro forma, commenting on the pro forma, or reviewing a business plan may qualify as an FPR.[45] However, prospective franchisees can ask existing and former franchisees in the system (who are listed in Item 20 of the FDD) for information regarding their own historical performance, even if such disclosures are not contained in Item 19. Franchisors can also provide information not included in an FDD in connection with the actual operating results for a specific outlet being offered for sale, provided the information is given only to potential purchasers of that outlet.[46] And, mere "puffery," i.e. a general statement that the

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[44] 16 C.F.R. § 436.1(e).
[45] *See, e.g., Coraud LLC v. Kidville Franchise Co., LLC*, 109 F. Supp. 3d 615, 619 (S.D.N.Y. 2015).
[46] 16 C.F.R. § 436.5(s)(4).

prospective franchisee will have a "great" return on its investment, typically does not constitute a FPR.

A franchisor making FPRs that are not contained in an Item 19 disclosure is violating the FTC's Franchise Rule irrespective of whether the disclosures are fraudulent, negligent, or innocent. But while the FTC has enforcement powers to subject the noncomplying franchisor and its officers and directors to injunctions, cease and desist orders, rescission, civil fines, and criminal penalties, the FTC's Franchise Rule does not provide a franchisee with a remedy or private cause of action for violations.

Some states have their own statutory franchise disclosure rules that provide a right to bring private lawsuits for violation of their requirements.[47] In other states, unfair trade practices statutes or "Little FTC Acts"[48] can often provide a franchisee with a means to bring suit to address false FPRs.[49] In addition, common law fraud and negligent misrepresentation claims are also available to redress material misrepresentations and omissions.[50] Under the foregoing statutory and common law protections, a franchisee may allege a claim based on the fact that either the franchisor or its representatives made oral misrepresentations regarding earnings, or that the franchisor provided written materials regarding earnings that were misleadingly omitted from an FDD.

A franchisor may seek to defend against FPR claims on the basis that its representations do not meet the definition of an FPR. A franchisor may also seek to defend itself against FPR claims by relying on provisions contained in the franchise agreement, including integration, "no representation," and "no reliance" clauses, to rebut a franchisee's alleged reliance on a representation or to assert that the reliance was unreasonable.[51] The weight afforded to these defenses varies depending on the jurisdiction and type of claim, as well as the specificity of the disclaimer or acknowledgement by the franchisee. For example, certain state disclosure statutes have anti-waiver provisions that prohibit franchisors from relying upon the protections of contractual provisions to waive a franchisee's statutory rights.[52] And certain of these

[47] *See* Section V.A.ii, *supra.*

[48] *See* Section V.A.v, *supra.*

[49] Unlike common law claims, claims under these acts do not generally contain a scienter requirement and liability may be found irrespective of an intent to deceive or proof of reliance.

[50] To be actionable, a particular fact must be one of sufficient significance to influence a reasonable prospective franchisee's decision to invest or not invest in a franchise.

[51] *See, e.g., Moxie Venture L.L.C. v. UPS Store, Inc.*, 156 F. Supp. 3d 967, 970 (D. Minn. 2016) ("the Franchise Agreement firmly establishes that even if TUPSS made misrepresentations in connection with the sale of Moxie's franchise, Moxie did not rely upon any of them and, if it did (contrary to the express terms of the Franchise Agreement), such reliance was unreasonable as a matter of law.").

[52] *See, e.g., Emfore Corp. v. Blimpie Assocs., Ltd.*, 51 A.D.3d 434, 435, 860 N.Y.S.2d 12, 14 (N.Y. 2008) (where the court held that a "franchise disclosure questionnaire" completed at the time of the franchise sale, in which the franchisee did not identify any earnings information that the franchisor provided outside of the FDD, could not be used to bar the franchisee from pursuing claims under the anti-fraud provisions of the New York Franchise Sales Act); *Cousin Subs Sys. Inc. v. Better Subs Dev. Inc.*, No. 09-C-0336, 2011 WL 4585541, at *8 (E.D. Wis. Sept. 30, 2011) (where the court held that a "no reliance" clause in the franchise agreement could not be used 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

defenses may be effective against common law claims (i.e. breach of contract or common law fraud), but may not be as helpful in defending against statutory claims.

iv. Violation of State Relationship Statutes

While the FTC regulates the offer and sale of a franchise, it does not regulate the relationship between the franchisor and franchisee after the franchise is purchased. Some states have enacted relationship statutes that apply to the relationship after the parties have executed the franchise agreement.[53] Where the business relationship meets the definition of a "franchise" under that state's relationship statute, these laws regulate various aspects of the franchisor-franchisee relationship such as transfers, discrimination between franchisees, encroachment of protected territories, franchisees' right to freely associate, and termination or nonrenewal of the franchise.

While franchise agreements (drafted by the franchisor) tend to favor the franchisor, these state relationship statutes are intended to be remedial and generally favor franchisees over franchisors. As such, it could constitute a violation of the state relationship statute for a franchisor to attempt to terminate a franchise agreement without having proper grounds and following specific statutory procedures, even if the franchise agreement specified its own less onerous procedures.

Often, a prerequisite to a franchisee claiming the protections of a specific state's relationship statute is that the franchisee must be operating a franchised business located in that state and/or the franchisee must be domiciled in that state.[54] If the franchisee is not a resident or not otherwise entitled to protection, a franchisor may defend on that basis. Conversely, a franchise agreement containing a choice of law provision is unlikely to provide the franchisor with a basis to overcome the protections afforded by a state relationship statute absent a provision mandating that the jurisdictional provisions of a franchise statute be independently met. Many of these state relationship statutes provide that any provision in a franchise agreement that is contrary to that state's statutory protections is invalid as a matter of public policy and will not be enforced. Some state regulatory agencies require that franchise agreements have addenda memorializing the state's statutory protections.

v. Unfair or Deceptive Trade Practices

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").

[53] The states of Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Virginia, Washington and Wisconsin all have laws regulating facets of the relationship between the franchisor and franchisee.

[54] In this way, the broad jurisdictional scope of certain state relationship statutes can result in the application of one state's laws to a transaction in another state that does not have its own laws, if one of the parties is a resident of a state with such protection. Other states have limited the extra-territorial application of their franchise relationship laws. *See, e.g., Hockey Enterprises, Inc. v. Total Hockey Worldwide, LLC*, 762 F. Supp. 2d 1138, 1146 (D. Minn. 2011) ("Plaintiffs have provided no relevant support for the notion that the statute is intended or has been held to extend to non-Minnesota franchisees that do not operate in Minnesota.").

Many states have enacted unfair and deceptive trade practice acts, or “Little FTC Acts,” which are modeled on or are similar to the FTC’s Franchise Rule.[55] They generally provide that a violation of the FTC’s Franchise Rule provides a private right of action under state law.[56] In some states, violation of the FTC’s Franchise Rule is a *per se* violation of law.[57]

Most states that permit claims under these Little FTC Acts provide that individuals or businesses (including corporations) can bring suit under them. Contrary to common law fraud and misrepresentation claims, claims under the Little FTC Acts do not necessarily require a showing of an intent to deceive or proof of reliance. For example, the Florida Deceptive and Unfair Trade Practices Act requires a claimant to show “1) a deceptive act or unfair practice; 2) causation; and 3) actual damages.”[58] In addition, a party must only show that a representation was likely or had the “tendency” to deceive; it does not have to show actual falsity. Little FTC Acts also expand potential liability to include unfair conduct that would not necessarily be “deceptive” under common law. Further, they provide for awards of attorneys’ fees and punitive damages which would otherwise not be available under common law. Contractual disclaimers do not bar Little FTC Act claims where the underlying claim is for fraud or misrepresentation.

A franchisor may have several defenses against a Little FTC Act claim. It may argue that the violation was a mere breach of contract rather than a violation of a Little FTC Act. A franchisor may also claim that a franchisee is not a “consumer” under the applicable Act.[59] While some Little FTC Acts do include the sale of franchises within the scope of the statute’s protection, others do not because the sale of franchises is sometimes viewed as a commercial, rather than a consumer, transaction. As a result, a franchisee’s claims brought under certain state statutes could potentially be subject to dismissal.

vi. Breach of the Implied Covenant of Good Faith and Fair Dealing

While the definition of the implied covenant of good faith and fair dealing varies somewhat from state to state, it generally provides that parties to all contracts, including franchise agreements, must act honestly, fairly, and in good faith in interpreting and carrying out the terms of their agreements, as well as their rights and responsibilities

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[55] *See generally* Section V.A.ii, *supra.*

[56] *See* https://www.nclc.org/images/pdf/udap/udap-report.pdf for a 50-state evaluation of unfair and deceptive practices laws (dated March 2018).

[57] *See, e.g., Morgan v. Air Brook Limousine, Inc.*, 510 A.2d 1197, 1206 (N.J. Law. Div. 1986) (where the court held that the franchisor’s failure to comply with the FTC’s Franchise Rule’s requirements in the sale of the franchise constitutes a *per se* deceptive or unconscionable commercial act or practice in violation of New Jersey’s Consumer Fraud Act).

[58] *KC Leisure, Inc. v. Haber*, 972 So. 2d 1069, 1073 (Fla. Dist. Ct. App. 2008).

[59] *See, e.g., Safe Step Walk in Tub Co. v. CKH Indus., Inc.*, 242 F. Supp. 3d 245, 262 (S.D.N.Y. 2017) (“[T]hese claims arise out of the parties' contractual relationship and are not directed towards consumers … Whatever protections are available under the New York and Rhode Island franchise statutory schemes for the alleged wrongful termination or failure to renew the agreements will have to suffice.”).

under those agreements. Application of the implied covenant ensures that the parties fulfill the express contract terms in accordance with the reasonable expectation of the parties (as derived from the language or purpose of the contract, as well as from other facts and circumstances known to the parties[60]).

Significantly, the implied covenant of good faith and fair dealing does not provide a basis to claim harm from conduct that is expressly permitted by the franchise agreement or to preclude a party from acting in its own self-interest.[61] It cannot be used to replace express terms of a franchise agreement with those deemed more "reasonable," nor does it create obligations where none exist in the language of the contract. Rather, where a franchise agreement gives one party discretion, the implied covenant of good faith and fair dealing functions to ensure that such discretion is exercised in good faith "to prevent one contracting party from unfairly frustrating the other party's right to receive the benefits of the agreement actually made."[62]

Claims for breach of the implied covenant of good faith and fair dealing allow a franchisee to seek redress from capricious or bad faith exercises of franchisor discretion in various post-sale conduct.[63] This may be especially important in the franchise context, where the prospective franchisee must generally sign a standard form of franchise agreement if it wants to become a franchisee, and will have unequal bargaining power to modify or clarify terms at the outset of the relationship. Franchisees often allege violations of the implied covenant of good faith and fair dealing in connection with terminations, transfers, renewals, system changes (including implementation of new products, remodeling demands, and changes to policies and procedures), supply requirements, menu pricing, prices of franchisor-supplied services and products, market withdrawals, site selection, encroachment and competition issues, as well as obligations to provide support, training, and advertising.[64]

Additionally, the relationship statutes of certain states impose a general standard of good faith or commercial reasonableness in the franchise relationship.[65] A franchisee

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[60] *See, e.g., Sons of Thunder, Inc. v. Borden, Inc.*, 690 A.2d 575 (N.J. 1997) (whether purchaser which had contract to buy clams from supplier breached its obligation to perform its duties in good faith was question for jury, where evidence indicated that purchaser knew that supplier depended on income from contract to pay loans on boats, that purchaser continuously breached contract by not buying required amount of clams from supplier, that purchaser knew supplier guaranteed loans of another clam supplier operation and that purchaser failed to fulfill obligations to other operation).

[61] *See Bonanza Int'l, Inc. v. Rest. Mgmt. Consultants, Inc.*, 625 F. Supp. 1431, 1448 (E.D. La. 1986) ("Regardless of the relevancy or irrelevancy of Bonanza's dealings with third parties [regarding alleged unequal treatment], any evidence of good faith and fair dealing cannot be used to override express provisions of the written contract.").

[62] *Dos Beaches, LLC v. Mail Boxes Etc., Inc.*, No. 09CV2401-LAB RBB, 2012 WL 1903905, at *1 (S.D. Cal. May 25, 2012).

[63] *See, e.g.*, *National Franchisee Ass'n.* 715 F. Supp. 2d 1232 (S.D. Fla. 2010); *Carvel Corp. v. Diversified Mgmt. Grp., Inc.*, 930 F.2d 228 (2d Cir. 1991).

[64] Many of these issues are also commonly raised in connection with violations of state relationship statutes. While many state relationship statutes do not expressly address breaches of the implied covenant of good faith and fair dealing, a violation of state franchise law (like an improper termination without "good cause") may create a cause of action for breach of the implied covenant of good faith and fair dealing as well.

[65] States with such statutes include Arkansas, Connecticut, Hawaii and New Jersey, among others.

trying to establish a breach of the implied covenant will often present evidence of bad faith to support its claims, such as contrary industry standards, course of performance, and course of dealing with other franchisees.

As noted though, the implied covenant of good faith generally will not supersede express terms addressing a particular issue or create new, independent rights.[66] A franchisor may look to the express terms of the franchise agreement in order to potentially foreclose claims for breach of the implied covenant. Sometimes the franchise agreement will specifically or at least partially address whether the conduct complained of by the franchisee is allowed or not. Alternatively, a contract provision may grant the franchisor wide latitude or "sole" or "exclusive" discretion, which may preclude the franchisee's claim that the discretion was exercised unreasonably or in bad faith.[67] As another defense, a franchisor may potentially argue that the waiver clause in the franchise agreement waived the implied covenant. Yet some state law holds that parties cannot waive implied covenants (or there may be applicable statutes which would supersede contrary contract terms). In any event, franchisees must analyze relevant state law carefully in considering whether or not it supports an implied covenant of good faith and fair dealing claim, including whether that state even permits claims under the implied covenant of good faith and fair dealing to exist independently of a claim for breach of contract.[68]

vii. Encroachment of Exclusive Territories

Franchisees and franchisors often have different interests when it comes to franchise territory. A franchisor's growth requires expansion of the brand through additional franchised locations (which in turn provide the franchisor with additional initial and continuing fees). In contrast, a franchisee, while benefiting from such increased brand awareness, wants to protect its franchised business in its geographic area against loss of revenue from other franchisees (or the franchisor) competing in the same area. Given these conflicting goals, it is not surprising that encroachment issues are a common source of franchise litigation.

Encroachment, cannibalization, or system impact are all terms that refer to a situation where a franchisor establishes a new business franchise unit within an existing franchisee's protected territory or sufficiently close to an existing franchisee's unit so as to adversely impact the existing franchisee's business. This can take the form of a

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[66] *See, e.g., Coldwell Banker Real Estate, LLC v. Plummer & Assocs., Inc.*, No. CIV.A.09-1313SRC, 2009 WL 3230840, at *3 (D.N.J. Oct. 2, 2009) ("The implied covenant of good faith and fair dealing cannot [ ] override a contract's express terms."); *Burger King Corp. v. Agad*, 941 F. Supp. 1217, 1222 (N.D. Ga. 1996) ("defendants cannot use the implied covenant of good faith and fair dealing to second guess [plaintiff's] legitimate business decisions.").

[67] *See, e.g.*, *Burger King Corp. v. H&H Restaurants, LLC*, No. 99-2855, 2001 WL 1850888, at *5 (S.D. Fla. Nov. 30, 2001) (where the court found that franchisor did not unreasonably withhold its consent to a proposed transfer because it had the "sole discretion" to determine whether the proposed transfer was acceptable).

[68] *See, e.g., H&H Restaurants, LLC*, 2001 WL 1850888 at *6 ("Florida law, however, does not recognize an independent duty of good faith, and a plaintiff must allege a separate breach in order to maintain a cause of action for breach of the duty of good faith.").

franchisor opening a company-owned unit or granting another franchisee the right to establish a unit. Franchise encroachment can also occur where a franchisor offers its products in alternative, nonfranchised, or nontraditional distribution channels, including the internet, mail order, catalog sales, or the sale of branded products in department stores, convenience stores, grocery stores, or kiosks.

The ultimate disposition of encroachment disputes usually turns on the specific language in the franchise agreement. A franchisee may be able to assert a claim for an express breach of the franchise agreement if there is a provision in the agreement that specifically prevents the type of encroachment at issue. If the franchise agreement is silent on the respective rights of the parties as to the location or expansion of future stores, then the franchisee may allege breach of the covenant of good faith and fair dealing implied in the franchise agreement.[69] Some state statutes may also apply.[70]

Conversely, if the franchise agreement specifically addresses encroachment issues, then regardless of the ultimate impact to that franchisee, there is likely no express or implied breach of the franchise agreement. For example, many franchise agreements explicitly reserve a franchisor's right to open or franchise a competing unit within a certain proximity to the franchisee (or even that the franchisee has no exclusive rights to any territory) as well as a franchisor's right to compete in alternative distribution channels.

viii. Wrongful Termination of Franchise Agreement

Most franchise agreements contain a finite term for the franchise relationship, subject to renewal provisions. Nonetheless, franchise agreements may be subject to termination at any point before expiration of the term, provided that the grounds and procedures satisfy the agreement and any applicable state statute.[71] Franchise agreements typically specify the categories of conduct or violations of their terms that will permit a franchisor to terminate. Some relate to specific actions, while others are catch-all provisions aimed at general and consistent failures to comply with the franchise agreement.

A franchise agreement will often specify grounds for termination that a franchisee is entitled to cure within a certain amount of time after receiving notice from the franchisor, as well as those grounds for termination where no cure rights exist. Common curable defaults include monetary defaults (i.e. a failure to pay royalties or other contractually required fees) and operational defaults. The incurable grounds generally include actions that either reflect bad faith on the part of the franchisee or have a profoundly negative

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[69] *See, e.g., Bryman v. El Pollo Loco, Inc.*, No. MC026045, 2018 WL 8459745 (Cal. Super. Ct., Los Angeles County, Aug. 1, 2018) (while the franchise agreement did not provide the franchisee with an exclusive territory, and the franchisor had an express contractual right to open a competing restaurant "in the immediate vicinity of or adjacent to" the franchisee's location, the court nevertheless found that the franchisor breached the implied covenant of good faith and fair dealing by improperly encroaching on the franchisee's nonexclusive territory and cannibalizing its sales).

[70] *See, e.g.,* Iowa Code Ann. § 523H.6; Wash Rev. Code Ann. § 19.100.180(f).

[71] While franchisors are given the right to terminate the franchise agreement, franchisees are often not given their own right to terminate.

impact on the franchise relationship, status of the franchisee, or goodwill of the franchised brand. Some examples of incurable grounds include: suspending business operations, transferring the franchise business without franchisor consent, filing bankruptcy and/or becoming insolvent, and conviction in a criminal proceeding. Termination by the franchisor is only permissible for acts specifically identified in the franchise agreement as terminable breaches.

A franchisor must follow all procedures for termination set out in the franchise agreement and must also show how a termination is based upon an event of default specified in the franchise agreement. If it fails to do so, a franchisee may allege that the agreement was wrongfully terminated, and seek breach of contract damages. To support an improper termination claim, it is incumbent upon the franchisee to prove that the franchisor acted unfairly or improperly in terminating its franchise agreement without a reason specified in the franchise agreement and/or appropriate notice. A franchisor may defend itself by maintaining a record of franchisee defaults and warnings, along with proof that it sent the appropriate notice as required by the franchise agreement.

Additionally, state relationship statutes often impose additional standards or prerequisites before a franchisor may terminate its relationship with its franchisee.[72] These may include specific minimum notice periods, such as requiring default notices or advance notices of termination, certain content contained in the notice, specific timing of the notice prior to termination, or a specified method for the delivery of the notice. These statutes also often require the franchisor to provide opportunities to cure defaults before termination may become effective and/or require a franchisor to have "good cause" to terminate a franchise (with the definition of "good cause" varying from state to state).[73] This good cause requirement is designed to protect a franchisee from arbitrary terminations that would result in the loss of its investment. In cases interpreting what constitutes "good cause," examples include the franchisee's failure to pay fees and underreporting sales, insolvency, the failure to maintain standards, the sale of competing products or unauthorized use of the franchisor's trademark, repeated default, and the franchisor's market withdrawal. Some states outline specific situations that constitute "good cause" for termination.[74]

State law also may prohibit termination of a franchise agreement if a franchisee does not meet demands set by the franchisor that are deemed to be unreasonable, such as unconscionable fees or impossible sales quotas. As a finding of improper termination under these state statutes may entitle the franchisee to recover specific categories of damages and/or attorneys' fees, the franchisor's potential exposure is greater than it would be for a mere breach of contract claim for wrongful termination under a franchise agreement.

[72] States with these kinds of additional standards include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Rhode Island, Virginia, Washington and Wisconsin.
[73] While these definitions vary slightly, they generally state that "good cause" is a failure to comply with the lawful and material provisions of the franchise agreement.
[74] The states include Connecticut, Illinois, Minnesota and Rhode Island.

ix. Refusal to Renew Franchise Agreement

The franchisee's ability to continue in business after the expiration of the initial term is often of critical concern to a franchisee. The potential loss of the franchise (and the franchisee's investment) can thus create a basis for a franchisee to litigate. Issues concerning nonrenewal arise at the end of the initial term of the franchise agreement. There is generally no automatic right of renewal. Absent anything to the contrary in a franchise agreement, a franchise agreement expires by its terms at the expiration date identified in the agreement. However, franchise agreements often do set forth whether the franchise agreement is renewable, and, if so, the conditions for renewal.

While state laws do not require franchise agreements to include a provision for renewal after the end of the initial term, if the franchise agreement does include such a provision, certain state relationship statutes restrict the franchisor's ability to refuse to renew the franchise agreement.[75] These statutes vary widely on this issue, but they can result in a franchisor having to renew a franchise agreement with a franchisee if the franchisor did not adhere to the statutory requirements. In some states, nonrenewal is treated similarly to termination.[76] There may be a requirement that the franchisor provide advance written notice of nonrenewal along with the opportunity to resolve issues precluding renewal and/or to have "good cause" for the nonrenewal. Other states require a lengthy notice period for nonrenewals, or prohibit nonrenewal unless a franchisee has had sufficient opportunity to recoup its investment. Still others require a *quid pro quo* exchange for nonrenewals: in order to not renew, a franchisor must release the franchisee from noncompetition provisions, repurchase the franchisee's inventory, or permit the franchisee to sell to a qualified purchaser.

x. Denial of Right to Transfer or Assign Franchise Agreement

A franchisee may want or need to transfer or assign its franchise during the term of the franchise agreement. Franchise agreements often address many of the circumstances in which a franchisee is likely to request a transfer or assignment. They also ordinarily include a right for the franchisor to consent to or approve the transfer or assignment in its discretion, and may sometimes also state that the franchisor may not withhold its consent unreasonably. Courts consider it reasonable for a franchisor to require certain conditions, including the execution of a release, as a prerequisite to approval of an assignment.[77]

Yet as is the case with many other aspects of the franchise relationship, a franchisor must, in addition to considering its contractual obligations, consider the requirements of applicable state relationship statutes that may affect the franchise agreement's provisions. Case law and some state statutes limit the franchisor's right to

[75] These states include: Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Washington and Wisconsin.
[76] *See, e.g.*, Cal. Bus. & Prof. Code § 20025.
[77] *See Am.'s Favorite Chicken Co. v. Suryoutomo*, 889 F. Supp. 916, 919 (E.D. La. 1995).

restrict transfers of franchises or the franchised businesses' assets. In ten states, it is illegal for a franchisor to refuse to allow a transfer of the franchise without "good cause."[78] Many of these states permit a franchisor to have a right of first refusal to purchase the franchise prior to a transfer.

When a franchisor blocks a transfer or assignment, it may be possible for a franchisee to commence an action against the franchisor for breach of contract along with any additional state statutory remedies. As should be done for other breach of contract claims, the franchisor should look carefully at the underlying franchise agreement to evaluate what its actual obligations are. A franchisor should ensure that its basis for denying a franchisee's transfer or assignment comports with the discretion it is afforded in the franchise agreement. Being able to show a business justification for denying a transfer to the intended third party can also help provide a defense to a claim of bad faith decision-making.

xi. Failure to Provide Training and Support

Virtually all franchise agreements require the franchisor to provide its franchisees with some level of training and support, although many afford the franchisor discretion as to those levels. Indeed, it is this promise of training and support that often leads people to purchase a franchise rather than open an independent business. Franchisees consequently expect franchisors to train them in the particular business of the franchise and to support their efforts to operate the franchise and sell its products and services. A franchisor will sometimes fail to provide adequate training and support and/or can become more focused on selling franchises than supporting existing units. When a franchisor fails to follow through on its promises, this can lead to a franchisee's claim for breach of contract.

Notwithstanding, sometimes a franchisee's expectations do not match the realities of the FDD and franchise agreement. A franchisor does not have to provide all assistance necessary or "general support" to help a franchisee succeed unless the specific language in the parties' franchise agreement expressly requires it. To the contrary, most franchise agreements are drafted in such a way to require only specified training and few, if any, support obligations. And even in those instances where "support" requirements are contained in the franchise agreement, they tend to be stated in broad language, usually reserving to the franchisor the right to exercise its "sole discretion" in deciding whether and in what ways to provide support. As discussed above, the franchisor's reservation of discretion in determining its support obligations will often give rise to franchisee claims for breach of the implied covenant of good faith and fair dealing. Franchisors can defend against these types of claims by relying on specific contract provisions that enumerate and limit what training and support they are contractually obligated to provide.

xii. Marketing Fund Mismanagement

[78] These states include: Arkansas, California, Hawaii, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey and Washington.

A franchisor will typically require its franchisees to contribute to a common marketing and advertising fund (generally on a weekly or monthly basis), which the franchisor is supposed to use to further the brand and promote the products or services sold across the system. Sometimes a franchisor will use advertising fund money for inappropriate purposes, such as general corporate purposes. This may constitute a breach of contract, a breach of fiduciary duty on the part of the franchisor (for commingling assets), or both. To avoid such claims, franchisors should ensure they keep marketing funds separate from corporate funds, and that their marketing fund expenditures comply with the franchise agreement's obligations. Most well-drafted franchise agreements reserve the franchisor's discretion to the use of marketing funds and disclaim the existence of any relationship that could give rise to a breach of fiduciary claim. As with many other types of claims for breach of the franchise agreement, review and analysis of the contract is a crucial first step in evaluating whether a franchisor has breached any of its duties.

xiii. Antitrust and Tying Restraints

The general purpose of most antitrust laws, both at the federal and state levels, is to preserve and promote competition in relevant markets. While antitrust issues were a significant source of litigation between franchisors and franchisees in the past, such claims are much less prevalent today.

Most frequently, today's franchise antitrust claims are concerned with unlawful tying restraints, where a franchisee may complain about supply and source restrictions imposed by the franchisor. Tying claims normally involve a franchisor conditioning the sale of the franchise itself (the tying product) upon the purchase of separate products or services (the tied product).[79] Franchisees allege such tying arrangements eliminate competition in the tied product market. Conversely, franchisors argue that the imposition and enforcement of source controls are necessary to maintain system quality standards, to maintain necessary uniformity, to make franchisees more efficient and successful, and/or to protect commercial secrets, such as recipes.

Success on antitrust tying claims for franchisees may be difficult to achieve because they are rarely if ever deemed *per se* illegal, and are instead evaluated under the "rule of reason." This requires the fact finder to weigh all circumstances regarding the restraint, including its justifications compared to its effect on competition in the relevant market. In order to have a substantial effect on competition, almost every antitrust violation requires the franchisor to be large enough to dictate or influence prices or other terms of transactions in a relevant market. Notably, however, the relevant market is not only other franchisees in the system. The relevant market for evaluating antitrust violations in that particular franchise industry will include all of the shops selling similar or substitutable products. Accordingly, even some of the largest franchisors and most powerful brand names will only possess a small percentage of an overall relevant market, thereby making it very difficult to demonstrate the requisite "market power." As a result, absent a franchisor having this market power, and as long as the disclosure of tying

[79] *See, e.g., Eastman Kodak Company v. Image Technical Services, Inc.*, 504 U.S. 451 (1992).

arrangement possibilities is clearly set out in the FDD, the franchisor should be able to successfully defend itself against such antitrust claims.[80]

B. Frequent Franchisor Claims and Franchisee Defenses

i. Noncompliance with System Standards

A common franchisor claim is that the franchisee failed or refused to comply with the operational standards or requirements of the franchise system. System standards can address many aspects of the brand. Some standards are aimed at ensuring the protection, health, and safety of the customer. Others are aimed at distinguishing the franchise system (including how it is perceived and who it competes with). Some are implemented to create a uniform experience for the customer across all franchised locations (including what customers can expect in look, feel and quality). And others are focused on the protection of the franchisor's trademarks, brand elements, and other intellectual property. If a franchisee is uncooperative in following system standards, a franchisor risks the possibility of noncompliance by other franchisees. There is also the risk of weakened brand identity, which can potentially cause lasting harm to other franchisees or the franchisor itself. As a result, franchisee compliance with system standards and requirements is viewed by franchisors as an important and necessary part of maintaining the franchise system.

In determining whether a franchisee has violated system standards, the franchise agreement—which specifies the system standards the franchisee must follow and contains an agreement to comply with them—should be the first reference point. System standards, as well as policies and procedures, may also be found in the franchisor's operating manual (with which franchise agreements generally mandate compliance). Violations of system standards can occur gradually over time, sometimes without the franchisor's awareness. As such, provisions in a franchise agreement prohibiting waiver and requiring written modification are important responses to franchisees who argue that the franchisor has failed to enforce its standards.

Franchise agreements often provide franchisors with several remedies to address a franchisee's failure to maintain system standards, including use of the courts. If a franchisor is otherwise trying to maintain the franchise relationship, a franchisor can seek an order of specific performance or injunctive relief to require the franchisee to adhere to system standards.[81] Alternatively, a franchisor may consider terminating the franchise relationship for violations of system standards. Failure to maintain system standards is a reason frequently included in franchise agreements as a basis for termination (though termination for this reason must generally follow a notice and cure period, at least for

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[80] *See Queen City Pizza, Inc. v. Domino's, Inc.*, 124 F.3d 430 (3d Cir. 1997) (where the court held that Domino's could eliminate other authorized suppliers and designate itself as the sole authorized supplier of pizza ingredients without creating an unlawful tie).

[81] *See Dunkin' Donuts Inc. v. Priya Enterprises, Inc.*, 89 F. Supp. 2d 319, 323 (E.D.N.Y. 2000) (where franchisor sued franchisee to enforce the franchise agreement's sanitation requirements and the sanitation requirements were found to be enforceable).

standards that do not implicate health and safety concerns). Courts have often held that a franchisee's failure to maintain system standards constitutes "good cause" for termination, especially for repeat offenders.[82] In order to support a case against a franchisee for judicially mandated compliance or termination, a franchisor must establish a clear record of the violation(s). This can include documenting each instance of franchisee noncompliance as well as the potential use of customer surveys, quality assurance reports, secret shopper reports, audits, and/or private investigations.

As discussed above, a franchisor must also provide the franchisee with the requisite notice of violation of system standards. The required notice for this type of violation of the franchise agreement, as well as other types of curable defaults, is generally a written notice of default. The notice should advise the franchisee of the specific violation or default, the availability of an opportunity to cure, the time period for doing so, and the consequences it may suffer if it does not (including the fact that failure to cure can lead to termination of the franchise agreement). The franchisor should provide the notice of default in the manner and method described in the franchise agreement. And, in addition to following the requirements of the franchise agreement, many states have their own mandatory notice and/or cure periods, which can also impact the timing and contents of the notice of default.[83]

A franchisee may defend against claims of system standard violations in several ways. It may argue that the violation is not sufficiently "material" to justify default and/or termination.[84] Or it may argue that a course of dealing between the parties has been established that is contrary to the system standard purportedly being violated (which could give rise to defenses such as contract modification, waiver, or estoppel). A franchisee may also argue that the franchisor does not enforce the particular standard with other franchisees, so that the franchisor has waived its right to claim noncompliance as against that franchisee (or that the claimed violation is mere pretext).[85] By that same token, in the context of an action seeking injunctive relief to enforce compliance with system standards, a franchisor's failure to enforce the particular standard with other

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[82] *See Original Great Am. Chocolate Chip Cookie Co.,* 970 F.2d 273, 279 (7th Cir. 1992) (repeated violations of the franchise agreement within 12–month period provided franchisor with "good cause" to terminate franchise under Illinois Franchise Disclosure Act).

[83] *See* Section V.A.viii, *supra.*

[84] However, this is unlikely to be a successful defense if the violations affect the protection, safety and health of the public. These types of violations are generally viewed as sufficiently "material" to justify termination. *See, e.g., Dunkin' Donuts Inc. v. N. Queens Bakery, Inc.*, 216 F. Supp. 2d 31, 42 (E.D.N.Y. 2001) ("Courts in a number of jurisdictions have recognized that a franchisee's failure to comply with health, safety, and sanitation standards set forth in a franchise agreement constitutes a material breach of the franchise agreement, sufficient to justify its termination" [citing cases]). However, violations affecting less significant concerns may not be.

[85] *But see, e.g., Original Great Am. Chocolate Chip Cookie Co.*, 970 F.2d at 279 (the fact that the franchisor may have treated other franchisees more leniently is not a defense to a breach of contract claim); *McDonald's Corp. v. Robertson*, 147 F.3d 1301, 1309 (11th Cir. 1998) (where the violation constituted a material breach of the franchise agreement sufficient to justify termination, it did not matter whether the franchisor also possessed an ulterior, improper motive for terminating the franchise agreement). In addition, nonwaiver clauses in most franchise agreements—which specifically provide that the franchisor's failure to enforce its contractual rights, whether intentionally or by oversight, does not result in a waiver of its rights or remedies relating to a franchisee's breach—can also be used to oppose waiver claims.

franchisees can undercut the argument that the franchisee's actions are causing it irreparable harm. Some state franchise relationship statutes prohibit franchisors from discriminating between franchisees.[86] A finding in a franchisee's favor on the enforceability of a franchisor's system standards could have system-wide ramifications.

ii. Failure to Pay Royalties and Other Contractual Payments

The failure to pay fees is another common reason for franchisee defaults and, sometimes, termination. The majority of franchise agreements include the franchisee's obligation to pay weekly or monthly ongoing franchise fees, or royalties, over the term of the franchise agreement. These fees are usually calculated as a percentage of the gross sales of the franchise (often 4% to 6%), or can be a fixed periodic amount regardless of sales. Franchise agreements also often contain additional franchisee obligations to pay advertising fees or additional fees for products and services. Most franchise agreements contain provisions explicitly stating that failure to pay these fees is a breach of the franchise agreement. Accordingly, a franchisee's failure to properly report and pay the fees identified in the franchise agreement can provide a basis for default and/or termination.

A franchisor will generally have little difficulty proving nonpayment of fees or other amounts due. As most franchise agreements provide for notice and cure periods for a franchisees' failure to pay, a franchisor should carefully review and comply with the steps it must take prior to terminating the franchise agreement and initiating a breach of contract action for monetary default. Franchisors should also weigh the benefit of collection versus the risk of counterclaims that may need to be disclosed in the FDD.

Sometimes, a franchisee may not pay its fees because it is simply unable. However, sometimes a franchisee is unwilling. A franchisee will often defend against nonpayment claims by arguing that withholding payment of fees is justified, either because the franchisor is not providing the required support, or the franchisor is materially breaching the franchise agreement in some way. The franchisee's position in such cases is that it is not realizing the expected benefit under the contract due to the franchisor's actions and thus does not have an obligation to pay. Courts have generally held that such self-help is not allowed,[87] the underlying rationale being that a franchisee is not allowed to consider the franchise agreement terminated (and stop payment) on the one hand while continuing to avail itself of any of the benefits of the franchise agreement (i.e. the franchisor's trademarks and system) on the other. Most franchise agreements require franchisees to waive any right of set off and provide that their obligations continue during the term of the agreement independent of any alleged breaches. As a result, a franchisee who believes it is not getting the required support from the franchisor can either continue

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[86] *See, e.g.*, Minn. R. 2860.4400.B. (prohibiting franchisor from "[d]iscriminat[ing] between franchisees in the charges offered or made for royalties, goods, services, equipment, rentals, advertising services, or in any business dealing").

[87] *See S & R Corp.,* 968 F.2d at 376 ("[W]hen one party to a contract feels that the other contracting party has breached its agreement, the nonbreaching party may either stop performance and assume the contract is avoided, or continue its performance and sue for damages. Under no circumstances may the nonbreaching party stop performance *and* continue to take advantage of the contract's benefits.").

to pay franchise fees and sue for breach based on the franchisor's failure to provide support, etc., or may cease paying the required fees, declare the contract terminated, and stop all performance under the franchise agreement (subject to the franchisor's claims that the franchisee's termination was improper or any surviving post-termination obligations).

iii. Holdover Franchisees / Trademark Infringement

When a franchise agreement expires or is terminated, the franchisee's right to use the trademark terminates as well. Franchise agreements often have provisions requiring a franchisee to promptly deidentify its business after the expiration or termination of a franchise agreement and to disassociate the former franchise from the franchisor's system. A holdover franchisee is one who, despite these disassociation requirements, continues to operate the franchised business and to use the franchisor's trademarks, service marks, trade dress, and methods of operation of the business after the contractual right to do so has ended.

Since a franchisor's trademark is often one of the most valuable components of the franchise system, the franchisor must take the matter seriously when a terminated franchisee continues to use its trademark. A franchisor who fails to take action to protect its trademarks risks their dilution, waiver, and loss of statutory protection. A cease and desist letter puts a former franchisee on notice of a franchisor's intellectual property rights, but may not be sufficient to obtain compliance. In these circumstances, the franchisor is forced to obtain a court order to require the former franchisee to comply with post-termination obligations under the franchise agreement. This is often accomplished by commencing an action and immediately moving for a preliminary injunction. As noted above, a successful early motion for a preliminary injunction often ends the case.[88]

A franchisee that continues in business using the franchisor's trademark without authority runs a high risk of liability to a franchisor. Additionally, the Lanham Act provides protection for registered trademarks from infringement and counterfeiting.[89] Section 32 of the Lanham Act prohibits the use "without the consent of the registrant" of any reproduction of a registered trademark in connection with the sale of goods or services in a manner that is "likely to cause confusion, or to cause mistake, or to deceive."[90] Additionally, Section 43(a) prohibits the use in connection with any goods or services of any word, name, or false designation of origin in a manner that is "likely to cause confusion, or to cause mistake, or to deceive as to . . . origin, sponsorship, or approval of [the user's] goods, services, or commercial activities."[91] Success on such Lanham Act claims turns on whether a franchisee's use of the franchisor's trademark creates a "likelihood of confusion." Courts have regularly found that where a terminated franchisee

[88] *See* Section IV, *supra.*
[89] 15. U.S.C. § 1501, *et. seq.*
[90] *Id.* § 1114.
[91] *Id.*§ 1125(a)(1)(A).

continues to use the former franchisor's trademarks, a strong risk of customer confusion is present.[92]

The Lanham Act allows franchisors who establish trademark infringement to obtain, in addition to injunctive relief, the recovery of their actual damages, the franchisee's profits, and (subject to the court's discretion) treble actual damages.[93] In the case of willful counterfeiting (where the former franchisee persists in displaying the franchisor's trademarks following termination), a court is *required* to award to the franchisor either: (a) treble damages incurred by the franchisor; (b) treble profits obtained by the franchisee due to the counterfeiting; or (c) statutory damages ranging from $1,000 to $2,000,000.[94]

A franchisee who believes its franchise agreement was wrongfully terminated may attempt to defend the continued use of the franchisor's trademark on the grounds that the rights to use the trademark should not have been lost in the first instance, perhaps because the franchise agreement was wrongfully terminated or not renewed.[95] As another alternative, a franchisee can claim that the franchisor has abandoned or lost its trademark rights if other former franchisees or unlicensed parties have continued to use the trademark without prosecution by the franchisor. Unlicensed use of the trademark by others can also cut against an irreparable harm argument by a franchisor.

iv. Improper Use / Disclosure of Confidential Trade Secrets

Trade secrets are financial, business, scientific, technical, economic, or engineering information that their owner has taken reasonable measures to keep secret, and that derive independent economic value from not being generally known to or readily ascertainable by others.[96] Trade secrets in franchising can take a variety of forms, including recipes and formulas,[97] methods of doing business, preferred vendors, customer lists and information, marketing and promotional strategies, and proprietary software. Franchisors often set forth many of their trade secrets in an operating manual. Indeed, operating manuals often themselves constitute trade secrets.[98] Item 14 of the FDD requires disclosure of information about intellectual property related to the

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[92] *See, e.g., S & R Corp.*, 968 F.2d at 376; *TGI Friday's Inc. v. Great Nw. Restaurants, Inc.*, 652 F. Supp. 2d 763, 771 (N.D. Tex. 2009); *Buffalo Wild Wings Int'l, Inc. v. Grand Canyon Equity Partners, LLC*, 829 F. Supp. 2d 836, 846 (D. Minn. 2011).
[93] 15 U.S.C. § 1117(a).
[94] *Id.* § 1117(b) and (c). *See, e.g., Century 21 Real Estate LLC v. All Prof'l Realty, Inc.*, 889 F. Supp. 2d 1198, 1234 (E.D. Cal. 2012), *aff'd,* 600 F. App'x 502 (9th Cir. 2015) (awarding treble damages upon finding that "[t]here are no such extenuating circumstances in this case. All Professional's infringement was willful and it refused to de-mark until the court issued an order enjoining its use of the marks.").
[95] *See e.g., S & R Corp.,* 968 F.2d at 375; *In re Tampa Checkmate Food Servs., Inc.*, 221 B.R. 541, 544 (Bankr. M.D. Fla. 1998).
[96] *See e.g.,* 18 U.S.C. § 1839.
[97] Recipes and formulas are specifically discussed as types of trade secrets that, when constituting part of a franchise system, should be disclosed in a franchisor's FDD. *See* 16 C.F.R. § 436.5(n)(7).
[98] Item 11 of the FTC's Franchise Rule requires that franchisors either disclose the table of contents in the FDD or provide prospective franchisees with the opportunity to view the operating manual itself prior to entering into the franchise agreement. *See* 16 C.F.R. § 436.5(k)(6).

franchise.[99] Due to their importance and sensitive nature, franchisors prohibit ex-franchisees from using their trade secrets after leaving the system. Trade secrets must be protected, and a franchisor who does not actively protect its trade secrets can find itself limited from doing so in the future.

Franchisors who seek to protect their intellectual property using a trade secret approach have various options available to them, particularly when litigation becomes necessary. They may pursue their claims under common law and various state trade secret laws, and/or may bring claims under the Defend Trade Secrets Act—enacted as an amendment to the Economic Espionage Act—which provides for a federal private cause of action for trade secret misappropriation and federal subject matter jurisdiction, allowing trade secret claims to be brought in federal court, as discussed above in Section II.[100]

Generally, a franchisor seeking to enforce a statute protecting trade secrets must first establish the existence of a trade secret. This can often be difficult; not all trade secrets are as clear-cut as a secret fried chicken recipe or special sauce.[101] Moreover, franchisees may honestly not know what the franchisor considers a trade secret until the parties are in litigation.[102] A franchisee may seek to defend against a trade secret claim by arguing that the purported trade secret was not learned from the franchisor but is in fact a basic tenet in the industry and/or widely known outside the franchise system. Before marching into court to pursue a trade secret claim, a franchisor must carefully consider whether it will be able to satisfy the definition of a trade secret, or risk setting a harmful precedent. Additionally, the franchisor must weigh the benefits against the potential of disclosure during the prosecution of the case.

Another key question that is likely to arise in litigation over the improper use of trade secrets is whether the franchisor made reasonable efforts to maintain the secrecy of the information. Types of measures that can be taken include restricting access to only those who need to know the trade secret information; where the information is stored electronically, restricting access with secure password protection; clearly labeling trade secret information to distinguish it from information that does not constitute a franchisor's trade secret information; in training programs, emphasizing the importance of maintaining secrecy of trade secret information; monitoring access to trade secret information; performing exit interviews with franchisees to ensure that they have returned or destroyed

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[99] *See* 16 C.F.R. § 436.5(n)(7).

[100] For a more in-depth discussion of the Defend Trade Secrets Act, Uniform Trade Secrets Act and its various state enactments and related trade secret topics, *see* Scott McIntosh and Natalma McKnew, *A New World for Trade Secrets in Franchising: New Options and Strategies Under the Federal Defend Trade Secrets Act*, ABA 40TH ANNUAL FORUM ON FRANCHISING (Oct. 2017), available at https://www.americanbar.org/content/dam/aba/events/franchising/course-an17/an17-w4-paper.pdf.

[101] *See, e.g. JTH Tax, Inc. v. Williams*, 310 F. Supp. 3d 648, 656 (E.D. Va. 2018) (dismissing the franchisor's misappropriation of trade secrets claim against a former franchisee because the franchisor alleged no facts establishing that its alleged trade secrets have "independent economic value, actual or potential, from not being generally known" and "not being readily ascertainable by proper means.").

[102] As a practice point, franchisees who are permitted to "compete" with their franchisor after leaving the system should make every effort to clarify the definition of trade secrets before buying the franchise and upon exiting the system.

all trade secret information; and using agreements that restrict access to, and proper use of, trade secret information. As this element is frequently disputed in trade secret litigation, taking appropriate steps to maintain secrecy, and documenting such steps so as to be able to efficiently demonstrate the efforts taken, is very important.[103] A franchisor's failure to establish reasonable protections may provide a franchisee with a defense to a trade secret claim.

v. Violation of In-Term Noncompetes

Nearly all franchise agreements contain a covenant against competition, or a noncompete clause. There are two basic types—an in-term covenant not to compete (which is in effect during the term of the franchise agreement), and a post-term covenant not to compete (which is in effect following the end of the franchise agreement). In-term noncompete clauses generally prohibit a franchisee from having any ownership or business interest in a competitive business while it is a franchisee. A "competitive business," often defined in the franchise agreement, is generally one that offers goods or services that are either identical to or competitive with the goods or services offered under the franchise system.

Historically, covenants against competition have been subject to a "reasonableness" standard for public policy reasons, because they have the potential to restrain trade and deprive a person of the ability to work in his or her chosen field. However, in-term noncompete clauses are generally not subject to the same level of scrutiny as post-term covenants for several reasons. Notably, their duration is limited to the term of the franchise agreement and thus cannot continue for an unreasonable period. In addition, courts often do not impose the same geographic restriction on in-term noncompetes.[104] In-term noncompetes are subject to less scrutiny because a franchisor has a greater legitimate business interest in ensuring franchisee loyalty and protecting the business and the interests of other franchisees against competition from a fellow franchisee who might otherwise operate a competing business at the same time.[105]

vi. Violation of Post-Term Noncompetes

In general, post-term noncompete provisions state that, after the term of the franchise agreement, the franchisee will not own or be involved in any competitive business. A franchisee will often argue that the post-term noncompete is unenforceable because it makes it impossible for the franchisee to continue working in its area of expertise. Nevertheless, courts (with the exception of California which has deemed them

[103] *See, e.g., Am. Express Fin. Advisors, Inc. v. Yantis*, 358 F. Supp. 2d 818, 832 (N.D. Iowa 2005).
[104] *See, e.g., Vendo Co. v. Stoner*, 105 Ill. App. 2d 261, 282 (Ill. App. Ct. 1969) ("the territory covered by a covenant against competition, otherwise unreasonably broad, will not invalidate the covenant to the extent that it exists during the terms of the employment, lease, franchise agreement, etc.").
[105] *See, e.g., Singas Famous Pizza Brands Corp. v. N.Y. Advert. LLC*, No. 10-CIV-8976-RJH, 2011 WL 497978, at *11 (S.D.N.Y. Feb. 10, 2011), *aff'd,* 468 F. App'x 43 (2d Cir. 2012) (in evaluating an injunction application by the franchisor, the court held that the franchisor could likely show that the franchisee was at least indirectly operating the competing business (by and through her husband) in breach of the in-term covenant, and thus likely had grounds to prevail on its claims and to terminate the franchise agreement).

invalid[106]) generally enforce such restrictive covenants so long as they are reasonable in time and geographic scope and are necessary to protect a franchisor's "legitimate business interest." Examples of a franchisor's legitimate business interest can include protection of trade secrets, valuable confidential business information, customer goodwill, and specialized training received by the franchisee.[107] A two to three-year period is generally viewed as a reasonable length of time for a post-term noncompete, and a reasonable geographic scope is generally held to be a radius between 5 to 25 miles around the former franchised location.[108] The geographic scope can sometimes also include a radius or other defined area surrounding the outlets of other existing franchisees.

Some states have statutes to guide a court in determining whether a noncompete agreement's time or geographic limitations are reasonable, as well as whether the protected parties' business interests are legitimate.[109] Otherwise, the enforceability of these covenants is primarily a question of state common law, and outcomes can vary. Different state statutes and case law can make it entirely possible that a restrictive covenant in a franchise agreement could be enforceable in one state but overbroad and possibly unenforceable in another.

It can thus be of critical importance if the franchise agreement includes a choice of law provision specifying which state's law will apply when questions concerning the franchise agreement arise.[110] Absent a choice of law provision, the state law where either the franchisor or the franchisee is located usually applies. However, in determining whether to enforce a noncompete clause, courts will also generally look to the laws and public policy concerns of the state in which the franchisee's business is situated. As a result, it is necessary to carefully review the franchise agreement and the laws of the home states of the franchisee, franchisor, and the state specified in the franchise agreement. For example, a franchisor might bring a lawsuit in California to enforce a noncompete clause against a California-based franchisee, under a franchise agreement stating that Pennsylvania law will apply to questions regarding the franchise agreement. Notwithstanding a Pennsylvania choice of law provision, that California court would likely not enforce the noncompete clause because California's laws generally deem them unenforceable.[111]

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[106] Cal. Bus. & Prof. Code § 16600 (contract "by which anyone is restrained from engaging in a lawful profession, trade, or business of any kind is to that extent void").
[107] *See, e.g., U.S. Lawns, Inc. v. Landscape Concepts of CT, LLC*, No. 6:16-CV-929-ORL41DAB, 2016 WL 9526340, at *6 (M.D. Fla. Oct. 31, 2016); *CiCi Enterprises, LP v. Four Word Motion, LLC*, No. 6:16-CV-1679-ORL41KRS, 2016 WL 9244626, at *8 (M.D. Fla. Oct. 17, 2016); *Sylvan Learning, Inc. v. Gulf Coast Educ., Inc.*, No. 1:10-CV-450-WKW, 2010 WL 3943643, at *6 (M.D. Ala. Oct. 6, 2010).
[108] *See, e.g., Ledo Pizza Sys., Inc. v. Singh*, 983 F. Supp. 2d 632, 642 (D. Md. 2013) (2 years, 10 miles); *Carvel Corp. v. Eisenberg*, 692 F. Supp. 182, 186 (S.D.N.Y. 1988) (3 years, 2 miles); *Winmark Corp. v. Brenoby Sports, Inc.*, 32 F. Supp. 3d 1206, 1219 (S.D. Fla. 2014) (1 year, 8 miles).
[109] *See, e.g.,* Fla. Stat. Ann. § 542.335.
[110] *See* Section II, *supra.*
[111] *See*, *e.g.*, *Scott v. Snelling & Snelling, Inc.*, 732 F. Supp. 1034, 1041 (N.D. Cal. 1990) ("The Court holds that it should apply California law to the question of the enforceability of the covenants restricting competition in the franchise agreements in this case despite the choice of law provision nominating

As a franchisor seeking to enforce a noncompete clause, or a franchisee seeking to contest one, the questions surrounding the restrictive covenant do not end with whether it will be enforceable as written. It is also important to know what the court will likely do if it determines that the restrictive covenant is overbroad. Generally, courts have three options, which vary by state. A court can: (1) reform or rewrite the provision to make it enforceable;[112] (2) "blue pencil" or strike out only the overbroad parts and keep the rest (without adding language or changing any terms);[113] or (3) "red pencil" the provision by deleting the entire restrictive covenant from the franchise agreement, thereby rendering it altogether unenforceable.[114] Accordingly, there is the possibility that even if a noncompete clause looks overbroad and unenforceable as written, in many states the language of that clause will be modified to provide some level of restriction on competition after the termination of the franchise agreement.

Yet, simply demonstrating the enforceability and breach of a covenant not to compete does not automatically entitle the franchisor to an injunction. An important consideration is whether the franchisor has a legitimate business interest to protect. For example, a franchisor may be unable to demonstrate a legitimate business interest in restraining a former franchisee's competition if the franchisor does not have the means to maintain service to the franchisee's former customers, has no presence in the former franchisee's geographic area, and does not have the current ability to franchise a new location in that area.[115] A franchise agreement's provision that a franchisor will suffer irreparable harm as a result of a franchisee's violation of a noncompete may not be enough.[116]

Pennsylvania law as controlling interpretation of the agreements. This is so under California choice of law principles because of the strong public policy of California embodied in section 16600, the lack of an applicable statutory exception to section 16600, and the broadly inclusive language of the statute.").

[112] *See, e.g., Kutka v. Temporaries, Inc.*, 568 F. Supp. 1527, 1538 (S.D. Tex. 1983) (holding that the court may reform an unreasonably overbroad territorial restriction in a covenant not to compete, and provide appropriate injunctive relief restricting competitive activities in an area determined to be reasonable under the circumstances); *Armstrong v. Taco Time Int'l, Inc.*, 30 Wash. App. 538, 544 (Wash. Ct. App. 1981).

[113] *See, e.g., Novus Franchising, Inc. v. Superior Entrance Sys., Inc.*, No. 12-CV-204-WMC, 2012 WL 6734202, at *2 (W.D. Wis. Dec. 28, 2012) (where part of the covenant appears overbroad and unreasonable, the court can choose to enforce only the reasonable portions of a covenant by applying the so-called "blue pencil" rule).

[114] *See, e.g., Unlimited Opportunity, Inc. v. Waadah*, 861 N.W.2d 437, 441 (Neb. 2015) (where the covenant is found unenforceable as written, "it is not the function of the courts to reform a covenant not to compete in order to make it enforceable. We have declined to apply the "'blue pencil' rule," which allows for the reformation of covenants to make them enforceable, stating that "we must either enforce [a covenant] as written or not enforce it at all.") (footnote omitted.).

[115] *See, e.g., Tutor Time Learning Centers, LLC v. KOG Indus., Inc.*, No. 1:12-CV-4129 NGG RER, 2012 WL 5497943, at *5 (E.D.N.Y. Nov. 13, 2012).

[116] *See, e.g., Exec. Home Care Franchising LLC v. Marshall Health Corp.*, No. CIV.A. 15-760 JLL, 2015 WL 1422133, at *3 (D.N.J. Mar. 26, 2015), *aff'd*, 642 F. App'x 181 (3d Cir. 2016) ("while the Court does take the language of the Franchise Agreement into consideration as part of its analysis of irreparable harm, it rejects the contention that such language may substitute for the preliminary injunction analysis to be made by this Court.").

In addition, franchisees should understand that noncompete obligations and trade secret obligations (discussed above) can operate independently. While a franchisee may be successful in limiting or eliminating the noncompete obligations, it will still be prohibited from using the franchisor's trade secrets. As such, the elimination of a noncompete does not always have the effect of allowing a franchisee to compete with the franchisor after leaving the system.

C. Remedies

Claims brought by franchisees and franchisors give rise to a variety of available remedies. It is important that litigants understand and evaluate these remedies in order to pursue the ones that best suit their interests. This section provides an overview of the various types of relief commonly sought by franchisees and franchisors.

i. Contract Damages

Generally speaking, a party asserting a breach of contract claim is entitled to recover actual or "compensatory" damages that are directly and proximately caused by the breach, and are designed to restore the injured party to the position it would have been in had the other party performed. So-called "benefit-of-the-bargain" damages are measured by the loss in value of the breaching party's failure to perform less any cost that the nonbreaching party avoided by not having to perform.[117] Compensatory damages are those most readily and accurately measured and sufficiently predictable as contemplated by the parties at the time of contracting.

A franchisee's actual damages might be lost sales when the franchisor has encroached on the franchisee's territory, or the difference in profits for a period when the franchisor failed to provide the franchisee adequate support. A franchisor's actual damages might be past royalties due and owing, termination damages (such as the costs to deidentify a location), and rents paid under a guaranty of a franchisee's lease. Once a breach is proven, calculating actual damages can be as simple as totaling overdue sums (as well as interest, late fees and attorneys' fees if the franchise agreement permits recovery of those amounts).

Lost profits are another type of contractual damage claim, but are less straightforward to prove. They are often asserted by franchisees (for lost future profits) or franchisors (for lost future royalties and other revenue) when a franchise is terminated before the expiration of the term. Jurisdictions differ as to the circumstances under which parties can recover lost future profits. For example, some courts hold that a franchisor is not entitled to recover future royalties if it terminates a franchisee for nonpayment of past due royalties, reasoning that the proximate cause of the franchisor's failure to receive royalty payments in the future is not the franchisee's breach but rather the franchisor's decision to terminate the franchise.[118] Other courts have rejected this reasoning, holding instead that if the franchisee commits a breach justifying termination before the end of the

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[117] Restatement (Second) of Contracts § 347.
[118] *See, e.g., Postal Instant Press v. Sealy*, 43 Cal. App. 4th 1704 (Cal. Ct. App. 1996).

term, the franchisor can terminate and still recover the lost future royalties if the parties contemplated that remedy for breach at the time they entered into the contract.[119] Sometimes a franchise agreement's limitation on the recovery of consequential damages can preclude a claim for lost profits.[120]

For both franchisees and franchisors, the general rule is that they must prove lost profit damages to a reasonable degree of certainty.[121] Whether this standard is met is often a very fact-specific inquiry, requiring proof of a track record of historical profitability, and is not satisfied by mere speculation or conjecture. Both franchisees and franchisors may face challenges in this regard. For franchisees that never open or are only open for a short time, the franchisor is almost certain to argue that a lost profit claim is barred by the common law "new business rule" on the ground that those damages are inherently too speculative to be awarded. This hurdle may potentially be overcome by looking to the financial performance of other successful franchisees in the same system.[122] Franchisors may face their own challenges. For example, if the franchisee is struggling financially at the time of termination and would likely have gone out of business within a year in any event, the franchisor may have difficulty recovering lost future profits beyond that time period even if the term would not have expired for several more years. Also, the franchisor may have a duty to take reasonable steps to mitigate its damages by putting a new franchisee in the terminated franchisee's market within a reasonable time.

Recovery of lost profit damages typically requires expert testimony regarding the franchise's future performance that takes into account a number of variables. From a franchisee's perspective, this would include projections of revenues and expenses in the future and the likelihood that the franchisee would remain in business for the balance of the term of the franchise agreement and any renewal terms. From a franchisor's perspective, this would include the calculation of the royalties that the franchisor would have earned had the franchisee operated the franchised business for the remainder of the term of the franchise agreement, less any expenses that the franchisor would save by no longer having to provide operational support and other services to the franchisee.

Some franchise agreements, particularly those in the hotel industry, contain liquidated damages clauses. A typical liquidated damages clause provides that the franchisee agrees to pay, as damages, a fixed sum or a sum based on a fixed formula in the event of a breach of the franchise agreement. In examining whether a liquidated damages provision is enforceable, courts will generally look at (1) the reasonableness of the amount agreed upon in relation to the actual damages that are likely to be suffered as a result of a breach, and (2) the difficulty in assessing actual damages at the time of

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119 *See, e.g., Progressive Child Care Systems, Inc. v. Kids "R" Kids Intern., Inc.*, No. 2-07-127-CV, 2008 WL 4831339 (Tex. App. Ct. Nov. 6, 2008).

120 *See, e.g., Meineke Car Care Centers, Inc. v. RLB Holdings, LLC*, 423 F. App'x 274, 280 (4th Cir. 2011) ("While the parties were certainly free to contract for liquidated damages or to bar a right to recover lost profits under North Carolina law, they did not do so in this case.").

121 *Id.*

122 *See, e.g., No Ka Oi Corp. v. Nat'l 60 Minute Tune, Inc.*, 863 P.2d 79, 83 (Wash Ct. App. 1993) ("Here, proof of the nationwide character of the franchise business at issue provided an ample basis for computation of probable losses.").

contracting.[123] The amount of the liquidated damages must be reasonably proportional to the amount of probable damage that will result from a breach.[124] Liquidated damages that are not a reasonable estimate of the probable damage arising from a breach are deemed penalties and are not enforceable as a matter of public policy.[125]

ii. Rescission and Restitution

The equitable remedies of rescission and restitution are used in franchise litigation—most often by franchisees[126]—to "undo" the franchise relationship and return the parties to the original positions they held before they entered into the franchise and ancillary agreements. In essence, this requires both parties to return to each other whatever they received under the contract.

If the franchisor failed to register its FDD, failed to provide it to the franchisee, or if the information contained in the FDD is false or misleading, a franchisee can often seek rescission and restitution in states with franchise disclosure statutes. However, these statutes vary in terms of the grounds for rescission, the measure of restitutionary damages, the availability of attorneys' fees if the franchisee prevails, and the statutes of limitations for actions based on rescission.[127] Rescission and restitution are also available as common law remedies where there is no state franchise law that applies. Grounds for common law rescission include fraud in the inducement, a material breach of the agreement, mistake, impossibility of performance or frustration of purpose.[128]

If rescission is granted, the court must then decide how to restore the franchisee and the franchisor as nearly as possible to their pre-contract positions through restitution. With few exceptions, there is little clear direction as to the appropriate elements of restitutionary relief.[129] Also, because rescission is an equitable remedy, it is subject to wide discretion by the courts, the results are far from predictable, and it is dependent on the facts and circumstances of each case.

Common defenses to an action for rescission are waiver or laches, which may apply when the franchisee continues to operate its business and "reap the benefits" of the

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[123] Restatement (Second) of Contracts, § 356.
[124] *Meyer Ventures, Inc. v. Barnak*, No. Civ A. No. 11502, 1990 WL 172648, at *5 (Del. Ch. Nov. 2, 1990) ("An amount which is not reasonably proportional to the amount of probable damages, but which is fixed instead as a punishment to deter the breach, will be held unenforceable as a penalty.").
[125] *See, e.g., id.*
[126] While rescission is most often a franchisee remedy, it is available to franchisors. When franchisors seek rescission, it is typically as an offensive move to cut short a franchisee's ability to bring actions for franchise law violations.
[127] *See, e.g.*, Minn. Stat. § 80C.17(2); N.Y. Gen. Bus. Law § 691.
[128] Restatement (First) of Restitution §§ 6, 7, 8.
[129] Two cases in which courts have attempted to explain the parameters of restitutionary relief in the franchise context are *Flagship W., LLC v. Excel Realty Partners L.P.*, No. 1:02-CV-05200 OWWDLB, 2006 WL 3300395 (E.D. Cal. Nov. 14, 2006), *amended in part,* No. CVF-02-5200 OWW/DLB, 2007 WL 1574967 (E.D. Cal. May 30, 2007), and *vacated and remanded sub nom.Flagship W., LLC v. Excel Realty Partners LP*, 337 F. App'x 679 (9th Cir. 2009), and *Dollar Systems, Inc. v. Avcar Leasing Systems, Inc.*, 890 F.2d 165 (9th Cir. 1989).

franchise for an extended period of time after the franchisee knew of the statutory or common law basis for rescission.[130] Likewise, some state statutes provide a limited time period for rescission claims. This effectively prevents a franchisee who discovers a factual basis for rescission from waiting to see whether the business will be profitable before electing to rescind. Franchisors may also argue that, in order to obtain a rescission remedy, a franchisee must still prove the causation and damages elements of its claim.[131]

iii. Injunctive Relief

As discussed above in Section IV, to stop a former franchisee's trademark infringement or breach of its noncompete, franchisors often seek preliminary and permanent injunctive relief from the courts. Franchisees may seek such relief to ward off what they believe to be an improper termination. As noted, a party seeking a preliminary injunction "must establish that he is likely to succeed on the merits, that he is likely to suffer irreparable harm in the absence of preliminary relief, that the balance of equities tips in his favor, and that an injunction is in the public interest."[132] "A preliminary injunction is an extraordinary remedy never awarded as of right."[133] Courts vary in how these factors are applied and weighed, such as whether each factor must clearly favor the moving party or if a sliding scale approach is more appropriate.

iv. Specific Performance

Faced with a franchisee who refuses to comply with system standards, return confidential materials, sell or transfer the franchise, or abide by some other obligation under the franchise agreement, a franchisor may decide (either in lieu of or in advance of termination) to seek an order of specific performance requiring the franchisee to comply with its obligations under the franchise agreement. In some cases, franchisors have been successful in these efforts,[134] while in other cases courts have characterized franchise agreements as personal services contracts which may not be enforced by an order of specific performance.[135] In those cases, the franchisor's only remedies are to sue for damages, which are often difficult to prove in the case of a nonmonetary breach, or terminate for noncompliance if there is a legitimate basis to do so.

v. Declaratory Judgments

During the term of a franchise agreement, disputes may arise between the franchisee and franchisor with respect to the meaning of certain provisions contained in

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[130] *See, e.g., Elias Bros. Restaurants, Inc. v. Acorn Enterprises, Inc.*, 831 F. Supp. 520 (D. Mass. 1993); *National School Reporting Services, Inc. v. National Schools of California, Ltd.*, 967 F. Supp. 127 (S.D.N.Y. 1997).
[131] *Morris v. Int'l Yogurt Co.*, 729 P.2d 33, 35 (Wash. 1986) ("[T]he franchisee must show that the violation actually caused him to suffer damages, not merely that a violation occurred.").
[132] *Winter,* 555 U.S. at 20.
[133] *Id.*
[134] *See, e.g., Dunkin' Donuts, Inc. v. Kashi Enterprises, Inc.,* 106 F. Supp. 2d 1325 (N.D. Ga. 2000).
[135] *See, e.g., North American Financial Group, Ltd. v. S.M.R. Enterprises, Inc.,* 583 F. Supp. 691 (N.D. Ill. 1984).

the franchise agreement, and a party may want a court's blessing on the validity of its position before it terminates a franchise agreement (or embarks on a course of action) based upon a potentially erroneous reading of the agreement. Such direction can afford the litigant relief from uncertainty or insecurity. Declaratory judgments can also be useful during the term of a franchise agreement for a determination of whether a party's conduct under the franchise agreement constitutes a breach, and whether such breach gives rise to a basis for termination. After a franchise agreement's termination, a party might seek a declaratory judgment regarding the enforceability of a noncompete, the scope of indemnification obligations, or ownership of intellectual property.

Parties can seek a declaratory judgment under the Federal Declaratory Judgment Act[136] or its state law counterparts. However, declaratory relief may be inappropriate in some circumstances, such as a pure breach of contract action. Given that courts have discretion as to whether to entertain a declaratory judgment action,[137] they may decline to do so under such circumstances.

Additionally, courts consider other concerns when analyzing whether to exercise their discretion and hear a request for declaratory relief. A declaratory judgment action may be inappropriate where it is filed to beat the natural plaintiff to the courthouse. This tactic may be intended to deprive the other party of its natural position as plaintiff. Or, it may be intended to deprive the natural plaintiff of its choice of forum. Federal courts sometimes discourage or reject such tactical maneuvers as inappropriate uses of the Federal Declaratory Judgment Act.[138]

vi. Punitive Damages

While actual damages seek to make the injured party whole, punitive damages are intended to punish and deter wrongful conduct. Generally, punitive damages are not available for breach of contract claims, but, as discussed above, some state franchise statutes, Little FTC Acts, and the Lanham Act provide for the award of punitive damages under specified circumstances.

vii. Attorneys' Fees

Attorneys' fees are generally only recoverable when permitted by statute or contract. Most state franchise statutes permit the franchisee to recover its attorneys' fees and expenses if it prevails on a statutory claim for rescission or damages. The recovery of attorneys' fees is also often permitted for violations of Little FTC Acts and the Lanham Act. Additionally, the majority of franchise agreements contain either a prevailing-party attorneys' fee provision, which can be reciprocal (to benefit either a successful franchisee

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[136] 28 U.S.C. § 2201.
[137] *See Wilton v. Seven Falls Co.*, 515 U.S. 277, 286 (1995). ("Since its inception, the Declaratory Judgment Act has been understood to confer on federal courts unique and substantial discretion in deciding whether to declare the rights of litigants.").
[138] *See, e.g., Alaska Airlines, Inc. v. Schurke*, No. C11-0616JLR, 2013 WL 1898209, at *6 (W.D. Wash. May 6, 2013).

or franchisor) or may only provide for attorneys' fees where the franchisor is the successful party. Even in cases where the attorneys' fee provision is one-sided in favor of the franchisor, state law may require that provision to be applied reciprocally.[139] Additionally, remedial limitations, including the franchisee's waiver of the recovery of attorneys' fees and costs, are unenforceable where a state statute makes franchisors liable to franchisees for attorneys' fees.[140]

Where attorneys' fees are allowed, courts will often scrutinize the amount of fees being demanded for purposes of evaluating their reasonableness. They may look to see if the attorneys' rates are in line with those prevailing in the community for similar services by lawyers of reasonably comparable skill, experience and reputation.

VI. Discovery

The discovery process in franchise litigation is generally the same as in other types of commercial disputes. It typically features written discovery—requests for the production of documents, interrogatories, and requests for admission—depositions of the parties and nonparty witnesses, subpoenas for document production from third parties, and expert discovery. It may also include discovery motions. The exact nature of discovery will obviously depend on the specific dispute, but below is a brief discussion of typical discovery in franchise disputes.

A. Written Discovery

Written discovery consists of requests for the production of documents, interrogatories, and requests for admission.

Document requests will almost always include a request for the franchise agreements, including all riders, amendments, and addenda, as those are the main contracts between the parties. Operations manuals and policies may be relevant to claims involving system standards. The parties may also seek leases, which also relate to the operation of the franchise. For disputes involving claims about representations made during the acquisition of the franchise, the parties may seek production of the FDD, FDD receipts and questionnaires, information exchanged in the sales process including franchisee applications and proformas, as those documents demonstrate what information was exchanged and what the franchisee may have relied on when it decided to acquire the franchise. If the dispute relates to the termination of a franchise agreement, discovery will likely seek information about the defaults that gave rise to the termination. The franchisor will also usually seek documents demonstrating the ongoing financial performance of the franchisee, which can be used to calculate damages. Document requests will also include any other documents germane to the specific dispute, including releases, if any.

[139] *See, e.g.*, Cal. Civ. Code §1717.
[140] *See, e.g., Sanchez v. CleanNet USA, Inc.*, 78 F. Supp. 3d 747, 756 (N.D. Ill. 2015).

Interrogatories and requests for admission will generally attempt to confirm information found in documents. They may also be useful to document a parties' position on issues important to the case, particularly if the claims relate to conversations that are not contained in writings that will be found in a document production. For example, interrogatories can be an effective way to pin down a franchisee alleging misrepresentations or omissions by seeking their identification with specificity.

B. Depositions

Depositions are a critical tool because so many cases settle before trial and thus they are often the only opportunity to directly confront a parties' witnesses. Generally, depositions in franchise cases will include the parties, relevant employees, corporate representatives under Federal Rule of Civil Procedure 30(b)(6), expert witnesses if the applicable rules permit their deposition, third party former employees, and third party brokers or agents involved in any disputed sale practices. Again, there are likely to be more depositions of individuals on the franchisor side since the franchisor is likely to have more employees who have information related to the dispute.

When a party notices a 30(b)(6) deposition of a corporate representative, they must include a list of topics about which they will ask questions. If the notice fails to provide sufficient information to identify and prepare witnesses, and the parties are unable to resolve the issue, the responding party may move for a protective order. The party being deposed may designate whichever individuals it chooses to testify on the various topics. The individuals selected do not need to have firsthand knowledge of the matters on which they will testify, but if they do not have firsthand knowledge, they will need to educate themselves so that they have the knowledge of the company and are knowledgeable enough to bind the company with their answers. For this reason, a franchisor may often designate multiple individuals to testify on different topics. Parties should be aware, however, that the seven-hour limit that typically applies to depositions under the Federal Rules is a per person limit and not a per deposition limit. Thus, if a franchisor designates multiple individuals as corporate designees, the franchisee is allowed to spend seven hours deposing each individual.

C. Experts

Experts are most commonly used to opine on damages. For example, they may attempt to calculate lost future revenue or profits, the amount of losses attributable to a breach of the franchise agreement, the value of lost goodwill, lost investments, or the amount of restitution needed to return a party to the position they were in before entering into the franchise agreement. Provided the expert is qualified to testify about damages and his or her opinion and methodology are relevant and reliable, expert testimony about damages is usually admissible.

Parties sometimes also use experts in the field of franchising who can testify about the typical franchise sales process, industry standards, the duties of franchisors and franchisees, the meaning of terms in the franchise agreement, or the effect on a franchise system of a particular breach. Such testimony is admissible when "the expert's specialized knowledge will help the jury understand the evidence or decide a fact in issue."[141] Nevertheless, experts who testify on issues related to liability, who are often attorneys, may face greater scrutiny about the admissibility of their testimony. Expert testimony that consists merely of legal opinions or conclusions can be held inadmissible.[142]

D. Discovery Motions

As in other commercial litigation, the parties in franchise cases may move for protective orders or use motions to compel to determine whether certain information is discoverable. Under the federal rules, "parties may obtain discovery regarding any nonprivileged matter that is relevant to any party's claim or defense and proportional to the needs of the case."[143]

One discovery issue that arises fairly frequently in franchise litigation is whether a franchisee may obtain discovery regarding other similarly situated franchisees, either for the purpose of demonstrating that another franchisee was treated differently or that another franchisee had different financial results. Courts have sometimes rebuked those attempts because the fact a franchisor may "have treated other franchisees more leniently is no more a defense to a breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket."[144] A franchisor may also try to protect this information on the ground that it is confidential business information, or that the franchisee may misuse the information to compete against the other franchisees. In such cases, the parties may agree to use an attorneys' eyes only designation.

Another common issue is whether certain discovery (e.g. substantiation for Item 19 disclosures) is too burdensome under Rule 26. The burden of production of document discovery is typically much greater for franchisors because they will generally have much more data and documents in their possession. This is particularly true in cases with extensive email and other e-discovery.

VII. Settlement

Because most cases end in settlement, the documentation and finalization of settlement agreements is an important part of the franchise litigation process. The complex relationships involved in franchising require litigators to pay special attention to certain settlement issues.

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[141] *TCBY Sys., Inc. v. RSP Co.*, 33 F.3d 925, 929 (8th Cir. 1994).
[142] *Traumann v. Southland Corp.*, 858 F. Supp. 979, 985 (N.D. Cal. 1994) ("Mr. Murphy's opinions regarding California franchise laws and their application to this case are not a proper subject for expert testimony because they do not help determine the facts in issue. . . . Expert testimony must embrace factual issues and may not include legal opinions or conclusions.").
[143] Fed. R. Civ. P. 26(b)(1).
[144] *Original Great Am. Chocolate Chip Cookie Co.,* 970 F.2d at 279; *McDonald's Corp. v. C.B. Mgmt. Co.*, 13 F. Supp. 2d 705, 712 (N.D. Ill. 1998).

The terms on which a case may be settled obviously depend on the facts of the case and the relationship of the parties. But some common methods include allowing a terminated franchisee to sell their units, allowing a terminated franchisee to buy out of a noncompete obligation, or agreeing to a new franchise agreement with modified terms.

Settlement agreements in franchise cases commonly provide for a payment from one party to the other, dismissal of existing litigation, if applicable, and the termination of a franchise agreement, amendment of its terms, or execution of a new franchise agreement. Other common provisions include mutual releases, confidentiality and nondisparagement provisions, and a carve out for specific surviving obligations (such as noncompete, nondisclosure, and indemnification provisions). Practitioners should also be sure to carve out from a release any claims that could arise from surviving obligations. Franchisors should make sure to identify the specific obligations that are not being released, and not just generally refer to the "surviving obligations," since that general reference could be ambiguous.[145]

As discussed in Section I above, both parties need to be cognizant of the Item 3 disclosure requirement for franchisors, as this may impact settlement terms, including warranting a carve out for the franchisor from any confidentiality obligation. In *Caudill v. Keller Williams Realty, Inc.*, a franchisee claimed that a franchisor breached the confidentiality provision of a settlement agreement by disclosing the settlement's terms in Item 3 of the franchisor's FDD.[146] The Seventh Circuit affirmed the dismissal of the franchisee's claim, but the fact the claim even existed suggests that most of the time franchisors should try to obtain one-way confidentiality provisions that bind only the franchisee. Franchisees usually exit the system after signing a settlement agreement—or have already exited the system—and so they have no reason to speak with other franchisees about their settlement. On the other hand, the franchisor needs to manage the franchise system and live with the consequences of the settlement. Thus, franchisees have no reason to disclose the terms of a settlement, but the franchisor should be able to make any truthful disclosures, voluntarily or as required by law.

Conclusion

While franchise litigation features many of the same procedural battles and disputes over substantive legal issues that are common to other types of commercial litigation, franchise-specific laws and strategic business considerations add nuance to cases involving parties to franchise agreements. The authors hope that this paper helped to explain the regulatory framework of federal and state franchise laws and the uniqueness of the franchise business model which together make franchise litigation a specialized area of practice.

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[145] *BASCO, Inc. v. Buth-Na-Bodhaige*, 198 F.3d 1053 (8th Cir. 1999); *see also Iron & Silk, Inc. v. Champion Arts, Inc.*, No. A099583, 2003 WL 21246599, at *4 (Cal. Ct. App. May 29, 2003) ("The reference to the Franchise Agreement provisions on post-termination obligations provides some assistance to the parties by identifying steps required to disassociate the businesses, even though the provisions may be fragmentary and partially inapplicable.").
[146] 828 F.3d 575, 578 (7th Cir. July 6, 2016).