BASICS TRACK:
FRANCHISE LITIGATION

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1. Introduction

Franchise litigation, as that term is commonly understood, is not confined to disputes between franchisors and franchisees arising out of the offer or sale of the franchise or the parties' ongoing franchise relationship. Rather, it embraces a broad range of disputes that arise out of or relate in some way to the franchise relationship or the franchised business, only some of which involve franchisors and franchisees asserting claims against each other. While this paper largely focuses on those types of franchisor and franchisee disputes, franchise litigation may also include whether the parties' business relationship contains the necessary elements to even be considered a franchise, whether that relationship is in fact one of employer and employee under certain statutes, whether customers or other third parties can hold the franchisor liable for the franchisee’s conduct, whether the franchisor is the joint employer of the franchisee's employees, 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.

Likewise, the concept of franchise litigation is not limited to courtroom disputes but encompasses a variety of dispute-resolution forums, including arbitration and mediation, as well as the formal and informal negotiation process that often precedes the use of these mechanisms. And 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, the regulatory framework of federal and state franchise laws and the uniqueness of the franchise business model together make franchise litigation a fairly specialized area of practice.

This paper highlights the unique procedural and substantive features of franchise litigation by focusing on the various stages of the lifecycle of a lawsuit or arbitration proceeding, from initial pre-filing considerations when a dispute first arises through the post-judgment, post-award or settlement phase. The paper begins with an overview of the various ways in which franchise litigation differs from other types of general commercial litigation (Section 2), continues with an exploration of some of the methods available for resolving a dispute short of filing a lawsuit or arbitration (Section 3), and then addresses the various procedural issues that franchisors and franchisees should consider in deciding whether to file a lawsuit or arbitration proceeding and, in the case of a lawsuit, in what geographic and federal/state court forum to file (Section 4). The paper then turns to the pre-trial/pre-hearing stages of the case, discussing issues such as motions to compel arbitration, TROs and preliminary injunctions, dispositive motion practice and discovery (Section 5), and catalogues the most common types of claims, defenses, and remedies available to franchisors, franchisees and non-parties to the franchise relationship (Section 6). The paper concludes with an analysis of the settlement options and related issues that should be evaluated by the parties throughout a case (Section 6), and, if a settlement is not reached, the post-judgment or post-award considerations that franchisors and franchisees must keep in mind (Section 7).
2. Unique Aspects of Franchise Litigation

From a procedural standpoint, litigating a franchise dispute involves many of the same steps and strategic considerations as litigating any other type of commercial dispute. But a number of factors, including the contractual underpinnings of the franchisor-franchisee relationship, the regulatory framework of federal and state laws that govern the franchise sales process and the ongoing franchise relationship, and the dynamics of the franchisor-franchisee relationship and business model, all combine to give franchise litigation a unique set of characteristics that distinguish it in many cases from other types of commercial litigation. Among those unique characteristics are the following:

a. Federal and state regulatory framework

The most pronounced difference between franchise litigation and general commercial litigation, not surprisingly, stems from the federal and state regulatory framework that governs the franchise sales process and, in some cases, the ongoing franchise relationship. As a consequence of perceived historical abuse, franchising is subject to a patchwork of federal and state regulation that imposes statutory duties on franchisors and, in some instances, grants franchisees enforceable legal rights. In addition, the Federal Trade Commission (“FTC”) requires certain disclosures in the sale of a franchise and has the power to investigate and enforce violations. A number of states also regulate the disclosure and sale process, in some instances requiring review and registration of pre-sale disclosure documents. Many states also regulate the ongoing business relationship between the franchisor and the franchisee. Among other things, state franchise statutes may supersede the terms of the parties’ agreement and limit or condition contractual rights to terminate or not renew the relationship.

Beyond FTC regulations and state franchise laws, there are other bodies of law that bear on the franchise relationship. Franchising typically involves the licensing of intellectual property rights, particularly trademark rights, which are protected under the Lanham Act. In addition, the federal antitrust laws have been a traditional source of concern for franchisors. Exclusive territories, the designation of approved or required suppliers, and designations of price points all have potential antitrust implications.

b. Procedural battles

The litigation of franchise disputes, to a greater degree than commercial litigation generally, very often involves skirmishes over procedural issues like jurisdiction, venue, choice of law, and even whether the dispute belongs in court or an arbitration forum. While these issues are typically addressed in the parties’ franchise agreement, franchisees often challenge the scope or enforceability of contractual provisions specifying jurisdiction, venue or choice of law under state franchise statutes or common law principles like unconscionability, believing that litigating in the franchisor’s chosen home court or under the franchisor’s home state law or in an arbitration forum in the franchisor’s home state will severely disadvantage them in terms of the cost of litigation.
or the chances of prevailing on their claims and defenses—or both. The fact that franchisors and their franchisees are very often located in different states, or in different countries for that matter, only heightens the stakes in the fight over procedural issues like jurisdiction, venue or choice of law.

c. Prevalence of Arbitration Agreements

Because many franchisors include broad arbitration clauses in their franchise agreements covering all or virtually all disputes arising out of or relating to the franchise relationship, a disproportionately large percentage of franchise disputes end up being arbitrated rather than decided by a judge or a jury as compared with other types of commercial disputes. While it is difficult, if not impossible, to measure the relative success of claims brought by franchisors or franchisees in arbitration proceedings or the relative cost of resolving those claims in arbitration vis-à-vis resolving those claims in a judicial forum, one consequence is clear: the prevalence of arbitration agreements means that there are far fewer judicial opinions being generated in franchise disputes that can be relied on as precedent by franchisors and franchisees. In addition, since franchisees often try to avoid arbitration based on the perception that it is far more costly, at least in terms of out-of-pocket expenses, than litigating in a judicial forum or that it impairs their substantive rights, franchise disputes, perhaps more so than any other type of commercial dispute, have generated a substantial body of case law on the scope and enforceability of arbitration agreements in commercial contracts.

d. Claims and Counterclaims

Franchise lawsuits or arbitrations almost always involve both claims and counterclaims, regardless of whether the franchisor or franchisee initiates the lawsuit or arbitration. That is partly a function of the numerous obligations that the parties owe each other under the franchise agreement, each of which can give rise to a claim (or counterclaim) for breach of contract. It is also a function of the prevalence of termination disputes in the franchise context, where the franchisor’s lawsuit to enforce the termination of a franchise agreement almost always elicits a counterclaim by the franchisee for wrongful termination. In fact, whenever a lawsuit or arbitration involves the termination of the franchise relationship—which likely accounts for a significant majority of franchise disputes—there is little disincentive for either side to assert any and all claims at their disposal, even those that might not have been asserted if the parties’ franchise relationship were still intact.

e. Ongoing relationship of the parties

Despite the observation just made about the prevalence of franchise termination disputes, not all disputes involve the demise of the parties’ franchise relationship. A significant percentage of franchise cases involve disputes over a more discrete aspect of the parties’ relationship, such as a franchisee’s pricing practices or the franchisor’s use of advertising contributions, that do not result in a termination of the franchise agreement at issue or, in the case of a multi-unit franchisee, a termination of the overall franchise
relationship between the parties. In these situations, both the franchisor and franchisee must be mindful of the goal of preserving the overall franchise relationship—if that is in fact the goal of one or both parties—and adopt litigation tactics and strategies that will not put that relationship in jeopardy. Both sides must also be cognizant of the cost of litigating the dispute, both in terms of attorneys’ fees and expenses and the distraction from their core businesses.

f. Potential System-Wide Impact of Franchise Litigation

Unlike most commercial disputes between two or more parties that end up in litigation, franchise lawsuits or arbitrations between a franchisor and a single franchisee or a small group of franchisees often have far-reaching and potentially system-wide implications. This is true both in a practical and a legal sense. Franchise agreements almost always include an acknowledgement by the franchisee that terms or agreements with other franchisees in the system may differ and that accommodations with respect to one franchisee do not constitute a waiver of the franchisor’s right to enforce a provision as to another franchisee. As a practical matter, however, franchisees communicate among themselves, both informally and through franchise advisory councils and independent associations, and instances of actual or perceived disparate treatment can lead to system disruption and, potentially, litigation.

Franchisors also must be cognizant of the potentially broad effects of judicial determinations in a particular case. In general business litigation, a settlement or a ruling as to the meaning of a disputed contractual term most often has little applicability beyond the particular case. For franchisors with hundreds or thousands of agreements containing the same provision, however, the precedential effect of litigation can be particularly significant. Also, franchisors must concern themselves with the disclosure obligations of pending and concluded litigation in their franchise disclosure documents and the effect that such disclosure may have on franchise sales as well as encouraging other franchisees to pursue similar claims.

g. Lack of adverse relationship between the parties

While the term franchise litigation is most often used to describe a lawsuit or arbitration where the franchisor and franchisee have asserted claims against each other and therefore are adverse, franchisors and franchisees are increasingly finding themselves on the same side of a lawsuit. Historically, this occurred primarily in the vicarious liability context, where a customer of the franchisee or other third party harmed by the franchisee’s conduct sued both the franchisee, on a direct liability theory like negligence, and the franchisor, on a principal-agent or respondeat superior theory of liability. More recently, and with increasing frequency, franchisors and franchisees have been sued as co-defendants under a joint-employer theory of liability, typically by a current or former employee of the franchisee, who sues the franchisee as his or her direct employer for federal or state wage-and-hour violations or employment discrimination claims and the franchisor as a joint employer, based on the alleged controls that the franchisor exerts over the franchisee’s business.
It is important to note, however, that while the interests of the franchisor and franchisee may be aligned initially as co-defendants in a vicarious liability or joint employer case, their interests may ultimately diverge if the franchisor seeks indemnification from the franchisee under a contractual indemnification provision in the franchise agreement for the franchisor’s attorneys’ fees and expenses incurred in defending the lawsuit and for any judgment or settlement contribution it is required to pay. The parties’ interests may also eventually be adverse if the franchisor seeks to default or terminate the franchisee for failing to comply with an “obey-all-laws” provision in the franchise agreement, particularly in the case of the franchisee’s failure to comply with wage and hour laws.

3. Pre-Filing Dispute Resolution

As any business person will tell you, litigation is almost never a good investment of time or resources. It creates conflict in the system, deflects attention from business initiatives, is very expensive, and creates risk and uncertainty. Accordingly, when disputes arise—and they inevitably will—both parties should strive to find ways to resolve the controversy informally before suit is filed. In this section, we will look at ways to resolve disputes, short of litigation.

a. Use of franchisee associations, influential franchisees, and ombudsmen

Franchise disputes commonly arise due to a breakdown in communication or trust between the franchisor and the franchisee, preventing both parties from rationally assessing the business issues at stake in the dispute. When this arises, the use of others within the system can be particularly effective for getting the parties to take a step back and find a business solution to the situation. Organizations or individuals who can be particularly effective in helping restore communications include franchisee associations, influential franchisees, and ombudsmen.

A franchisee association is a group of franchisees that join together for a common purpose, usually to address issues within a franchise system. Franchisors often seek to discourage associational activity by their franchisees because it can create significantly more leverage on the part of the franchisees and can make it politically more difficult for the franchisor to execute the business plan that it believes will improve the overall system. In some cases, franchisee associations can even negotiate a role in system decisions like marketing, further limiting the franchisor's ability to implement its strategy.

Despite the negative consequences that sometimes befall franchisors with franchisee associations, these associations also represent an opportunity for the franchisor to prevent and manage conflict with franchisees. Officers of franchisee associations are elected by the franchisees, and the officers can often serve as informal mediators in potentially contentious situations, such as when franchisees are struggling financially or have poor operations, or when large numbers of franchisees are upset with
the performance of the system or a franchisor's business decisions. If a franchisor knows that implementing a particular business decision may be controversial, explaining it to the association's representatives in advance and getting their buy-in can go a long way to keeping peace.

With respect to issues that arise with individual franchisees, franchisee association officers are not the only ones who can serve as informal mediators. In systems both with and without associations, there are often influential franchisees who can speak to other franchisees when the franchisor can't, due to a breakdown of trust. These influential franchisees are often larger or more successful than most, so they often have the trust of both the franchisor and the smaller franchisees who aspire to grow the way the influential franchisee has. These influential franchisees will be in a position to make suggestions to both franchisor and franchisee that might not otherwise be well received, such as suggesting that a franchisor enter into a forbearance agreement, or suggesting that a franchisee change its approach to doing business.

While it may be helpful for franchisors to seek out informal mediators like association officers or influential franchisees, franchisors should not divulge non-public information concerning a franchisee's business to other franchisees without the consent of the affected franchisee. Revealing negative details about a private contractual relationship can affect a franchisee's reputation, as well as the value of the franchisee's business. In addition, revealing matters that a franchisee wants to keep private can create additional animosity and increase the likelihood of full-blown conflict.

Another approach for keeping lines of communication open is the use of ombudsmen, who can serve as emissaries for franchisors in large franchise systems. These ombudsmen can be charged with visiting significant numbers of franchisees in the system and becoming intimately acquainted with the daily struggles of individual franchisees. Their role will not be to audit the performance of individual stores or compliance with system standards, like other field team members or outside vendors do. Rather, their role will be to understand the franchisees' challenges at a macro level and report back to the franchisor as appropriate. The ombudsmen can become a personal and familiar presence in the lives of franchisees where they actually live and work, rather than just a remote presence at the franchisor's headquarters. Similar to association officers and influential franchisees, these ombudsmen can serve as a bridge between the franchisor's management employees at headquarters and struggling franchisees, offering suggestions to both in order to avoid legal conflict.

b. Mediation (mandatory and optional)

When it is clear that informal discussions designed to avoid a dispute are at a dead end, formal mediation may help to create conditions that can avoid litigation. Some franchise agreements require formal mediation before either party resorts to litigation. There are pluses and minus to pre-suit mediation. On the plus side, pre-suit mediation can lead to the informal resolution of the suit before significant legal fees are incurred. From the franchisor's perspective, there may also be benefit in mediating before suit is
filed, because a settlement can avoid an Item 3 disclosure (discussed below) and the release of otherwise confidential settlement terms. The negative of pre-suit mediation is that, without the benefit of any discovery, settlement talks may be premature. As such, the time and cost of early mediation may be wasted.

Regardless of whether mediation is required, it is not likely to be successful unless the parties enter into a mediation agreement in advance that lays out ground rules and provides for who will pay for the mediation. Experienced mediators can often recommend terms and conditions for a mediation agreement. The choice of mediator is often the key ingredient to success. Both sides should want to choose a mediator that the other side will also respect and listen to regarding both the formalities of mediation and any proposals or suggestions for resolution.

Mediation typically involves each side laying out its case clearly to the mediator and to the other side. There are different options with respect to the timing of this. The mediation agreement can provide that both sides initially submit a brief or statement privately to the mediator in order to give the mediator an opportunity to make suggestions to modify the structure or pace of the mediation process, based on what was submitted, to try to increase the likelihood of coming to agreement. Alternatively, briefs or statements can be submitted directly between the parties to allow for reply briefs or statements addressing perceived weaknesses in the other party's arguments. It is essential that the mediation agreement provide that all written and verbal communications in connection with the mediation constitute settlement discussions and are inadmissible in litigation.

c. Work-out agreements; forbearance agreements

Another way that disputes can be resolved before or in lieu of litigation is by working out a business deal to allow the parties to separate or solve the problems, without resorting to litigation and without waiving rights. This is commonly done through workout or forbearance agreements. These agreements allow the parties to set conditions or delay certain events before further action is required. Take, for instance, the common circumstance of a franchisee who is having trouble paying royalties or other charges on a timely basis. Franchisees may often decide that it is less risky to miss a royalty payment to their franchisor than to miss a loan payment to their bank. Regardless, the failure to make timely payments is usually a symptom of a larger problem with the franchisee's business, and bankruptcy court can often be the franchisee's next stop if things do not improve. A bankruptcy filing is typically not desirable for a franchisor because of the automatic stay of legal proceedings. In addition, if a very large or influential franchisee

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3 Scott and Tegt, *supra* note 1, at 13.
files for bankruptcy, it can affect the public reputation of the brand and even the stock price of a publicly traded franchisor.

The franchisor is then left with the decision to exercise a termination right (which may have several consequences, including counter-suit, abandoning a territory, and other business considerations), or to allow the franchisee to continue down a path that could lead to a large financial exposure for the franchisor. This is one situation where a forbearance or workout agreement can be used in lieu of a termination. These agreements are also sometimes called assistance agreements, because their purpose is to give the franchisee some breathing room to improve its financial situation, which might be suffering due to circumstances like accidents, the closure of a nearby source of customers, the unexpected death of an owner or other circumstances unrelated to simply poor business skills.

The exact terms of a workout agreement will differ depending on the circumstances, but there are several approaches to consider. A common approach is to take a promissory note from the franchisee for all past due receivables, with an agreed amortization schedule for payment of the principal plus interest. If possible, the schedule should be structured in such a way that the franchisee will be able to pay all current amounts owed while simultaneously making the required payments on the note.

In difficult cases that involve unforeseen events similar to those described above, the franchisor may consider allowing the franchisee to close certain units that are losing money. In such a situation, the franchisor may even consider conditional debt forgiveness, particularly in connection with the units that the franchisee is allowed to close. While this is a particularly generous concession, it can make sense for a franchisor to provide it in order to protect the reputation of its brand or to preserve the viability of an important or high-profile franchisee who otherwise operates successful units.

Another advantage of a workout agreement is that it can set strict conditions for the forbearance or debt forgiveness that is granted, and this will almost always be an improvement on what would result from a bankruptcy proceeding. The conditions can go beyond what is in a typical franchise agreement in terms of restricting the operation of a franchisee’s business. The agreement can provide for heightened oversight of the franchisee’s operations, with more frequent reviews of the franchisee’s financial records by the franchisor. It can also require that actions be taken to improve or renovate profitable units so that the franchisee’s favorable turnaround is not short-lived.

A workout agreement should be signed by all owners and guarantors of the franchise. The agreement should also provide that all amounts that were subject to forgiveness or forbearance will become immediately due in full in the event of any bankruptcy filing by or against the franchisee. Structured properly, a workout agreement can be an excellent tool to protect a franchise brand and preserve valuable franchisees within the system.
4. Pre-Filing Considerations

a. Lawsuit vs. Arbitration

In many franchise disputes, the first consideration for both franchisors and franchisees in deciding how and where to assert a claim is whether to bring that claim in an arbitration proceeding or a judicial forum, assuming that the franchise agreement has a permissive or mandatory arbitration provision covering the claim in question. As discussed elsewhere in this paper, many franchisors have traditionally viewed arbitration as offering a number of advantages over court litigation. Among those advantages are greater efficiency and economy due to more limited discovery and streamlined pre-hearing procedures, the ability to select a decision-maker with franchise industry experience or at least commercial contracts experience, greater likelihood of enforcement of contractual limitations on remedies, preserving the confidentiality of the proceedings, and the general lack of a preclusive effect of an adverse arbitration award.

Critics of arbitration often question some of these perceived advantages of arbitration, pointing to the increased “judicializing” of arbitration procedures, such as expanding the ability to bring pre-hearing motions to dismiss or for summary judgment. However, for the vast majority of franchise disputes, it is considerably less expensive to conduct discovery and prepare and try an arbitration case through the final hearing stage than it is to take that same case through a jury or bench trial in federal court, especially given the onerous federal pre-trial order requirements. Regardless of one’s view of arbitration, however, some franchisor claims are clearly not well suited for arbitration, such as those that require expedited relief in the form of a TRO or preliminary injunction.

Franchisees may not view arbitration as an attractive alternative to a lawsuit because of the much higher filing and administrative fees in arbitration as well as the need to pay the share of the arbitrator’s compensation for pre-hearing and hearing time, to say nothing of the sacrifice of a right to a jury trial. But arbitration does offer the franchisee some advantages over a judicial forum, including a greatly relaxed standard for pleading claims, a greater likelihood that some or all of their claims will survive until the final hearing given the more limited use of motions to dismiss and motions for summary judgment in arbitration, and the increased ability to rely on evidence that would be inadmissible in court or make arguments based on general notions of fairness or equity rather than legal principles—arguments that might not be entertained by a judge. Of course, regardless of whether the franchisee views arbitration as more advantageous than a judicial forum to assert its claims or defend against the franchisor’s claims, if the franchise agreement requires arbitration of the claims at issue and there are no defenses available to the franchisee for challenging the enforcement of the arbitration agreement, the franchisee may have no choice but submit to arbitration or undertake the cost of challenging the arbitrability of the claims and potentially subject itself to paying the franchisor’s attorneys’ fees if it loses that challenge.
b. State vs. Federal Court

Whether a franchisor or franchisee chooses to sue in a state or federal court depends in part on the nature of each party’s substantive claims and in part on where the franchisor and franchisee (and any other necessary parties) reside. If both the franchisor and franchisee reside in the same state, the case will be heard in state court unless the case involves a federal statute or a federal question. Some federal statutes, such as the Lanham Act, which governs trademark infringement actions, provide for concurrent jurisdiction in state and federal court, while other federal statutes, like the Sherman Antitrust Act, provide for exclusive jurisdiction in federal court.

If the franchisor and franchisee reside in different states (or if either party resides in a foreign country) and the amount at issue in the case exceeds $75,000, exclusive of costs, a federal court will have subject-matter jurisdiction over the case based on diversity of citizenship. In cases where the only or primary relief sought is an injunction or a declaration of rights and not the recovery of damages, the $75,000 jurisdictional requirement is measured by the value of the rights sought to be vindicated. The federal jurisdictional statute requires complete diversity between the parties, meaning that none of the plaintiffs may be a resident of the same state as any of the defendants. For purposes of determining citizenship of the parties, a corporation is deemed to be a citizen “of any state by which it has been incorporated and of the state where it has its principal place of business.” Limited liability companies are citizens of every state in which any individual member is a citizen. Based on the foregoing, the majority of franchise disputes are litigated in federal court rather than state court, because these disputes typically involve monetary claims or legal rights valued at more than $75,000, and they arise between franchisors and franchisees that are often located in different states.

c. Removal

If a case is filed in state court, it may be removed to federal court as long as the case is one over which the federal court would have original subject-matter jurisdiction. In other words, if one or more of the claims implicates a federal question or federal statute, or if the case involves more than $75,000 in dispute and there is complete diversity of citizenship between the franchisor and franchisee parties, the case may be removed to federal court. Even if there is complete diversity of citizenship, however, a lawsuit may not be removed if any of the defendants is a citizen of the state in which the lawsuit was filed. This is rarely the case in franchise disputes, because the franchisee will almost always sue in its home state court rather than in the franchisor’s home state court, unless the franchisee voluntarily complies with a forum-selection clause in the franchise agreement that requires suit to be filed in a state or federal court in the franchisor’s home state.

There are a number of technical requirements that need to be followed in removing a case to federal court. For example, all defendants must join in the removal petition, the

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notice of removal must be filed within 30 days after the defendant is served or otherwise
receives a copy of the complaint, and the notice of removal must state the grounds for
the federal court’s jurisdiction, particularly in those cases based on diversity of citizenship
where the $75,000 amount at issue requirement does not appear on the face of the
complaint. If a case is improperly removed, the plaintiff may seek to remand the case to
the state court in which it was originally filed, and the court may award costs and
attorneys’ fees to the plaintiff if there was no basis for removal.

One of the most frequently litigated issues in the remand context is “fraudulent
joinder.” Fraudulent joinder occurs when a plaintiff has named an in-state party as a
defendant solely for the purpose of destroying complete diversity and defeating removal,
and not because the plaintiff has a legitimate claim for relief against that defendant. In
the franchise context, fraudulent joinder issues arise when a franchisee brings a state
court action not only against the franchisor but also against an in-state employee or local
development agent of the franchisor or even a neighboring fellow franchisee in order to
thwart the franchisor’s ability to remove the case to federal court. Generally speaking, a
franchisor that removes a case under those circumstances, claiming fraudulent joinder,
will have difficulty avoiding a remand to state court unless it can establish that the
franchisee’s claim against the alleged fraudulently joined in-state defendant is without any
legal merit on its face.

d. Forum-Selection Clauses

Most franchise agreements contain forum-selection clauses which provide that all
disputes, or at least certain types of disputes, between the franchisor and franchisee
either are required to be, or are permitted to be, filed in a state or federal court in the
franchisor’s home state. Some franchisors utilize mandatory forum-selection clauses that
require all franchisee claims to be brought in the franchisor’s chosen forum but reserve
the right to sue their franchisees in the franchisees’ home state courts for particular types
of claims, such as enforcing post-termination trademark rights or non-compete covenants.
Some franchisors believe that injunctive relief obtained from a court in the franchisee’s
home state will be quicker and easier to enforce than an injunction from a court in the
franchisor’s home state. Also, franchisors who choose to file suit in their franchisees’
home state courts for preliminary injunctive relief, for example, can usually also avoid
time-consuming and costly battles on forum issues.

Forum-selection clauses in franchise agreements give rise to a number of
frequently litigated issues, including (1) whether the clause is mandatory or permissive,
(2) whether the clause covers the claims at issue, (3) whether the clause is enforceable,
and (4) how much weight a federal court should give to the parties’ choice of forum when
deciding whether to transfer a case for convenience purposes from the federal court in
the franchisee’s home state to the federal court in the franchisor’s home state, as
designated in the clause, or vice versa.

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9, 2010).
i. Permissive vs. mandatory forum-selection clauses

Forum-selection clauses come in two basic types: permissive and mandatory. A permissive clause authorizes the parties to file suit in a designated forum (a state or federal court in a particular state, or both) but does not prohibit them from filing suit in a different forum. A mandatory clause, on the other hand, prescribes the exclusive forum for litigation. Because, in the absence of a forum-selection provision, statutory venue for most franchisor-franchisee disputes is proper both where the franchisor resides and where the franchisee resides (at least in federal court), there is usually little reason for franchisors to include permissive forum-selection clauses in their franchise agreements—with the one exception mentioned above, when franchisors include a permissive venue clause for injunction actions in the franchisee’s home state. Thus, most of the venue cases in the franchise context that turn on the mandatory/permissive distinction are probably examples of careless drafting, where the franchisor intended to have the courts in its home state be the exclusive venue for all disputes.8

ii. Scope of forum-selection clauses

Forum-selection clauses can be drafted narrowly, applying only to specific types of claims, or can encompass all claims arising under or relating to the franchise agreement or the parties’ franchise relationship. Courts typically will interpret a broad forum-selection clause to cover both contract and tort claims that arise out of or implicate the franchise agreement in any way.9 Since most franchisors draft their forum-selection clauses as broadly as possible to cover all conceivable types of franchisee (and franchisor) claims, litigation over the scope of forum-selection clauses is relatively rare. One scope issue that does rise with some frequency, however, is whether a forum-selection provision in a franchise agreement applies to claims arising under an ancillary agreement between the franchisor and franchisee—such as a guarantee or lease—that does not contain its own forum-selection provision or contains a different provision.10 Ultimately, resolution of this issue turns on the intent of the parties as reflected in their various agreements or their contemporaneous communications.

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8 See, e.g., Cluck-U Chicken, Inc. v. Cluck-U Corp., No. 8:15-CV-2274-T-23MAP, 2016 WL 1588677 (M.D. Fla. Apr. 20, 2016) (holding that forum-selection clause under which parties “consent to jurisdiction and venue in the Circuit or District Court of Prince Georges’ County” was permissive and not mandatory since it “neither command[ed] venue in that county nor exclude[d] venue elsewhere”). There have been a considerable number of cases in the forum-selection clause context that discuss the distinction between a clause specifying that all disputes will be resolved in the courts of a particular state and a clause providing that all disputes will be resolved in the courts in a particular state. A number of courts have held that since federal courts are not courts of a particular state but rather courts of the United States of America, the parties’ agreement to limit venue to the courts of a particular state means that the state court chosen was the exclusive venue for resolution of the parties’ disputes, preventing removal by the defendant. See, e.g., American Soda, LLP v. U.S. Filter Wastewater Group, Inc., 428 F. 3d 921 (10th Cir. 2005).


iii. Enforceability of forum-selection clauses

Forum-selection clauses are presumed to be valid and enforceable, and the party challenging enforcement of the clause bears a heavy burden of proof.\(^\text{11}\) Federal law, which governs the enforceability of forum-selection clauses in diversity cases, recognizes only three exceptions to their enforceability: (1) the inclusion of the forum-selection clause in the agreement was the product of fraud or overreaching; (2) the party challenging enforcement will, for all practical purposes, be deprived of its day in court because of the inconvenience or unfairness of the selected forum; and (3) enforcement of the forum-selection clause would contravene a strong public policy of the forum state.\(^\text{12}\) To invalidate a forum-selection provision in a franchise agreement based on fraud, the fraud must be directed to the provision itself and not merely to the underlying franchise agreement.\(^\text{13}\)

It is rare for a franchisee to successfully challenge a forum-selection clause on the basis of fraud, because the language itself of an unambiguous forum clause is almost always sufficient to defeat a claim that the franchisor represented that the clause meant something different than what it says on its face or that the franchisor would not enforce it. Likewise, it is difficult for franchisees to meet the high threshold of inconvenience or unfairness of litigating in an out-of-state court that is required to invalidate a forum-selection clause. The franchisee must essentially show that it cannot afford to litigate its claims in the contractually chosen forum, but that it can afford to litigate its claims if the case proceeds in the forum where the case was filed.

Franchisees have had the most success challenging forum-selection clauses on the ground that they contravene a strong public policy of the forum state. Approximately 15 states, including California, Illinois, Michigan, Minnesota and Rhode Island, have franchise statutes or regulations that render void a provision in a franchise agreement requiring the franchisee to litigate certain claims in an out-of-state forum. Franchisees have successfully relied on these types of statutes and regulations to nullify forum-selection clauses requiring them to litigate in an out-of-state franchisor’s home state.\(^\text{14}\) Of course, these statutes and regulations do not necessarily guarantee the franchisee an in-state forum; they simply preclude the franchisor from relying on the forum-selection clause to place venue in the franchisor’s home state. Many of these state statutes exempt from their coverage agreements to arbitrate that specify the out-of-state franchisor’s home state as the locale for arbitration in deference to long-standing Supreme Court precedent in the franchise context that state legislative attempts to restrict enforcement of arbitration agreements in this way violate the Federal Arbitration Act and run afoul of the Constitution’s Supremacy Clause.\(^\text{15}\)

\(^{12}\) See id.
\(^{13}\) See, e.g., Moses v. Business Card Express, 929 F.2d 1131 (6th Cir. 1991).
\(^{14}\) See, e.g., Jones v. GNC Franchising, Inc., 211 F.3d 495 (9th Cir. 2000).
e. Transfer of venue

When a franchisee files suit in a federal court other than the court specified in the forum-selection clause (or files suit in its home state court and the case is then removed by the franchisor to federal court), the federal court may dismiss the case on forum non conveniens grounds for failure to comply with the forum-selection clause. It is far more likely, however, that the court will transfer the case to the federal court specified in the forum-selection provision under 28 U.S.C. § 1404(a), assuming that the convenience and public interest factors mentioned in that statute weigh in favor of a transfer. These factors include the convenience of the parties and witnesses, the availability of the subpoena power over third-party witnesses, the place where the agreements were entered into, the location of the dispute, the transferor and transferee courts’ familiarity with the governing law, the relative financial means of the parties, the plaintiff’s choice of forum, the relative court congestion and time to trial of the two courts, any public policy of the forum state embodied in a franchise statute or elsewhere regarding the preservation of an in-state forum for its residents, and whether the parties’ forum-selection clause is mandatory or permissive.

In 2013, the United States Supreme Court, in *Atlantic Marine Construction Co. v. U.S. District Court for the Western District of Texas*¹⁶, clarified how the Section 1404(a) factors should be weighed when there is a valid forum-selection clause present. The Supreme Court observed that valid forum-selection clauses “should be given controlling weight in all but the most exceptional cases,” and that when the parties have agreed on a forum in their agreement, the plaintiff’s choice of forum and the other “convenience” factors are not entitled to any weight. Only the public interest factors, like court congestion and the interest in having the trial of a diversity case in a forum that is at home with the applicable law, can be considered in the Section 1404(a) balancing test. One issue that the Supreme Court’s analysis left unresolved is how to treat a public policy embodied in a state’s franchise statute that protects the franchisee’s right to an in-state forum, such as under the California Franchise Relations Act, which some pre-*Atlantic Marine* courts, particularly those in California, have found outweighs the parties’ contractual choice of forum.¹⁷ Some courts have held that such a statute renders the forum-selection clause invalid at the outset and that therefore the clause does not need to be considered in the Section 1404(a) analysis, at least where the lawsuit originated in the forum whose public policy is at issue, whereas other courts have dealt with the statutory public policy issue in the context of the Section 1404(a) public interest factors.¹⁸

f. Choice of law clauses

Most franchisors include choice of law clauses in their franchise agreements specifying that the law of the franchisor’s home state will govern. Franchisors do this for

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¹⁷ See, e.g., Jones v. GNC Franchising, Inc., 211 F.3d 495 (9th Cir. 2000).
a number of reasons, including familiarity with their home state’s law, the desire to avoid application of franchisee-protective laws in their franchisees’ home states, and the need for nationwide uniformity and predictability in their legal relationships with franchisees. Franchisors who are located in states with franchisee-protective statutes that still want to choose their own state’s law to govern sometimes carve out particular issues from a general choice of law clause and provide for the franchisee’s home state law to apply to those issues. California-based franchisors, for example, may utilize California choice of law clauses but specify that post-term non-compete covenants will be governed by the law of the franchisee’s home state to avoid having those covenants invalidated under California law. Similarly, franchisors may provide in their choice of law clauses that their home state’s franchise relationship or disclosure law will not apply unless the jurisdictional requirements of that law are met independently of the choice of law clause. This avoids having a franchisee-protective law in the franchisor’s home state apply to an out-of-state franchisee who may otherwise not be covered by the statute.

Under the test utilized in most jurisdictions, choice of law clauses will generally be enforced unless (1) the chosen state’s law has no reasonable relationship to the parties’ agreement and there is no other reasonable basis for the parties’ choice of law, or (2) application of the chosen law would violate a fundamental public policy of the state with the greater interest in the determination of the issue. Most choice of law litigation in the franchise context involves issues related to the scope of the clause—i.e. whether the clause covers contract or statutory and tort claims as well—or to the enforceability of the clause in the face of a contrary public policy of the franchisee’s home state.

i. **Scope of choice of law clauses**

A choice of law clause can be narrow in scope, for example, providing only that the franchise agreement be “interpreted” under a particular state’s law, or specifying that the chosen law apply only to disputes “based on” or “arising under” the contract. Alternatively, a choice of law clause can be broad in scope, providing that the franchise agreement be “interpreted, governed by, and construed in accordance with” a particular state’s law, or specifying that the chosen law will apply to all claims “arising under, related to or concerning” the franchise agreement. The breadth of the choice of law clause will usually determine whether claims other than straightforward breach of contract claims, such as alleged violations of state franchise or deceptive trade practices statutes, are governed by the chosen state’s law. In some cases, even contract-based torts, such as fraud in the inducement of the franchise agreement, have been held to fall within the scope of a broad choice of law clause. For most tort claims, however, courts will apply the law of the place where the tortious conduct occurred or where the alleged harm was sustained.

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19 Restatement (Second) of Conflicts of Laws, § 187.
ii. Enforceability of choice of law clauses

As noted above, almost all choice of law clauses in franchise agreements select the law of the state where the franchisor is incorporated or has its principal place of business, and in some cases choose the law of the franchisee's residence or place of business to govern specific issues like non-compete covenants to avoid application of a franchisee-protective law of the franchisor's home state. As a result, it is relatively rare for a choice of law clause to be challenged on the ground that it does not bear a reasonable relationship to the parties' agreement. Even in cases where the choice of law clause specifies the law of the franchisor's home state and the franchisor then relocates its headquarters to another state, courts generally will still enforce the choice of law clause, either because a reasonable relationship to the parties' agreement existed at the time of contracting or because there is a reasonable basis (e.g., consistency of application) for the parties to choose one state's law to govern their relationship.21

The vast majority of challenges to the enforceability of choice of law clauses in the franchise context are based on the argument that the clause violates a strong public policy of the franchisee's home state, most often embodied in a state franchise disclosure or relationship statute. Many of these statutes address the enforceability of choice of law clauses. Some do so directly, by declaring void and unenforceable choice of law clauses that specify the application of another state's law.22 Others do so indirectly, by invalidating any provision in a franchise agreement that purports to require a franchisee to waive any of the protections of the statute.23 Because a franchisee would lose the protections of its home state's franchise relationship or disclosure law if the choice of law clause were enforced—assuming its home state's franchise law is more protective than the chosen state's franchise law, if the latter even exists—the clause is rendered void by virtue of this statutory anti-waiver provision. Franchisees have generally been successful in avoiding the application of a choice of law clause where their state franchise disclosure or relationship statutes contain such anti-waiver provisions or specific provisions invalidating choice of law clauses.24 However, some courts have observed that an anti-waiver provision in a state franchise or dealership statute does not necessarily mean that the statute embodies a strong public policy sufficient to override a choice of law clause.25

21 A California state appellate court held that a Washington choice of law clause in an agreement between a Canadian franchisor and a California franchisee was enforceable, even though neither of the parties nor their agreement had any contact with Washington, because there was reasonable basis for the franchisor's selection of the law of a state that was closest to its Canadian headquarters. See 1-800 Got Junk? LLC v. Superior Court of Los Angeles County, 189 Cal. App. 4th 500, 116 Cal. Rptr. 3d 923 (Cal. Ct. App. 2010), as modified (Nov. 19, 2010). In that case, the court may well have been influenced by the fact that it was the franchisor itself that was challenging the validity of its own choice of law provision in an effort to take advantage of California law, which was more favorable than Washington law to the franchisor's position.
23 See, e.g., Ill. Comp. Stat. § 705/41.
25 See, e.g., id.
One pitfall that franchisors may encounter in selecting their own state’s law to govern the franchise relationship is that they may inadvertently adopt a state franchise disclosure or relationship law that would otherwise not apply by its own terms. For example, the California Franchise Relations Act (“CFRA”), by its terms, applies only to franchised businesses operating in California. A California-based franchisor with a California choice of law clause in its franchise agreements, therefore, runs the risk of adopting the CFRA, with its substantial restrictions on termination and non-renewal, to govern its relationships with out-of-state franchisees under circumstances where the statute would otherwise not apply. Several courts have reached this very result under statutes other than the CFRA, despite the fact that the franchisor almost certainly did not intend to have its franchise relationships governed by a franchisee-protective state statute that did not even apply by its own terms.26 This problem can be addressed by including language in the choice of law clause stating that the particular franchise statute at issue does not apply unless its jurisdictional requirements are met independently, without reference to the choice of law provision.

g. Class actions

Franchise claims would appear to be tailor-made for resolution in a class action framework. Franchise systems typically have a substantial number of similarly situated franchisees who operate under uniform franchise agreements, who are subject to system-wide standards of operation, and who have an incentive to aggregate their claims against the franchisor in order to increase their damages recovery and settlement leverage. But other characteristics of the franchise relationship make class actions difficult to maintain. The long-term nature of the franchise relationship gives rise to more individualized issues of liability and damages than, for example, a one-time purchase of a product by a consumer that forms the basis for many class actions. Also, state law breach of contract, tort and statutory claims that franchisees typically assert in the class context give rise to differences in the law to be applied, statutes of limitations, forums where the actions can be brought, limitations on damages, class action waivers, jury waivers and arbitration clauses. Individualized damages issues also make class treatment of franchise claims more problematic. As a result, very few franchisees have been successful in obtaining class certification of claims against franchisors.

Rule 23 of the Federal Rules of Civil Procedure sets out the requirements for obtaining class certification in federal court, which involves a two-step process. First, the proposed class must meet four prerequisites for certification under Rule 23(a), which are known as the numerosity, commonality, typicality, and adequacy of representation requirements. If those prerequisites are met, the proposed class must then satisfy one of the three categories of class action suits in Rule 23(b).

Generally speaking, putative franchisee classes have not had much difficulty satisfying the four prerequisites to class certification under Rule 23(a). Because most courts will assume that the numerosity requirement is satisfied if the proposed class has

more than 40 members, it is fairly easy for a proposed franchisee class to satisfy Rule 23(a)(1)’s requirement that the class be “so numerous that joinder of all members is impracticable.” Likewise, franchisees can rather easily satisfy the commonality requirement of Rule 23(a)(2) that there be “questions of law or fact common to the class,” because this requirement is satisfied if even a single issue of law or fact is common to all class members. Franchisees also will have little difficulty meeting the typicality requirement of Rule 23(a)(3), which requires that the “claims or defenses of the representative parties are typical of the claims or defenses of the class,” as long as franchisees do not designate multiple class representatives whose individual claims are not typical of the entire class.

The fourth prerequisite for class certification—the adequacy of representation requirement of Rule 23(a)(4), which asks whether the named parties (and their counsel) will adequately represent the interests of the unnamed and absent class members—is the only one that has presented a significant hurdle for franchisees. The problem arises when different groups within the proposed class of franchisees have conflicts of interest regarding the appropriate form of relief to be sought by the class. For example, if the proposed class includes both current and former franchisees, the current franchisees, because they have an interest in the continued viability of the franchise system, may prefer injunctive relief, whereas former franchisees may be interested only in a large damages recovery even if it means the end of the franchise system. Similarly, if the proposed class members’ franchise agreements permit differing types of remedies or differing amounts of damages, those differences may also create an impermissible conflict of interest.

As noted above, if the proposed franchisee class satisfies the four prerequisites to class certification, the proposed class must then fall within one of the three types of class actions maintainable under Rule 23(b). Virtually all of the putative franchisee class actions have arisen under the “predominance” category in Rule 23(b)(3), which provides for class certification where “the court finds that the questions of law or fact common to class members predominate over any questions affecting only individual members, and that a class action is superior to other available methods for fairly and efficiently adjudicating the controversy.” Generally speaking, the more that common issues of law or fact predominate over issues affecting only individual class members, the more likely it is that a court will find the class action to be a superior method for resolving the claims. Franchisors frequently challenge class certification under Rule 23(b)(3) by attempting to show that the franchisees’ causes of action require highly individualized factual determinations on liability or damages, or both, and that these individual issues predominate over issues common to the class. Still, franchisees in a few cases have been successful in certifying a class under Rule 23(b)(3) where their breach of contract claims were premised on the same contract terms and the same conduct by the franchisor constituting the breach.27 Of course, satisfying the predominance requirement for breach of contract claims becomes more difficult if the contract provisions at issue vary to some degree from year to year or franchisee to franchisee, or if the franchisor did not engage

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in a single course of conduct in breaching the franchise agreements, or if claims are governed by the laws of multiple states.

While franchisee breach of contract claims may lend themselves well to class treatment, tort claims, particularly fraud or negligent misrepresentation claims, are not well suited for class certification because in most cases varying representations are made to each individual class member. In addition, the circumstances of each franchisee’s actual and reasonable reliance on the franchisor’s representations are likely to vary depending in part on the amount of information known or reasonably available to each franchisee regarding the subject matter of the representations. However, one court certified a class of franchisees asserting misrepresentation claims based in part on the fact that the franchisor had utilized the same PowerPoint demonstration and provided the same documents to each franchisee at a series of meetings to induce them to sign a new form of franchise agreement, the franchisees had all signed the same form of agreement, and the franchisees had all done so within a three-week period of attending the meetings and receiving the franchisor’s documents, creating an inference of reliance on the same representations by all of the class members.28

Finally, franchisees’ claims for damages may be too individualized for class treatment under Rule 23(b)(3). In evaluating whether damages claims meet the test for predominance and superiority, courts generally focus on whether there is a disparity in the nature of the damages claims or the evidence supporting the claims, not the amount of damages sought by each class member. Courts are reluctant to grant certification where the damages cannot be determined by a mere mechanical calculation but require “separate mini-trials” of individual damages claims. As a result, franchisees may have difficulty satisfying the predominance and superiority test in relation to damages claims, especially if franchisees are seeking lost profits damages, because the circumstances of each franchisee are likely to vary widely in terms of the location of the franchisee’s business, the management of the franchisee’s business, and local economic conditions.

h. Franchise association actions

In addition to class actions, franchisees may seek relief collectively or on a system-wide basis through the vehicle of a franchisee association. Since these associations are not parties to the franchise agreement and rarely are directly harmed by the franchisor’s conduct, in most cases they seek relief only on behalf of their franchisee members and therefore must satisfy the subject-matter jurisdictional requirement of “associational standing” to file suit in state or federal court. The Supreme Court has established a three-part test for associational standing, under which an association must demonstrate (1) that one or more of its members have suffered harm and thus have standing to sue in their own right; (2) that the interests the association seeks to protect are germane to its purpose; and (3) that neither the claim asserted nor the relief requested requires the participation of individual members in the lawsuit.29

Franchisee associations usually have little difficulty satisfying the first two prongs of this test. However, they have not fared as well under the third prong, which focuses on the extent to which individual members of the association will need to provide evidence on the issues of liability or the type of relief sought. As a general rule, courts are more likely to hold that an association has standing where the association seeks only equitable relief, such as a declaratory judgment or an injunction, rather than damages, since damages usually require individual proof of causation and amount. Similarly, courts are more inclined to find that a franchisee association has standing to pursue claims on its members’ behalf if the claims are based on a uniform franchise agreement provision and a single course of conduct by the franchisor. Because standing is a subject-matter jurisdictional requirement, a court may revisit the issue of associational standing at any point in the lawsuit. Thus, even if a court denies a franchisor’s challenge to associational standing at the outset of a case, discovery or other subsequent developments may expose the need for extensive individual franchisee participation in the lawsuit and therefore justify dismissal on standing grounds at a later stage of the case.

One unresolved issue is whether a franchisor whose franchisees are all obligated on an individual basis to arbitrate disputes with the franchisor can meet the associational standing test or whether, by definition, the franchisees cannot satisfy the third prong of the test because their individual participation is necessary as a result of agreeing to arbitrate disputes with the franchisor on an individual basis.

5. Pre-Trial Procedural Matters and Other Considerations
   a. Enforcing arbitration provisions

As noted above, arbitration continues to be a preferred method of resolving disputes for many franchisors. Generally speaking, that is because arbitration is considered by most practitioners to be a quicker, more efficient and less expensive way to resolve disputes than litigation. Over time, however, arbitration has taken on many of the characteristics traditionally associated only with litigation, such as dispositive motion practice, expanded discovery (including fact witness depositions and expert disclosures and depositions), and extensive pre- and post-hearing briefing. These characteristics often diminish or eliminate altogether the perceived benefits of economy and efficiency in arbitration. Still, many franchisors continue to include arbitration clauses in their franchise agreements to eliminate the possibility of a catastrophic result in a jury trial or a class action lawsuit, as well as to minimize the risk that an adverse result in litigation will be taken advantage of by other franchisees in the system.

31 See, e.g., National Franchisee Ass'n v. Burger King Corp., 715 F. Supp. 2d 1232 (S.D. Fla. 2010) (rejecting a franchisor’s challenge to associational standing on the grounds that there was only one form of franchise agreement at issue and that the issue for determination—whether the franchisor had exercised its discretion in good faith in imposing a maximum price on a particular menu item—was focused primarily on the franchisor’s decision-making process and not its effect on individual franchisees).
Franchisees, on the other hand, typically dislike arbitration because it involves much more out-of-pocket expense than litigation for filing fees and arbitrator compensation; arbitrators are perceived as being much less favorably disposed than juries to franchisee claims; arbitration agreements often specify an out-of-state hearing locale that, as noted above, is more immune to attack than a litigation forum-selection clause; and arbitration agreements often prohibit the franchisee from bringing its claims on a consolidated or class-wide basis.

These sharply divergent views of arbitration produce a great deal of litigation between franchisors and franchisees over the enforcement of arbitration agreements. This litigation falls into two basic categories: (1) challenges by franchisees to the arbitrability of particular disputes based on the language of the arbitration clause, including whether a court or an arbitrator is the proper decision-maker to determine the issue of arbitrability, and (2) challenges by franchisees to the enforceability of arbitration clauses based on common law defenses such as fraud or unconscionability or the franchisor’s waiver of the right to arbitrate by initially pursuing claims or defenses in a judicial forum. Procedurally, these challenges to arbitration occur in the context of a motion to compel arbitration and/or stay litigation brought by the franchisor in response to a franchisee’s lawsuit in state or federal court, an independent action to compel arbitration brought by the franchisor in federal court in the same district where the arbitration agreement specifies that the arbitration hearing will be held, or a lawsuit filed by the franchisee to stay an arbitration proceeding brought by the franchisor.

i. Scope of arbitration clauses

The scope of an arbitration clause—whether the clause covers the dispute at issue—is generally an issue for the court to decide unless the parties have “clearly and unmistakably” delegated that issue to the arbitrator. The Supreme Court has long held that the Federal Arbitration Act, which governs arbitration agreements in all franchise relationships between franchisors and franchisees located in different states, requires that as a matter of federal law “any doubts regarding the scope of arbitrable issues should be resolved in favor of arbitration.” As a result, arbitration clauses are to be construed broadly, and arbitration should not be denied “unless it may be said with positive assurance that the arbitration clause is not susceptible of an interpretation that covers the asserted dispute.” Given this strong presumption of arbitrability, courts narrowly construe carve-outs or exceptions to an arbitration clause.

The issue of the scope of an arbitration clause involves not only which substantive claims of the franchisor and franchisee under the franchise agreement are required to be arbitrated, but also whether claims under related agreements (such as guarantees, leases or supply agreements) are subject to arbitration. In light of the strong presumption of arbitrability.

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35 See Armijo v. Prudential Ins. Co., 72 F.3d 793, 800 (10th Cir. 1995).
arbitrability, courts often will conclude that tort claims that relate to the parties’ franchise relationship are arbitrable, as are claims that arise under ancillary agreements between the franchisor and franchisee that do not contain their own arbitration clauses.

Another scope issue that has received increasing attention of late is whether the court or the arbitrator should decide the arbitrability of a particular dispute or the enforceability of the arbitration agreement itself. As a general rule, courts decide scope issues and challenges to the enforceability of an arbitration agreement itself while arbitrators address challenges to the enforceability of the underlying agreement containing the arbitration clause. However, if the parties “clearly and unmistakably” indicate in their arbitration agreement that the issue of arbitrability or enforceability of the arbitration agreement itself is for the arbitrator to decide, courts will honor that agreement, which essentially permits the arbitrator to determine his or her own jurisdiction to decide the dispute. Some courts have held that the existence of a very broad arbitration clause covering any and all disputes between the parties arising out of or relating to their agreement, coupled with the incorporation of the procedural rules of an arbitral organization (e.g., the American Arbitration Association) that expressly provide that the arbitrator has the power to rule on his or her own jurisdiction, including issues relating to the existence, scope or validity of the arbitration agreement, is sufficient to require scope or enforceability issues to be decided by the arbitrator.36

ii. Enforceability of arbitration clauses

Under Section 2 of the Federal Arbitration Act, arbitration agreements are “valid, irrevocable and enforceable, save upon such grounds as exist at law or in equity for revocation of any contract.”37 This means that while common law defenses to any type of contract, such as fraud, unconscionability, or lack of mutuality, can render an arbitration clause unenforceable, a state may not pass a law that specifically targets arbitration agreements for unfavorable treatment. Moreover, as noted above, the defense of fraud or unconscionability or the like must be directed at the arbitration clause itself and not merely at the contract as a whole. As a result, franchisees have had very little success in challenging the validity of arbitration clauses based on fraud in the inducement of the arbitration agreement, because the plain language of the arbitration agreement usually will defeat any argument that the franchisee did not understand the agreement or was misled regarding its legal effect.

Franchisees have had considerably more success challenging arbitration agreements on the basis of unconscionability, particularly in California and the Ninth Circuit. Under the common law of most states, the defense of unconscionability requires both procedural and substantive unconscionability, focusing on the unfairness of the process by which the parties reached their agreement to arbitrate as well as the unfairness of the particular substantive terms of that agreement. Courts that have invalidated arbitration agreements on unconscionability grounds have cited such factors as the relative disparity in bargaining power between the franchisor and the franchisee,

the take-it-or-leave-it nature of the franchise agreement, the expense and unfairness of requiring the franchisee to arbitrate in a distant forum, and the substantial out-of-pocket expenses for filing fees and arbitrator compensation in comparison to the relatively modest out-of-pocket costs of filing and maintaining a lawsuit.\textsuperscript{38}

While franchisees historically have used state unconscionability principles to challenge the enforceability of class action waivers in arbitration clauses, in 2011 the United States Supreme Court, in \textit{AT&T Mobility LLC v. Concepcion},\textsuperscript{39} held that those waivers were enforceable because the California doctrine of unconscionability at issue in that case, at least as applied to the issue of class action waivers, was not a ground that applied to invalidating contracts generally in California.

Some franchise agreements are silent on the issue of whether class actions are permitted in arbitration proceedings, giving rise to the issue of whether the parties intended to permit class actions in arbitration. Prior to 2010, the general rule was that when an arbitration clause was silent on whether a class action was permissible in an arbitration proceeding, the arbitrator and not the court decided whether a franchisee could pursue relief on behalf of a class. Perhaps not surprisingly, arbitrators presented with the opportunity of presiding over substantial class action arbitrations were regularly finding that silence in the parties’ arbitration agreement did not preclude a class action in arbitration. In 2010, the Supreme Court fundamentally changed the rule and held that an arbitration agreement that was silent on class arbitration could not be construed by an arbitrator to authorize a class action, at least not without some other extrinsic evidence of the parties’ intent to permit class arbitrations.\textsuperscript{40}

\textbf{b. TROs and preliminary injunctions}

Both franchisors and franchisees occasionally have reason to seek emergency relief in the form of temporary restraining orders (“TROs”) and/or preliminary injunctions in the course of litigating or arbitrating their disputes. Franchisors typically seek TROs or preliminary injunctions to enforce post-termination contractual obligations like trademark de-identification and compliance with non-competition or non-solicitation covenants, to prevent post-termination use of their trademarks or other types of unfair competition under the Lanham Act, and to compel franchisees’ compliance with system standards, particularly in cases where public health or safety or the franchisor’s goodwill are affected. Franchisees often seek TROs or preliminary injunctions to prevent a termination from becoming effective and triggering their post-termination obligations.

Until a few years ago, TROs and preliminary injunctions were effectively available only from a court and not from an arbitrator or arbitration panel because of the practical impossibility of having a single arbitrator or a panel of arbitrators chosen and appointed in time to grant meaningful emergency relief. However, in 2013, the American Arbitration Association amended its Commercial Arbitration Rules to provide a mechanism for parties

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\textsuperscript{38} See, e.g., Nagrampa v. MailCoups, Inc., 469 F.3d 1257 (9th Cir. 2006) (en banc).
\textsuperscript{39} 563 U.S. 333 (2011).
\end{flushleft}
to obtain TROs or preliminary injunctions within a matter of a few days through the administrative appointment of an arbitrator designated solely for the purpose of hearing applications for emergency relief and granting interim awards. These emergency relief procedures apply only to arbitration agreements entered into on or after October 1, 2013. It remains to be seen how often these emergency relief procedures are utilized or how well they work in practice, since an interim award granting a TRO or preliminary injunction, just like any other arbitration award, is not self-enforcing (like a court order would be) unless and until it is confirmed by a court, and the process of seeking court confirmation of non-final arbitration awards granting emergency relief can be time-consuming.

In the termination context, a race to the courthouse often ensues between the franchisor and franchisee, with dueling motions filed for emergency relief. In many of those cases, each side will seek emergency relief in its home state court, which adds a layer of complexity to the dispute, since one or both courts may have to decide issues of venue and choice of law, or determine whether the “first-filed” rule requires dismissal or abstention, before even addressing the merits of either party's request for a TRO or preliminary injunction.

In many cases, the grant or denial of a preliminary injunction, either upholding the franchisor’s right to terminate or affirming the franchisee’s right to continue operating its franchised business and using the franchisor’s trademarks pending a trial on the merits, will effectively end the litigation, since it is generally quite difficult to persuade a court or arbitrator to reach a different result once the merits are presented at trial. As a result, franchisors and franchisees are well advised to treat the preliminary injunction phase as effectively the best and last opportunity to persuade the trier of fact that they have a likelihood of succeeding on the merits of their claims that the balance of hardships weighs decisively in their favor.

c. Pre-trial and pre-hearing motion practice

Like most commercial litigation, franchise litigation typically involves a significant amount of pre-trial (or pre-hearing) motion practice. Among the most common pre-trial motions brought by franchisors in response to franchisee claims, in addition to motions to compel arbitration or stay proceedings pending arbitration discussed above, are (a) motions to dismiss or transfer based on a mandatory forum-selection clause in the franchise agreement; (b) motions to dismiss statutory or common law claims based on statutory or contractual statute of limitations provisions or choice of law provisions; (c) motions to dismiss statutory or common law fraud or negligent misrepresentation claims based on contractual integration or “no-reliance” provisions; and (d) motions to dismiss breach of express or implied contractual claims based on the absence of an express obligation under the franchise agreement or, in the case of a claim for breach of the implied covenant of good faith and fair dealing, the existence of an express provision of the contract that contradicts the alleged implied good faith obligation.

From the franchisee’s perspective, among the most common pre-trial motions brought in response to franchisor claims are (a) motions to dismiss or transfer to the
franchisee’s home state court based on convenience of the parties and witnesses and the interests of justice under Section 1404(a) of the federal venue statute;\footnote{28 U.S.C. § 1404(a).} (b) motions to dismiss based on the unenforceability of in-term or post-term non-competition covenants; and (c) motions to dismiss based on the franchisor’s failure to comply with contractual or statutory notice and opportunity to cure provisions in connection with a franchise termination.

If the franchisor’s or franchisee’s motion to dismiss is denied because material issues of fact are found to be in dispute, motions for summary judgment can be filed after discovery has concluded in an attempt to dispose of the claims before trial. Franchisors have found considerable success in obtaining summary judgment on franchisee claims for common law or statutory fraud in the sale of a franchise by relying on contractual disclaimers and no-reliance clauses and on franchisee claims for wrongful termination, where the undisputed facts demonstrate that the franchisee has breached a material provision of the franchise agreement and failed to timely cure the breach.

As already noted, pre-hearing dispositive motion practice is far less common in arbitration proceedings, both because historically the rules of the various arbitration providers did not expressly authorize those types of motions to be brought and because the general feeling among arbitrators was that dispositive motion practice was incompatible with the more informal nature of arbitration and the arbitration goals of speed and economy. However, since the rules of the American Arbitration Association now expressly provide that arbitrators may entertain motions to dismiss or motions for summary judgment, the use of these motions will undoubtedly increase in the years to come.

d. Discovery in franchise litigation

The discovery process in franchise litigation is much the same as it is in other types of commercial disputes, typically featuring comprehensive document requests by both sides, written interrogatories, requests to admit, depositions of the parties and non-party witnesses, subpoenas for document production from third parties, and motions to compel compliance with discovery requests. In some cases, one or both sides may utilize expert witnesses, principally for establishing economic damages but occasionally also to prove custom and practice in the franchise industry. Generally speaking, the burden of producing documents and witnesses for deposition falls more heavily on the franchisor than the franchisee, because franchisors typically generate and retain more documents than their franchisees and because in most cases there are considerably more franchisor representatives who have dealt with the individual franchisee and therefore have relevant knowledge of the issues in dispute than there are employees of the franchisee who may have such knowledge.

The topics of discovery in franchise litigation matters obviously depend on the particular claims at issue, and a discussion of those discovery topics is beyond the scope of this paper. But one discovery issue that arises fairly frequently in franchise litigation
and merits attention is whether a franchisee may obtain discovery on the franchisor’s treatment of other similarly situated franchisees, primarily for the purpose of demonstrating whether that treatment was more lenient vis-à-vis other franchisees. Franchisees seek discovery of this evidence for a number of different reasons. They may want to show that the franchisor’s failure to enforce a particular contractual provision against other franchisees amounts to a waiver of the franchisor’s right to enforce that same provision against them, or that the contractual provision at issue is not material in light of the franchisor’s failure to enforce it under similar circumstances against other franchisees. They may even try to establish that the franchisor’s selective enforcement of the contract provision is indicative of a bad faith or opportunistic motive on the franchisor’s part, particularly in the termination context. Finally, a number of state franchise statutes expressly prohibit unfair discrimination by franchisors in the fees they charge to franchisees or more generally in their treatment of franchisees.

Franchisors often resist such discovery, both because it is intrusive and because it can be very burdensome to comply with. In some cases, franchisors can rely on provisions in their franchise agreements in which the franchisee acknowledges that agreements with other franchisees may include different terms or may include the same terms and be enforced differently, or a provision that states that the franchisor’s waiver of a right to enforce a particular term of the franchise agreement with respect to one franchisee does not constitute a waiver of that same right as to another franchisee. In addition, franchisees generally cannot excuse their own non-performance by pointing to the non-performance of other franchisees. Nonetheless, courts have come to opposite conclusions in deciding whether discovery of the franchisor’s differing treatment of other franchisees or its selective enforcement of particular franchise agreement terms is allowable. Given the broad standards applicable in the discovery process and the courts’ general reluctance to make relevance determinations at the discovery stage, discovery of a franchisor’s differing treatment of other franchisees may be permitted even if that discovery is ultimately deemed inadmissible at trial or on summary judgment. In the meantime, however, the burden of complying with such requests can be extremely burdensome for franchisors, particularly those with large networks of franchisees.

### e. The use of experts in franchise litigation

The use of damages or economic experts is fairly common in franchise litigation, particularly when the franchisee seeks to recover lost profits resulting from a wrongful termination of the franchise or from the establishment of a nearby competing franchise in breach of the franchisee’s territorial exclusivity rights. By the same token, franchisors sometimes use damages experts to prove claims for lost future royalties in the case of a

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42 See, e.g., *Original Great American Chocolate Chip Cookie Co. v. River Valley Cookies, Ltd.*, 970 F.2d 273 (7th Cir. 1992) (observing that “the fact that [the franchisor] may have treated other franchisees more leniently is no more a defense to breach of contract than laxity in enforcing the speed limit is a defense to a speeding ticket”).

43 See, e.g., *Cohn v. Taco Bell Corp.*, 147 F.R.D. 154 (N.D. Ill. 1993) (allowing requested discovery concerning other franchisees on the ground that it is potentially indicative of bad faith); *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999) (affirming denial of discovery with respect to the franchisor’s treatment of other franchisees).
franchisee’s abandonment of the franchised business or decision to break away from the system and operate independently, although in many of those cases franchisors rely on internal personnel such as CFOs or controllers to present that expert testimony.

Franchisors and franchisees are increasingly using expert witnesses to testify on the issue of custom and practice in the franchise industry, particularly in the areas of franchise disclosure practices and joint employer liability. In the joint employer context, expert testimony is utilized to demonstrate what franchisor controls over trademark use by its franchisees and over other aspects of the franchisee’s business operations are customary in the franchise industry, for purposes of determining whether the franchisor’s controls in question exceeded that industry standard and should give rise to joint employer liability. Some franchisors and franchisees even utilize experts to testify regarding the nature and extent of the legal requirements for disclosure under the FTC Rule 44 and state franchise statutes and regulations, on the theory that the statutes and regulations are sufficiently arcane and vague that the testimony of a franchise disclosure expert would assist the judge or arbitrator in determining what the disclosure laws require and whether the franchisor met those requirements. Not surprisingly, expert testimony on the purely legal issue of what the disclosure statutes and regulations require is permitted more often in arbitration than in court, since judges are more inclined to find that an expert’s opinion on what the law requires is their exclusive province to decide.

6. Substantive Claims and Defenses

a. Frequent franchisor claims and franchisee defenses

   i. Non-compliance 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 non-compliance 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 system standards have been violated, the franchise agreement—which specifies the system standards to be followed and contains the franchisee’s agreement to comply with those standards—should be the first reference.

44 See Section 6(b)(i), infra.
point. System standards, as well as policies and procedures, may also be found in the franchisor’s operating manual (with which the franchise agreement mandates compliance).

Franchise agreements often provide franchisors with several remedies to address a franchisee’s failure to maintain system standards, including the use of the courts. If a franchisor is otherwise trying to maintain the franchise relationship, a franchisor can seek injunctive relief to require the franchisee to adhere to system standards.\(^{45}\) Alternatively, a franchisor may consider terminating the franchise relationship for violations of system standards. A franchisee’s failure to maintain system standards is a reason frequently included in franchise agreements as a basis for termination (though termination must generally follow a notice and cure period\(^{46}\)). Courts have often held that a franchisee’s failure to maintain system standards constitutes “good cause” for termination, especially for repeat offenders.\(^{47}\) 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 non-compliance as well as the potential use of customer surveys, quality assurance reports, secret shopper reports, audits and/or private investigations.

A franchisor must also provide the franchisee with the requisite notice of a 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. In the notice, the franchisee should be advised of the specific violation or default, the availability of an opportunity to cure and 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 notice of default should be provided 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.\(^{48}\)

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.\(^{49}\) Or it may argue that a course of dealing between the parties has been

\(^{45}\) 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).

\(^{46}\) See Section 6(b)(vii), infra.

\(^{47}\) See Original Great Am. Chocolate Chip Cookie Co., 970 F.2d at 279 (repeated violations of the franchise agreement within 12–month period provided franchisor with “good cause” to terminate franchise under Illinois Franchise Disclosure Act).

\(^{48}\) See Section 6(b)(vii), infra.

\(^{49}\) 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
established that is contrary to the system standard purportedly being violated. It 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 non-compliance as against that franchisee (or that the claimed violation is mere pretext).\textsuperscript{50} By that same token, in the context of an action seeking injunctive relief to enforce system standards compliance, a franchisor's failure to enforce the particular standard with other franchisees can undercut the argument that the franchisee’s actions are causing it irreparable harm. 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 unusually 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 have 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. 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 non-payment 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 position in such cases is that it is not realizing its expected benefit under the contract due to the franchisor’s actions and thus does not have an obligation to pay. However, courts have generally held that such self-help is not allowed,\textsuperscript{51} the underlying rationale being that a franchisee

\textsuperscript{50} But see, e.g., \textit{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); \textit{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, non-waiver 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.

\textsuperscript{51} See \textit{S & R Corp. v. Jiffy Lube Int'l, Inc.}, 968 F.2d 371, 376 (3d Cir. 1992) ("[W]hen one party to a contract feels that the other contracting party has breached its agreement, the non-breaching party may either stop performance and assume the contract is avoided, or continue its performance and sue for damages. Under no circumstances may the non-breaching party stop performance and continue to take advantage of the contract's benefits.").
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. As a result, a franchisee who believes it is not getting the required support from its franchisor can either continue to pay franchise fees and sue for breach based on the franchisor’s failure to provide support, etc., or, it may cease paying the required fees, consider the contract terminated and stop all performance under the franchise agreement (subject to the franchisor’s claims that the franchisee’s termination was improper).


iii. Violation of in-term non-competes

Nearly all franchise agreements contain a covenant against competition, or a non-compete 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 non-compete clauses generally prohibit a franchisee from having any ownership or business interest in a competitive business while it is also a franchisee. A “competitive business” is generally one that offers goods/services that are either identical to or competitive with the goods/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 non-compete 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). Also, a franchisor has a 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.52


iv. Violation of post-term non-competes

In general, post-term non-compete 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 non-compete should be deemed unenforceable because it makes it impossible for the franchisee to continue to work in his or her area of expertise. However, courts (with the exception of California which has deemed them invalid53) generally enforce such restrictive covenants so long as they are reasonable in time and geographic scope and are necessary to protect a

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52 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).

53 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”).
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. A two to three-year period is generally viewed as a reasonable length of time for a post-term non-compete. A reasonable geographic scope is generally held to be a radius between 5 to 25 miles around the former franchised location. 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 reasonable time or geographic limitations, or legitimate business interests. Otherwise, the enforceability of these covenants is primarily a question of state common law, and outcomes can vary. Accordingly, different state statutes and case law make it entirely possible that a restrictive covenant in a franchise agreement could be enforceable in one state but determined to be 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. Absent a choice of law provision, the state law to be applied will usually be that of the state where either the franchisor or the franchisee is located. However, in determining whether to enforce a non-compete clause, courts will also generally look to the laws and public policy concerns of the state in which the franchisee’s business is situated. Accordingly, careful reading of the franchise agreement and the laws of the home states of the franchisee, franchisor and the state specified in the franchise agreement are all required. For example, a franchisor might bring a lawsuit in California to enforce a non-compete clause against a California-based franchisee, under a franchise agreement stating that Pennsylvania law will apply to questions regarding the franchise agreement. Notwithstanding that Pennsylvania law is specified, that California court would likely not enforce the non-compete clause because California’s laws generally deem them unenforceable.

As a franchisor seeking to enforce a non-compete 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 indeed 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; (2) “blue pencil” or strike out only the overbroad parts and keep the rest

54 See Section 4(c), supra.
55 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 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.”).
56 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
(without adding language or changing any terms);\textsuperscript{57} or (3) “red pencil” the provision by deleting the entire restrictive covenant from the franchise agreement, thereby rendering it altogether unenforceable.\textsuperscript{58} Accordingly, it is entirely possible that even if a non-compete 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.\textsuperscript{59}

**v. Holdover franchisees / trademark infringement**

Another common franchisor claim involves a “holdover” franchisee. When a franchise agreement expires or is terminated, the right to use the trademark terminates as well. A franchisee thus has to promptly de-identify 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 its franchised business and to use the franchisor’s trademarks, service marks, trade dress and methods of operation in its business after its contractual right to do so has ended.

When a terminated franchisee continues to use a franchisor’s trademarks, etc., the franchisor must take the matter seriously. In these circumstances, the franchisor is generally forced to obtain a court order to require the former franchisee to comply with its post-termination obligations under the franchise agreement. A franchisee that continues in business using the franchisor’s trademark without authority runs a high risk of liability to a franchisor. Under the Lanham Act, protection against trademark infringement and appropriate injunctive relief restricting competitive activities in an area determined to be reasonable under the circumstances.); \textit{Armstrong v. Taco Time Int’l, Inc.}, 30 Wash. App. 538, 544, 635 P.2d 1114, 1118 (Wash. Ct. App. 1981).

\textsuperscript{57} \textit{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).

\textsuperscript{58} \textit{See, e.g., Unlimited Opportunity, Inc. v. Waadah}, 290 Neb. 629, 634, 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.)

\textsuperscript{59} \textit{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).
counterfeiting is offered to registered trademarks.\textsuperscript{60} 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 that are “likely to cause confusion, or to cause mistake, or to deceive.”\textsuperscript{61} Additionally, Section 43(a) prohibits the use in connection with any goods or services of any word, name or false designation of origin “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.”\textsuperscript{62} Success on such Lanham Act claims turns on whether a name or mark used by a franchisee creates a “likelihood of confusion” with the franchisor’s trademark. Courts have regularly found that where a terminated franchisee continues to use its former franchisor’s trademarks, a strong risk of customer confusion is present.\textsuperscript{63}

For instances of trademark infringement, the Lanham Act permits the recovery of the plaintiff’s actual damages, the defendant’s profits, and (subject to the court’s discretion) treble actual damages suffered by the injured plaintiff.\textsuperscript{64} 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 an injured plaintiff either: (a) treble damages incurred by the plaintiff; (b) treble profits obtained by the defendant due to the counterfeiting; or (c) statutory damages ranging from $1,000 to $2,000,000.\textsuperscript{65}

A franchisee who believes its franchise agreement was wrongfully terminated may attempt to defend its continued use of the franchisor’s trademark on the grounds that it should not have lost its contractual rights to use the trademark in the first instance. As another alternative, a franchisee can claim that its 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.

b. Frequent franchisee claims and franchisor defenses

i. Misrepresentation and unauthorized FPRs

Before investing in a franchise, most prospective franchisees understandably ask how much money they will make if they become a franchisee. However, there are regulations governing the circumstances in which a franchisor may give financial

\textsuperscript{60} 15. U.S.C. § 1501, et. seq.
\textsuperscript{61} 15 U.S.C. § 1114.
\textsuperscript{64} 15 U.S.C. § 1117(a).
\textsuperscript{65} 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.”).
performance information to a prospective franchisee prior to their purchase of a franchise. In order to offer and sell franchises in the United States, compliance with the FTC’s pre-sale disclosure requirements contained in the rule “Disclosure Requirements and Prohibitions Concerning Franchising” (the “FTC Rule”)

is required for non-exempt franchise sales. Under the FTC Rule, franchisors are required to prepare and provide to a prospective franchisee a document containing specific information about the franchisor and the franchise opportunity in the form of a “franchise disclosure document” or “FDD.” The form and content of the FDD is described in the FTC Rule and requires the franchisor to disclose over 20 kinds of financial and business information. However, disclosure about financial performance is optional. If a franchisor wants to be in a position to make financial performance representations (“FRPs”) in connection with the sale of franchises—including discussing historical performance and future performance projections with prospective franchisees—they must be included in the franchisor’s FDD in an Item 19 disclosure. If included in an FDD, Item 19 disclosures must comply with certain requirements, including certain reasonableness and written substantiation requirements. However, disclosure may be made in many formats and present various types of information. If FRPs are not included in an FDD, the franchisor is prohibited from discussing financial performance information with prospective franchisees and from providing any written materials to them that concern financial performance, even informally. The franchisor’s sales representatives or 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.

These FRPs, sometimes referred to as “earnings claims,” include not only what is contained in Item 19 of the FDD, but also information that is not contained in the FDD. This can include information provided in the franchisor’s brochures and advertising materials, on its website, and in verbal representations made by its franchise sellers. FRPs are broadly defined by the FTC to include:

any 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.

FRPs include representations from which a prospective franchisee can infer a specific level or range of income, sales or profits, including “break-even” points. Additionally, assisting a prospective franchisee in preparing a pro forma, commenting on the pro forma, or reviewing a business plan also may qualify as an FRP. However, prospective franchisees can ask existing and former franchisees in the system (listed in Item 20 of the FDD) for information regarding their own historical performance, even if

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66 16 C.F.R. § 436.
67 16 C.F.R. § 436.1(e).
such disclosures are not contained in Item 19. Franchisors can also provide information not included in an FDD if in connection with the re-sale of a franchise by an existing franchisee (but not the re-sale of a company-owned unit). And, mere “puffery,” i.e. a general statement that the 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 Rule. This is irrespective of whether the disclosures are fraudulent, negligent, or innocent. Likewise, misrepresentations and omissions in FPRs provided by franchisors are a separate ground for liability. However, while the FTC has enforcement powers to subject the non-complying party and its officers and directors to injunctions, cease and desist orders, rescission, civil fines, and criminal penalties, there is no right to a private franchisee remedy or cause of action under the FTC Rule.

Some states have their own statutory franchise disclosure rules that provide a right to bring private lawsuits for violation of those requirements.69 For other states, unfair trade practices statutes or “Little FTC Acts”70 can often provide a franchisee with a means to bring suit to address false FPRs. In addition, common law fraud and negligent misrepresentation claims have also long been available to redress material misrepresentations and omissions.71

Based on the foregoing statutory and common law protections, a franchisee may allege that either the franchisor or its representatives made oral representations regarding earnings or that the franchisor provided written materials regarding earnings that were not in an FDD. A franchisor will often defend itself against FPR claims by relying on provisions contained in the franchise agreement, including integration, “no representation” and “no reliance” clauses. The weight afforded to these various defenses varies depending on the jurisdiction and type of claim. For example, certain state disclosure statues have anti-waiver provisions which prohibit franchisors from relying upon the protections of contractual provisions.72 And certain of these affirmative 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.

69 See Section 6(b)(iii), infra.
70 See Section 6(b)(v), infra.
71 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.
72 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 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”).
ii. Franchisor non-compliance with franchise disclosure and/or registration requirements

Claims alleging improper or incomplete disclosure are very common types of franchisee claims. Franchises are regulated and defined by both federal and state law. Federal law regulates how a franchisor can sell franchises; the franchisor’s FDD must disclose various specified information. For example, it must contain disclosures regarding 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. Potential earnings are not required to be disclosed, but can be if the franchisor follows certain guidelines. The FDD also should include a copy of all proposed agreements between the parties, including the franchise agreement the prospective franchisee will be expected to sign to become a franchisee, as well as any applicable leases and purchase agreements. A franchisee must be given the FDD at least 14 days before it signs any contract or pays any money to the franchisor. The FTC Rule applies in all states and creates a minimum standard of disclosure which franchisors nationwide have to comply with. However, states are allowed to provide greater protection and require further disclosures. The FTC Rule only preempts state franchise statutes to the extent the statute does not provide a franchisee with equal or greater protections as the FTC.

The FTC Rule has no registration requirement, and the FTC has no mechanism for filing or registering FDDs. However, in order to offer and sell franchises in certain states, a franchisor must comply with state franchise statutes. These statutes range from requiring filing of an annual notice to comprehensive review of franchise registration applications and a renewal registration application on an annual basis. For example, thirteen states have statutes requiring a franchisor to register its disclosure document with the appropriate state regulatory authority, or obtain an exemption from registration, prior to the offer or sale of franchises in the state.

As noted, there is no private right of action for failure to comply with the FTC Rule. However, a franchisor’s failure to abide by state franchise statutes in these disclosure and registration states does provide the franchisee with a private cause of action against

73 See Section 6(b)(i), supra.
74 See id.
75 16 C.F.R. § 436.5(v).
76 16 C.F.R. § 436.2(a).
77 16 C.F.R. § 436.10(b).
78 The states that require registration are California, Hawaii, Illinois, Indiana, Maryland, Minnesota, New York, North Dakota, Rhode Island, South Dakota, Virginia, Washington and Wisconsin. Wisconsin, South Dakota, and Hawaii 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. 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.
79 See Section 6(b)(i), supra.
the franchisor, and often the franchisor’s officers, directors and managers who assisted in the violations, to recover damages caused by the statutory disclosure and/or registration violations.\textsuperscript{80} Many of these state franchise statutes also contain anti-fraud provisions that prohibit the sale or offer of a franchise containing untrue statements or omitting statements necessary to prevent any statements made from being misleading. And some make elements of a fraud claim easier to prove that under the common law. Remedies may include actual damages (\textit{e.g.} recovery of the franchisee’s investment and operational losses) or rescission, which involves the cancellation of the franchise agreement and restoration of the franchisee to its economic position prior to its execution of the franchise agreement. Some state statutes also provide for punitive damages and attorneys’ fees.

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 have indeed been triggered. It should also look at the disclosures claimed to have been made, including analyzing whether they were mandatory disclosures and whether they were material to the franchisee’s investment decision.

\textbf{iii. Violation of state relationship statutes}

The FTC does not regulate the relationship between the franchisor and franchisee after the franchise is purchased. However, state relationship statutes, in contrast to laws governing the offer and sale of a franchise, apply after the franchise agreement has been executed.\textsuperscript{81} Where the business relationship meets the definition of a “franchise” in a particular state relationship statute, these laws regulate various aspects of the franchisor-franchisee relationship such as transfers, termination or non-renewal of the franchise.

Franchise agreements (drafted by the franchisor) tend to favor the franchisor, but these state relationship statutes are intended to be remedial and generally favor franchisees over franchisors. As such, it could be a violation of the state relationship statute to attempt to terminate a franchise agreement without following the specific statutory procedures, even if the franchise agreement specified its own less onerous procedures. And, while most franchise agreements contain a choice of law provision, many of the state relationship statutes provide that any provision in a franchise agreement that is contrary to the statutory protections is invalid as a matter of public policy, and cannot be enforced.

Often, as a prerequisite to claiming the protections of a specific state’s relationship statute, the franchisee must be operating a franchised business located or operated in that state and/or the franchisee must be domiciled in that state. In this way, the broad jurisdictional scope of certain state relationship statutes can result in the application of

\textsuperscript{80} See Minn. Stat. § 80C.17(2); N.Y. Gen. Bus. Law § 690.

\textsuperscript{81} 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 franchisee and franchisor.
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 regulatory law.

iv. Breach of duty of good faith and fair dealing

While the definition of the duty (or 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 their respective rights and responsibilities and carrying out the terms of their agreement. This implied covenant seeks to ensure that the parties fulfill the express contract terms in accordance with the reasonable expectations of the parties. The reasonable expectations of the parties may be determined by the language of the contract, the purpose of the contract and other facts and circumstances known to the parties. 82

The implied covenant of good faith and fair dealing generally will not displace express terms of a franchise agreement with those deemed more “reasonable” to either party and will not create contract terms where none exist. The implied covenant does not provide a basis to claim harm from conduct that is expressly permitted by the franchise agreement or to preclude the parties from acting in their own self-interest. 83 Rather, where a franchise agreement gives a party discretion, the implied covenant will act to ensure that such discretion is exercised reasonably so that both sides have their expectations met and obtain the fruits of their contract. The implied covenant may also be invoked to fill in “gaps” in the contract, i.e. to clarify or supply a term where a provision in the franchise agreement is ambiguous or is open to interpretation.

Claims for breach of the implied covenant of good faith and fair dealing allow a franchisee to seek redress from unreasonable exercises of franchisor discretion in various post-sale conduct. 84 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. The implied covenant of good faith and fair dealing is often raised in connection with terminations, transfers, renewals, system changes (including implementation of new products or changes to policies and procedures),

82 See, e.g., Sons of Thunder, Inc. v. Borden, Inc., 148 N.J. 396, 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).

83 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.”).

84 See, e.g., National Franchisee Ass’n, 715 F. Supp. 2d 1232; Carvel Corp. v. Diversified Mgmt. Grp., Inc., 930 F.2d 228 (2d Cir. 1991).
market withdrawals, discriminatory treatment and competition issues. Additionally, the relationship statutes of certain states impose a general standard of good faith or commercial reasonableness in the franchise relationship. A franchisee trying to establish a breach of the implied covenant will often present objective evidence of bad faith to support its claims, such as contrary industry standards, course of performance, and course of dealing with other franchisees. It may also present subjective evidence if such evidence can be obtained through discovery or otherwise.

As noted however, the implied covenant of good faith generally will not supersede express terms addressing a particular issue. 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 conduct complained of will be specifically addressed in the contract (or at least partially) as to whether it 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. As another defense, a franchisor may potentially argue that the waiver clause in the franchise agreement waived the implied covenant. However, some state law holds that implied covenants cannot be waived (or there may be applicable statutes which would supersede contrary contract terms). In any event, relevant state law must be analyzed carefully in considering the viability of such a 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.

v. Unfair or Deceptive Trade Practices

Many states have enacted unfair and deceptive trade practice acts or “Little FTC Acts,” which are modeled on or are similar to the FTC Rule. They generally provide that a violation of the FTC Rule provides a private right of action under state law. In some states, violation of the FTC Rule is a \textit{per se} violation of law.

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85 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.

86 States with such statutes include Arkansas, Connecticut, Hawaii and New Jersey, among others.

87 See, e.g., \textit{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).

88 See, e.g., \textit{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.”).

89 See Section 6(b)(i), supra.

90 See, e.g., \textit{Morgan v. Air Brook Limousine, Inc.}, 211 N.J. Super. 84, 103, 510 A.2d 1197, 1206 (N.J. Law. Div. 1986) (where the court held that the franchisor’s failure to comply with the FTC Rule’s requirements in the sale of the franchise constitutes a \textit{per se} deceptive or unconscionable commercial act or practice in violation of New Jersey’s Consumer Fraud Act).
Most states that permit claims under these Little FTC Acts provide that suit can be brought by individuals or businesses (including corporations). 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. 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. The Little FTC Acts also expand potential liability to include unfair conduct that would not necessarily be “deceptive” under common law. The Little FTC Acts additionally provide for awards of attorneys’ fees and punitive damages which would otherwise not be available under the 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. 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 viewed as a commercial, rather than a consumer, transaction. As a result, a franchisee’s claims brought under certain state statues could potentially be subject to dismissal.

**vi. Franchisee and franchisor 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, understandably 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 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, non-franchised, or non-traditional 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 expressly prevents the type of encroachment at issue. If, however, 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. Some state statutes may also apply.

Conversely, if the franchise agreement specifically addresses encroachment issues, then regardless of the ultimate impact to that franchisee, there is a significant legal basis to find that there has been no express or implied breach of the franchise agreement. For example, many franchise agreements explicitly state that a franchisor is reserving to itself the right to 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 reserving its rights to compete in alternative distribution channels.

vii. Wrongful termination

A franchisee will often allege that its franchisor wrongfully terminated the franchise agreement. Termination may occur at any point before expiration of the term of the franchise agreement. Franchise agreements generally state how and why a franchise may be terminated by the franchisor. For franchisee termination, most franchise agreements require notice of an alleged breach and an opportunity to remedy the breach prior to termination. Franchise agreements typically specify the categories of conduct or violations of the franchise agreement 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. The incurable grounds generally include actions that either reflect bad faith on the part of the franchisee or have a profoundly negative impact on the franchise relationship or status of the franchisee. Termination by the franchisor is only permissible for acts specifically noted in the franchise agreement to constitute a breach by the franchisee.

A franchisor must follow any and 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, it may be liable for breach of contract damages to the franchisee. To support an improper termination claim, it is incumbent upon the franchisee to prove that the franchisor acted unfairly or improperly terminated 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.

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91 See Section 6(b)(iv), supra.
93 While franchisors are given the right to terminate the franchise agreement, franchisees are generally not given their own right to terminate.
Additionally, state relationship statutes often impose additional standards or prerequisites before a franchisor may terminate its relationship with its franchisee. 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). 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.

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.

viii. Refusal to renew

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 non-renewal 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 state whether the franchise agreement is renewable, and, if so, the conditions for such renewal.

While state laws do not require franchise agreements to include a provision for renewal after the end of the initial term, if they do, certain state relationship statutes restrict the franchisor’s ability to refuse to renew the franchise agreement. These statutes vary widely on this issue, but they can result in a franchisor having to renew with

94 States with these kinds of additional standards include Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Michigan, Mississippi, Montana, Minnesota, Nebraska, New Jersey, Virginia, Washington and Wisconsin.

95 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.

96 The states include Connecticut, Illinois, Minnesota and Rhode Island.

97 These states include: Arkansas, California, Connecticut, Delaware, Hawaii, Illinois, Indiana, Iowa, Minnesota, Mississippi, Missouri, Nebraska, New Jersey, Washington and Wisconsin.
a franchisee if the franchisor did not adhere to the statutory requirements. In some states, non-renewal is treated similarly to termination. There may be a requirement that the franchisor provide advance written notice of non-renewal along with the opportunity to resolve issues precluding renewal and/or to have “good cause” for the non-renewal. Other states only require a lengthy notice period for non-renews. Still others require a quid pro quo exchange for non-renews: in order to non-renew, a franchisor must release the franchisee from a non-competition provision, repurchase the franchisee's inventory, or permit the franchisee to sell to a qualified purchaser.

ix. Refusal to approve transfer or assignment

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.

However, 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 provisions. Case law and some state statutes limit the right of the franchisor to restrict transfers of franchises or the assets of franchised businesses. In 10 states, it is illegal for a franchisor to refuse to allow a transfer of the franchise without "good cause." 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.

x. Failure to provide training and support

Virtually all franchise agreements require the franchisor to provide its franchisees with some level of training and support. Indeed, it is this promise of training and support that often leads people to purchase a franchise rather than open an independent business. Accordingly, franchisees expect to be trained in the particular business of the franchise and to be supported by the franchisor in efforts to operate the franchise and to sell the franchise 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 claim for breach of contract.

98 These states include: Arkansas, California, Hawaii, Indiana, Iowa, Michigan, Minnesota, Nebraska, New Jersey and Washington.
Notwithstanding, sometimes franchisee expectations do not match the realities of the 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.

xi. Hidden franchises

A business relationship can be created through a variety of arrangements, including license agreements, distributorships, joint ventures, capital investments and consulting agreements. However, if the business relationship has all the definitional elements of a “franchise,” it is franchise under the law and subject to regulation.

The FTC Rule and the state franchise disclosure and registration statutes all include franchise definitions. Additionally, many of the state relationship statutes also include franchise definitions. As such, there is no uniform definition of a franchise. However, essentially all a business relationship must contain to fall under the definition of a “franchise” are three main elements. First, there must be a grant of authority to use another’s 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 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.99 Third, there must be the direct or indirect payment of a franchise fee for the right to operate the business. This element may be satisfied through license fees, ongoing royalty payments, consulting fees, training fees or site assistance fees.100

If all three elements are present, then the relationship is a franchise.101 In such a case, the label the parties attach to their business relationship has little bearing on

99 Hawaii, Minnesota, Wisconsin and New Jersey are examples of states that take the community of interest approach.
100 Notwithstanding, each of the franchise laws exempts payments for goods purchased for resale in reasonable quantities and at bona fide wholesale prices.
101 However, 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.
determining if the relationship constitutes a franchise. Whether the parties even intended to create a franchise relationship is irrelevant; a “hidden” or an “accidental” franchise may be created. The protections afforded by the franchise laws generally cannot be waived, and the benefits of the applicable statute(s) will control, despite contractual language to the contrary. As such, an FDD must be provided and, in states where registration is required, a disclosure document must also be registered before the business may be offered for sale.

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.

xii. Antitrust

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 on it by its 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). Such tying arrangements are alleged to eliminate competition in the tied product market. However, 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. 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

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as the disclosure of tying arrangement possibilities is clearly set out in the FDD, the franchisor should be able to successfully defend itself against such antitrust claims.

xiii. Mismanagement of marketing funds

A franchisor will typically require its franchisees to contribute to a common advertising fund, which is supposed to be used for the common good of the franchisees specifically to conduct system advertising. However, 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. 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 any duties have been breached.

c. Remedies

Claims brought by franchisors and franchisees give rise to a variety of available remedies, including damages, injunctive relief, rescission and restitution, declaratory relief and specific performance. This section provides an overview of the various types of relief available to both franchisors and franchisees, focusing on those areas that are most often the subject of litigation.

i. Contract damages

From the franchisor’s perspective, the most common type of contract damages sought are past due royalties and advertising fees. Once a breach is proven, recovery of these damages is usually very straightforward, requiring a simple calculation of the past due amounts, as well as interest, late fees and attorneys’ fees if the franchise agreement permits recovery of those amounts.

The greater difficulty for the franchisor lies in recovering future royalties (or future advertising/marketing fees) that the franchisor could otherwise be expected to receive over the remaining term of the franchise agreement if the agreement had not been terminated for nonpayment of royalties or some other default, or if the franchisee had not abandoned the business before the end of the term. Generally speaking, a party asserting a breach of contract claim is entitled to recover damages that are directly and proximately caused by the breach, and those damages are designed to restore the injured party to the position it would have been in had the other party not breached. These damages, also characterized as “benefit-of-the-bargain” damages, are usually sought in the form of lost profits. From the franchisor’s perspective, these lost profits consist of the royalties that the franchisor would have earned had the franchisee operated its franchised business for the remainder of the term of the franchise agreement, less any expenses.

103 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).
that the franchisor would save by no longer having to provide operational support and other services to the franchisee.

Some courts, most notably a California appellate court in *Postal Instant Press v. Sealy*,\(^{104}\) have held 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. Other courts have rejected this reasoning, holding instead that if the franchisee commits a breach justifying termination before the end of the term, the franchisor can terminate and still recover the lost future royalties if that remedy for breach was within the contemplation of the parties at the time the contract was entered into.\(^{105}\) Courts generally agree that if the franchisee abandons its business before the end of the term and the franchisor then formally terminates the agreement, the franchisee’s breach should be viewed as the proximate cause of the franchisor’s loss of future royalties, entitling the franchisor to recover those royalties as damages.\(^{106}\)

A franchisor’s claim for future royalties must be reasonable and cannot be based on speculation or conjecture in terms of the amount of royalties or time period over which they are sought. If the franchisee is struggling financially at the time of termination and would likely have gone out of business within a year or two in any event, the franchisor may have difficulty recovering lost future royalties beyond that time period even if, for example, the term would not have expired for another five or six 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.

Some franchise agreements, particularly those in the hotel industry, contain liquidated damages clauses, which are contractual provisions that specify the amount of damages recoverable in the event of a breach of the agreement. Liquidated damages clauses are used most often for franchisee abandonment or other breaches that lead to termination, or in some cases for breaches of post-term obligations, such as de-branding or non-compete covenants. The enforceability of liquidated damages provisions depends on (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 contracting.\(^{107}\) If the amount of liquidated damages is unreasonably large, it will be deemed a penalty and will not be enforced on public policy grounds. Generally speaking, franchisors have been quite successful in enforcing


\(^{107}\) Restatement (Second) of Contracts, § 356.
liquidated damages provisions that are based on some multiple (e.g., two years’ worth) of their franchisees’ historical average annual royalty payments.\textsuperscript{108}

From the franchisee’s perspective, the ability to recover lost profits damages based on the franchisor’s wrongful termination of the franchise agreement is typically not a causation issue but instead turns on how certain the amount of lost profits is. Whether a franchisee can satisfy the “reasonable certainty” test for lost profits damages is often a very fact-specific inquiry. In addition, franchisees generally must establish a track record of historical profitability, since courts often apply the “new business” rule to preclude fledgling or historically unprofitable businesses from recovering lost profits on the ground that those damages are inherently too speculative to be awarded. However, franchisees that have never opened, or that have been open for only a short time, may be able to overcome the new business hurdle to recovery of lost profits damages by relying on the financial performance of other successful franchisees in the same system. Finally, recovery of lost profits damages typically requires expert testimony regarding the franchisee’s future performance that takes into account a number of variables, including projections of revenues and expenses in the future and the likelihood that the franchisee will remain in business for the balance of the term of the franchise agreement and any renewal terms.

\textbf{ii. Rescission and restitution}

Rescission and restitution are companion remedies that are utilized almost exclusively by franchisees to unwind a franchise relationship and return the parties to their respective positions before they entered into the franchise agreement. Fourteen states have franchise-specific statutes that set forth various grounds for a franchisee to rescind a franchise agreement and describe the types of restitutionary relief available to the franchisee upon rescission.\textsuperscript{109} Many of these state laws permit the franchisee to rescind if the franchisor has failed to provide the required disclosure document or if the information contained in the disclosure document is false or misleading. These statutes vary widely 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. 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 of a contract, mistake, duress, and a fundamental breach of contract.

The most common defense to an action for rescission is a waiver or laches defense, which may apply when the franchisee continues to operate its business and “reap the benefits” of the franchise for an extended period of time after the franchisee


knew of the statutory or common law basis for rescission.\textsuperscript{110} A waiver of the statutory right to rescind is possible even if the action is timely filed within the statute of limitations period.\textsuperscript{111} The waiver or laches defense effectively prevents a franchisee who discovers a factual basis for rescission from gaming the system by waiting to see whether the business will be profitable before electing to rescind.

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 the remedy of restitution. The majority of state statutes provide only for a return of the initial franchise fee and royalties paid to the franchisor and do not take into account other expenses that a franchisee ordinarily incurs in opening a franchise business, such as lease payments and deposits, equipment, inventory, working capital loans and employee training expense, most of which may be paid to third parties other than the franchisor. As part of the restitutionary process, the franchisee is also required to return any benefits received from the franchisor, which could include any profits earned by the business as well as the value of the franchisor’s training, marketing and promotional services, use of the franchisor’s trademarks, the benefit of depreciation and amortization, and occupancy of the premises if leased from the franchisor. With few exceptions, courts have been rather vague in describing the appropriate elements of restitutionary relief.\textsuperscript{112} Also, because rescission is an equitable remedy, it is subject to wide discretion by the courts, and consequently the results are far from predictable.

\textbf{iii. Specific performance}

Specific performance is a remedy sometimes utilized by franchisors to bring franchisees into compliance with system standards or some other obligation under the franchise agreement when the franchisor does not want to terminate the agreement. A franchisor may choose this remedy because it believes the relationship is salvageable or because there is some uncertainty surrounding the enforceability of the system standard or the degree of the franchisee’s noncompliance, and in light of that uncertainty the franchisor does not want to risk a wrongful termination claim. While some franchisors have been successful in obtaining specific performance of contractual obligations,\textsuperscript{113} courts in other cases have held that franchise agreements are personal services contracts and may not be enforced through specific performance.\textsuperscript{114} In those cases, the franchisor’s only remedies are to sue for damages, which are often difficult to prove in the


\textsuperscript{111} See, e.g., \textit{Meg-La, Inc. v. Uniforms for America}, Bus. Franchise Guide (CCH) ¶ 11,910 (D. Minn. 2000).

\textsuperscript{112} Two cases in which courts have attempted to explain the parameters of restitutionary relief in the franchise context are \textit{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 \textit{vacated and remanded sub nom.Flagship W., LLC v. Excel Realty Partners LP}, 337 F. App’x 679 (9th Cir. 2009), and \textit{Dollar Systems, Inc. v. Avcar Leasing Systems, Inc.}, 890 F.2d 165 (9th Cir. 1989).


case of a non-monetary breach, or terminate for non-compliance and run the risk that the termination will be viewed in hindsight as wrongful by the jury or judge or arbitrator.

iv. Declaratory judgments

An alternative to specific performance is for the franchisor (or the franchisee) to seek a declaration regarding whether a party's conduct under the franchise agreement constitutes a breach and whether the breach gives rise to a basis for termination. Declaratory judgment actions are also useful when the franchisor and franchisee disagree about the interpretation of a franchise agreement provision and want a court's guidance before they embark on a course of action based on a potentially erroneous reading of the agreement. Parties can seek a declaratory judgment under the federal Declaratory Judgment Act\(^\text{115}\) or its state law counterparts. However, federal courts have discretion to decline to hear cases for declaratory relief if there is a substantial likelihood that a declaratory judgment will not end the controversy, if there is another remedy that is more efficient or effective, or if the claim for declaratory relief was filed in a “race to the courthouse” to gain a tactical advantage over the other side.\(^\text{116}\)

v. Attorneys' fees

Claims for attorneys' fees figure prominently in many franchise litigation cases, since the vast majority of franchisors have standard agreements that contain either a reciprocal or a franchisor-only prevailing-party attorneys' fee provision. 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.\(^\text{117}\) In addition, 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. Attorneys' fees are also recoverable for violations of the Lanham Act in “exceptional cases,”\(^\text{118}\) which courts have generally held to require some form of willful, deliberate or fraudulent conduct.\(^\text{119}\)

As noted earlier, franchise disputes very often involve both claims and counterclaims, and in cases where a prevailing-party attorneys' fee provision is involved, the determination of which party has “prevailed”—if any—if the franchisor and franchisee win some of their claims and lose some of their claims can be complicated and depends in large part on whether each side’s claims are viewed individually or whether the lawsuit or arbitration is viewed as a whole. If the claims are viewed individually, the process of allocating fees and expenses among the individual claims after determining which party has prevailed on which claims adds another layer of complexity to the process of awarding attorneys' fees.

\(^{115}\) 28 U.S.C. § 2201.
\(^{119}\) See, e.g., Taco Cabana International, Inc. v. Two Pesos, Inc., 932 F.2d 1113, 1127 (5th Cir. 1991).
d. Settlement

i. Impact of settlement on disclosure obligations

Trying to settle disputes before the initiation of litigation is important when one or both parties do not want the dispute, or the terms of any settlement, to become public. The Franchise Rule requires disclosure in Item 3 of a franchisor's FDD of the terms of any settlement of a material civil action involving the franchise relationship. The settlement terms must be disclosed even if the parties have agreed to keep them confidential. The inclusion of an Item 3 disclosure may have consequences to the franchisor in the sales process or signal to other franchisees how a franchisor may react when faced with similar claims (often times, regardless of the legitimacy of the claims). These disclosures can thus lead to more litigation, or scare off a prospective franchisee. The possibility of an Item 3 disclosure can lead a franchisor to dig in and vigorously defend a case, thus making settlement more difficult. Accordingly, the franchisor or franchisee, and sometimes both parties, strive to avoid the formal initiation of litigation whenever possible. Once litigation (or arbitration) is filed, the parties will need to be cognizant of the impact of the disclosure on how and when they settle the case.

ii. Identifying opportunities for settlement

If the parties are unable to avoid the initiation of litigation, there will be many opportunities to try to forge a settlement before trial. A savvy litigator will be able to identify certain break points in the litigation where settlement is more likely to be successful. Common examples of settlement break points include all of the following:

- At the conclusion of pleadings motions;
- After written discovery is exchanged;
- After depositions of key witnesses;
- Following dispositive motion practice;
- Following the threat of potential sanctions; and
- Following pre-hearing motions.

While there may be several other break points, the key in identifying settlement opportunities is for counsel to constantly determine how discovered facts or rules change the risk analysis of the case, and how to value the same. Looking for opportunities to settle at each stage of the litigation should be part of each party’s overall strategy.

Litigation counsel should also proactively plan the litigation to exploit settlement opportunities. For instance, counsel may want to consider frontloading discovery or certain depositions to let the other side know it is in for a fight. In the common case of

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120 Scott and Tegt, supra note 1, at 42.
121 16 C.F.R. § 436.5(c)(3)(ii).
122 Id.
123 See Deborah S. Coldwell and Michael Einbinder, Pressure Points in Franchise Litigation, American Bar Association, 38th Annual Forum on Franchising, October 14-16, 2015.
suit to terminate a franchise agreement and recover unpaid royalties, the franchisor may seek to force a franchisee to admit liability with respect to unpaid royalties early on. Once established, the franchisor can shift attention to defeat or weaken any affirmative defenses filed by the franchisee. The point being, litigation counsel should always be looking for options to resolve the case, and adopt strategies to reach points at which both sides in the litigation can re-set and re-evaluate the risks of moving forward. Once leverage has changed, it may make the possibility of resolution more viable than it was pre-suit or at early stages of a pending case.

 iii. Mediation

 Much like pre-suit mediation, post-filing mediation can also be a very effective tool in resolving franchise disputes short of trial. Using a third party to digest the information gathered to date and give the parties an outside opinion on the risks of moving forward can be a very effective way to resolve disputes. This can help when a party is getting a very one-sided opinion on the potential merits of the case from its litigation counsel. Moreover, from a human prospective, litigants sometimes simply need their "day in court" before they are emotionally ready to let go of the case. Mediation can give provide them that sense of having been heard.

 Most post-filing mediations will be within the discretion of the parties. Counsel for both sides should look for opportunities for mediation and assess when using this form of alternative dispute resolution may function to resolve the case. In some instances, however (such as federal court litigation), post-filing mediation may not be optional. Instead, the court will require mediation (also called early neutral resolution or a "settlement conference") at certain points in the proceedings. This commonly occurs at the close of discovery and before dispositive motions are filed. If mediation is required by court order, the parties will likely have less control over the rules of the mediation and who conducts the mediation. Nevertheless, the strategies and approaches to mediation will generally be similar in the post-filing context to those discussed above in the pre-filing context. The relative strengths and weaknesses of each side’s position will be better known in a post-filing mediation, and any pre-trial rulings in a party’s favor should be highlighted for the mediator.

 7. Post-Judgment/Post-Award Considerations

 a. Appeal

 Once a judgment has been entered, the losing party may consider whether to pursue an appeal. An appeal presents both of the parties with significant risks. The losing party is on the hook to pay what could be a significant money judgment (which may accrue interest while the case is on appeal). Meanwhile, the prevailing party must get the judgment affirmed in order to collect. This could potentially be difficult if the damage

\[\text{Id.}, \text{ at 13.}\]

\[\text{The judgment is also subject to collection while the appeal is pending unless a stay is granted or bond posted.}\]
award was unusually high and/or if there is some uncertainty concerning the legal issues in the case. And, if the judgment is reversed and the case is remanded to the trial court, the whole process starts all over again.

Given the foregoing—along with the additional costs and inevitable delays of an appeal—settlement may be preferable to the risks and costs of an appeal. Having gone through the trial process, the parties may be able to more clearly recognize certain weaknesses in their respective positions (and/or their previous unrealistic expectations) which could now lead to a settlement. For the party holding a money judgment, a settlement not only eliminates the risk of reversal or collection, but also ensures that payment will be made sooner. And, for a franchisor, the risk of a published appellate opinion establishing adverse legal precedent for the franchisor or the franchise system in future cases could also make settlement desirable. The voluntary resolution of a case post-trial provides the parties with certainty and closure.

b. Impact of judgment/award on franchise system

After a dispute between a franchisor and one or more of its franchisees—especially one where the subject matter of the case has broad implications—a judicial ruling may directly or indirectly affect the entire franchise system. For example, because most franchise systems utilize standard-form franchise agreements, a dispute concerning the meaning of a contract provision can affect all franchisees, not just the individual franchisee that was a party to the dispute. Many franchise systems have a franchisee association (or will at least have a “grapevine” of interested franchisees) that will be closely following the case. If a large judgment adverse to the franchisor is entered, it could unleash a flood of similar claims from other franchisees. The larger the system, the greater the universe of potential plaintiffs. Conversely, if the judgment is favorable to the franchisor, it could chill similar lawsuits from being brought in the future and cause franchisees to re-think the advisability of going up against their franchisor (even to assert meritorious claims).

From a financial standpoint, a large monetary award can also jeopardize a franchisor’s economic well-being and/or require that it divert financial resources away from growing or improving the system. As a result, a franchisor may be left without sufficient funds to fulfill obligations to other franchisees, causing additional potential issues. A large monetary award can also be sobering for the morale of other franchisees, especially if there is negative press or publicity associated with the judgment. These franchisees could potentially be witnessing another franchisee “take down” the system they have partnered with, which in turn may affect the value of their own franchise investment. And finally, a growing number of unhappy and vocal franchisees will undoubtedly discourage new prospects and make it difficult to sell new franchises.