

International Franchise Association
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2019 Judicial Update

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Additional State Law Issues

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Introduction

In the past year, franchisees have pursued various tort theories for recovery and relief against franchisors in traditional franchise lawsuits pertaining to terminations, establishments/encroachments, and relocations. This section highlights a few of those cases, several of which are from the automotive industry. To narrow the scope of this section and to focus on the state law claims which have universal, franchise-wide application, analyses of alleged violations of state statutes have been excluded.

Caselaw Evaluation

1. *Mercedes-Benz USA, LLC et al. v. Carduco, Inc. d/b/a Cardenas Metroplex*, No. 16-0644, 2019 WL 847845 (Tex. 2018).

In this case, the Texas Supreme Court considered reasonable reliance in light of a dealer agreement and also the fiduciary responsibilities, if any, that arise in a franchisor and franchisee relationship. Plaintiff/Respondent's former owner, Rene Cardenas ("Rene"), owned and operated the Autoplex Mercedes-Benz dealership in Harlingen, Texas. *Id.* at 1. Defendant/Petitioner, Mercedes-Benz ("Defendant"), became dissatisfied with Rene's dealership because it was outdated and had overall poor performance. *Id.* In discussing the possible termination of Rene's dealer agreement, Defendant urged Rene "to invest in a modern 'Autohaus' dealership facility and showed [Rene] studies indicating that the optimal location for this facility would be near McAllen," a town 20 miles to the west of Harlingen *Id.* Rene discussed relocating the dealership to McAllen with Defendant, and suggested that he would hire his father's construction company to build the new dealership. *Id.* The parties never agreed on a site or plan for the relocation because Rene refused to sign an agreement to set a deadline for relocation. *Id.* After Rene's dealership failed to improve its performance and Rene pled guilty to felony charges for failing to report a transaction, Defendant moved to terminate the dealer agreement. *Id.*

In an attempt to avoid termination, Rene entered into an Asset Purchase Agreement (the "APA") with his father for the dealership's assets.¹ *Id.* The APA stated Plaintiff was "only purchasing the right to conduct a Mercedes-Benz retail sales dealership at Purchaser's present location in Harlingen, Cameron County, Texas." *Id.* at *2. In addition, when Plaintiff submitted the APA and application to become a dealer to Defendant, the cover letter stated Plaintiff would "operate the franchise at its current location in Harlingen." *Id.* At the same time, Defendant was negotiating with an existing, successful Mercedes-Benz dealer from another Texas city about opening a location in McAllen; Plaintiff was not aware, nor did Defendant make Plaintiff aware, of these communications. *Id.*

Because Defendant practically had no choice under state law but to approve the APA, Defendant continued to negotiate and work with Plaintiff regarding an update to

¹ The Plaintiff/Respondent is the result of Rene's father buying the dealership from Rene, which is hereinafter referred to as "Plaintiff."

Plaintiff's facility in Harlingen. *Id.* Plaintiff met with two of Defendant's representatives to survey the dealership's condition and discuss what improvements needed to be made. *Id.* During the meeting, Plaintiff mentioned moving the dealership to McAllen, and Defendants' representatives told Plaintiff it could submit two proposed facility plans: one for the Harlingen location and one for the McAllen location. *Id.* Plaintiff only submitted plans for a Harlingen location. *Id.* Several months later, Defendant's representative met with Plaintiff and Rene, and Rene's father asked the representative to accompany Rene to McAllen to look at two possible sites for future dealerships. *Id.* After observing the sites, Defendant's representative stated the locations looked viable "but that any application to relocate would have to go through . . . the regional franchise manager," as Defendant's written approval was required prior to any relocation. *Id.* Plaintiff never submitted an application to relocate to McAllen.

Two months after the acceptance of the APA, Plaintiff executed a dealer agreement (the "Agreement") with Defendant. *Id.* The Agreement, in relevant part, identified Harlingen as the only authorized location for the dealership; prohibited Plaintiff from relocating the dealership without Defendant's written consent; and permitted Defendant to add dealers into Plaintiff's market area at its discretion. *Id.*

A couple months later, Defendant announced that a new dealership would be opening near McAllen with another dealer, which prompted Plaintiff to finally submit a formal application to relocate to McAllen. *Id.* at *3. Defendant denied Plaintiff's request. *Id.*

Plaintiff subsequently filed suit against Defendant and its representatives, personally, stating they "fraudulently induced [Plaintiff] to believe that its bargain with [Defendant] included the opportunity to relocate to McAllen as the exclusive Mercedes-Benz dealership in the region." *Id.* Plaintiff also asserted a breach of fiduciary duty claim.

The jury found for Plaintiff, and awarded \$15.3 million in actual damages and \$115 million in punitive damages against Defendant and three of its representatives. *Id.* Defendant appealed to the Texas Court of Appeals, which affirmed the jury's verdict and award generally.² *Id.* Both parties then appealed to the Texas Supreme Court. *Id.*

The Texas Supreme Court reversed and rendered a take nothing judgment against Plaintiff. *Id.* at *9. First, the Court found Plaintiff's fraudulent inducement claim failed because Plaintiff could not have justifiably relied on Defendant's representations that Plaintiff "could relocate to McAllen, Texas as the exclusive new Mercedes-Benz dealership in the region and that [Defendant] was not planning to put another dealer in the McAllen Area." *Id.* at *3. The Agreement's terms directly contradicted these representations. *Id.* at *5.

² The Court of Appeals "suggested a remittitur of the punitive damages award [from \$115 million] to \$600,000". *Id.*

The Court further found Plaintiff should have done more to protect its interests and insisted on terms in the Agreement for exclusive dealership rights in or near McAllen. *Id.* at *6. Because Plaintiff failed to do so, its reliance on Defendant's conduct, statements and actions was unjustified as a matter of law. *Id.* at *9. "[T]he parties' relationship and sophistication required greater diligence than the execution of a written contract that directly contradicted [Plaintiff's] assumed bargain and assertion of fraudulent inducement." *Id.*

In addition, the Court made an important holding relative to whether a special, or fiduciary, relationship exists between a franchisor and franchisee. *Id.* The Court stated: "[a]s a general rule, a failure to disclose information does not constitute fraud unless there is a duty to disclose the information." *Id.* at *8 (citation omitted). The Court went one step further and stated, generally, a franchisor and franchisee relationship is not special or fiduciary. *Id.*

2. *Brooks Automotive Group, Inc. et al. v. General Motors LLC*, No. 2:18-CV-00798, 2019 WL 452494 (W.D. Penn. Feb. 5, 2019).

In this case, the federal District Court for the Western District of Pennsylvania focused on what could happen if a franchisor has unfettered discretion to approve decisions impacting a franchisee's business. Plaintiff Brooks ("Brooks") owned and operated Brooks' Buick and GMC dealership in Connellsville, Pennsylvania. *Id.* at *1. Brooks decided to sell the dealership and began negotiations with Harper Autogroup ("Harper"), who owned and operated several GM dealerships already. *Id.* Brooks and Harper struck an agreement, and Harper agreed to purchase Brooks' dealership assets and consolidate and relocate Brooks' dealership with Harper's dealership in Belle Vernon. *Id.* Meanwhile, because the Connellsville property would no longer be used as a dealership, Plaintiff B.L.P. Real Estate ("BLP") planned to sell the dealership real estate to an unrelated third-party. *Id.* Brooks and Harper executed an asset purchase agreement ("APA"), and per Brooks' dealership agreement, the closing on the sale was conditioned upon General Motors' ("Defendant") approval. *Id.*

Defendant refused to approve the APA based on Harper's proposed relocation of the dealership to what Defendant believed was an inferior location. *Id.* at *2. Approximately six months later, Brooks and Harper executed a revised APA with two material changes: no relocation of the dealership and a reduction in the purchase price. *Id.* Due to these revisions, BLP executed a Sales Agreement with Harper for the sale of the dealership real estate. *Id.* Defendant approved the revised APA. *Id.* Despite this approval, Plaintiffs filed suit against Defendant for violations of various state statutes, tortious interference with contract, and breach of the duty of good faith and fair dealing. *See generally id.*

The Court found Defendant did not interfere with Plaintiffs' contracts, mainly relying on language within the dealer agreement as in the *Mercedes* case above. *Id.* at *5. First, Defendant and Brooks had "a dealer agreement that governed changes in management and ownership." *Id.* The dealer agreement specifically gave Defendant

“sole discretion in its business judgment to execute its right to refuse consent to a transfer.” *Id.* Second, Plaintiffs were required to show Defendant’s conduct was improper, which they failed to do. *Id.* at *4-5. The Court found that Defendant properly refused consent because it did not want the dealership relocated, which was supported by valid business considerations which went uncontradicted by Plaintiffs. *Id.* at *5. In addition, although not referred to by the Court as the economic loss rule, the Court held Brooks’ claim had no legal basis because Brooks’ remedies derived from the dealer agreement and did not sound in tort. *Id.*

Relying on a Fifth Circuit case applying Michigan law, the Court found Brooks’ breach of the duty of good faith and fair dealing claim also failed.³ *Id.* The Court reiterated a holding of the Fifth Circuit as follows:

[T]he covenant has no role to play in the relocation dispute between GM and [the dealer] . . . These clauses . . . flatly preclude relocation absent GM’s approval . . . The contract does not limit the reasons upon which GM can base its relocation decisions. [The dealer] and GM have referred to no decisions regarding relocation or the relevant factors. They gave GM the authority to approve or disapprove relocation for its own reasons, and thus set out the limits of what the contract requires of these parties. [The dealer] agreed to operate at the specified location and to request relocation in writing. It can point to no portion of this contract creating ‘reasonable expectations’ that GM would grant such requests.

Id. (quoting *Hubbard*, 873 F.2d at 878). Based on the same rationale established in *Hubbard*, the Court found there was no “independent claim for breach of any implied covenant of good faith and fair dealing.” *Id.* at *6.

3. *JJM Sunrise Automotive, LLC v. Volkswagen Group of Am. et al.*, Nos. 601658-14, 602591-14 (N.Y. Feb. 16, 2018).

JJM Sunrise is another example of a franchise case in which the Supreme Court in the State of New York analyzed what constituted reasonable reliance in light of a written agreement. Here, Plaintiffs were Long Island dealers encouraged to expand and renovate their dealerships to comply with the facility requirements of Defendant Volkswagen (“Volkswagen”). *Id.* at *1-4. Plaintiffs acquired other dealerships and land to improve and expand their dealerships as well as invested money to improve their existing facilities. *Id.* at *3.

Based on market studies, Volkswagen later decided to open a dealership in Westbury, adjacent to Plaintiffs’ locations. *Id.* at *9-10. Volkswagen supported its decision with the following evidence: Volkswagen’s “underperformance in the Westbury area, the economic demographics of that area, the presence of competing dealers with

³ In *Hubbard*, a dealer brought suit against a manufacturer after the manufacturer refused the dealer’s request to relocate its dealership. *Hubbard Chevrolet Co. v. General Motors Corp.*, 873 F.2d 873, 874 (5th Cir. 1989). The dealership agreement expressly prohibited any dealership relocation without the written consent of the franchisor. *Id.*

significant dealerships in the area and the benefits resulting therefrom . . . and the probability of little impact on sales (and value) of the plaintiff dealerships.” *Id.* at *13.

Plaintiffs filed suit, claiming Defendant Volkswagen “breached express and implied obligations contained in various agreements by, *inter alia*, contracting for and scheduling the opening of a new and competing dealership at a location which infringes on their market territories, potentially impacting sales and service and thereby lowering the value of the plaintiffs’ dealerships.” *Id.* at *2. Plaintiffs contended they would not have expanded and improved their facilities to the extent that they did if they knew their primary area of influence was going to be reduced with the addition of a Westbury dealer. *Id.* at *3. Volkswagen countered, arguing the relevant provision in the dealer agreements provided Volkswagen unfettered discretion to add another dealer in Plaintiffs’ market area. *Id.* at *8.

The Court found Plaintiffs did not have a reasonable expectation under the dealer agreements that another dealership would not be added within their sales market. *Id.* at *13. The dealer agreements expressly stated that the “Agreement does not give Dealer any exclusive right to sell or service Authorized Products in any area or territory.” *Id.* Further, the Court found Volkswagen’s decision to open a Westbury dealership was a sound business decision based on its preparation and review of the market studies. *Id.* For these reasons, the Court found Volkswagen did not breach its contract with Plaintiffs or the implied covenants of good faith and fair dealing.

Conclusion

A common thread in all of these cases is the importance of the language in the agreement between the franchisor and the franchisee. Both parties should take care when drafting, negotiating, and entering into such agreements to ensure their interests are protected, and authority is not too greatly vested in one party over another. A franchisee should be diligent and protect its own interest by ensuring the written agreement reflects the franchisee’s interest. Any failure to do so will increase the likelihood of success for the franchisor.

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No-Poaching Provisions in Franchise
Agreement Under Fire from Private
Class Action Plaintiffs and Government
Enforcement Actions

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In 2018 the franchise industry became a high profile target of politicians and class action plaintiff's lawyers aiming at the common practice of including no-poach and/or no-solicitation provisions in form franchise agreements which, in various forms and degrees, restrict franchisees of a brand from soliciting or hiring employees of the franchisor and/or another franchisee within that brand (a "No-Poach Clause"). They alleged that these provisions suppress wages and are a primary cause of wage stagnation, at first focusing on lower-level employees in the fast food industry and then expanding to franchises in other industries. In addition to the ongoing efforts of several state attorneys general and proposed state legislation that intend to end the practice of using No-Poach Clauses now and in the future, there are also numerous pending class actions against multiple franchisors and franchisees to recover damages for past use of No-Poach Clauses as alleged violations of antitrust law. This paper discusses the history and status of these enforcement actions at both the state and federal level as well as the recent and pending class actions.

I. No-Poach Clauses Become a Target

A recent point of reference for the start of this current attack on No-Poach Clauses is actually unrelated to the franchise industry. The Department of Justice Antitrust Division ("DOJ") and Federal Trade Commission (together, the "Agencies") jointly enforce the various U.S. antitrust laws. In addition to competition among sellers in an open marketplace, federal antitrust laws also apply to competition among companies to hire employees. Per the DOJ, "workers, like consumers, are entitled to the benefits of a competitive market. Robbing employees of labor market competition deprives them of job opportunities, information, and the ability to use competing offers to negotiate better terms of employment." It is well-settled that so-called "naked" No-Poach Clauses and other agreements between companies competing for employees about what employee salary or other compensation terms to provide employees are *per se* illegal under the antitrust laws when they are not reasonably necessary to any separate, legitimate business collaboration between the employers.

Starting in 2010, the DOJ became aware of an unexpected amount of anti-competitive activity in the employee marketplace and brought civil enforcement actions against multiple Fortune 500 companies. In October 2016, the Agencies issued guidance, directed to HR professionals, stating that "competition among employers helps actual and potential employees through higher wages, better benefits, or other terms of employment. <https://www.justice.gov/atr/file/903511/download>. An agreement among competing employers to limit or fix the terms of employment for potential hires may violate the antitrust laws if the agreement constrains individual firm decision-making with regard to wages, salaries, or benefits; terms of employment; or even job opportunities." While this has been established law, the guidance provided a warning, promising heightened enforcement of the existing laws against these *per se* illegal No-Poaching and wage-fixing agreements. The Agencies indicated an intent to proceed with criminal enforcement actions, a power the DOJ has always possessed but had rarely exercised. The threat of criminal penalties is substantial – corporations face criminal penalties up to \$100 million for a violation of the Sherman Antitrust Act, and

individuals face fines up to \$1 million and risk years in prison. This policy change evidenced the DOJ's intent to treat naked no-poaching and wage-fixing agreements the same as other *per se* illegal agreements like price-fixing, bid-rigging, and market share allocation agreements. The Agencies stated that the guidance was "intended to alert human resource professionals and others involved in hiring and compensation decisions to potential violations of antitrust laws."

In April 2018, the DOJ settled a civil action involving no-poach agreements for the first time under the Trump administration. <https://www.justice.gov/atr/division-operations/division-update-spring-2018/antitrust-division-continues-investigate-and-prosecute-no-poach-and-wage-fixing-agreements>. The DOJ expressly stated that this case was brought civilly, and not criminally, because the company had terminated its no-poaching agreement prior to the issuance of the 2016 guidance. The settlement contains certain provisions that the DOJ noted were specifically intended to terminate the no-poaching agreements and prevent future violations by both companies involved. These provisions included 7-year injunctions prohibiting any such anti-competitive activity, a requirement that each company affirmatively notify its employees, recruiters and the rail industry of the settlement, and an agreement that lowers the DOJ's burden of proof in any action to enforce the settlement. In the competitive impact statement filed with the settlement as well as in its April 2018 policy update, the DOJ reiterated its intent to pursue criminal enforcement of these types of no-poaching and wage-fixing agreements that were entered into or continued after the issuance of the October 2016 guidance: "Market participants are on notice: the Division intends to zealously enforce the antitrust laws in labor markets and aggressively pursue information on additional violations to identify and end anticompetitive no-poach agreements that harm employees and the economy."

Again, none of these actions by the DOJ involved any franchise nor did the DOJ issue any guidance directed toward the franchise industry. However, in 2017, McDonalds was hit with a class action challenging its No-Poach Clause. Then in 2018, several state Attorneys General, United States Senators and plaintiff class action lawyers focused their aim squarely at the franchise community through direct challenges to No-Poach Clauses in franchise agreements. While many franchisors have agreed to remove the No-Poach Clause from their form franchise agreements going forward and have agreed not to enforce such provisions, the litigation over their past use and legality continues.

II. Antitrust Law Relevant to the Franchise Industry and No-Poach Clauses

A. Elements and Proof of an Antitrust Claim

1. Elements of an Antitrust Claim

Section 4 of the Clayton Act, 15 U.S.C. § 15, provides a private right of action for treble damages to any person "injured in his business or property by reason of anything forbidden in the antitrust laws." The antitrust laws are designed to protect market

competition and support the goal of enhancing output and reducing price. See *Arizona v. Maricopa Cty. Med. Soc.*, 457 U.S. 332, 348 (1982). The underlying purpose of the Sherman Antitrust Act is to prohibit each “contract, combination in the form of trust or otherwise, or conspiracy, in restraint of trade or commerce...”, which has been interpreted to prohibit only unreasonable restraints of trade. 15 U.S.C. § 1; *State Oil Co. v. Khan*, 522 U.S. 3, 10 (1997). “In order to prevail on a cause of action for violation of 15 U.S.C. § 1, a plaintiff must show (1) there was an agreement, conspiracy, or combination between two or more entities; (2) the agreement was an unreasonable restraint of trade under either a *per se* or rule of reason analysis; and (3) the restraint affected interstate commerce.” *Am. Ad Mgmt, Inc. v. GTE Corp.*, 92 F.3d 781, 784 (9th Cir. 1996).

2. Concerted Action Element

“The question whether an arrangement is a contract, combination, or conspiracy is different from and antecedent to the question whether it unreasonably restrains trade.” *Am. Needle, Inc. v. Nat’l Football League*, 560 U.S. 183, 186 (2010). To satisfy this element, there must be (i) an agreement (ii) between two or more entities capable of engaging in concerted action. *Id.* at 189-90. “The reason Congress treated concerted behavior more strictly than unilateral behavior is readily appreciated. Concerted activity inherently is fraught with anticompetitive risk. It deprives the marketplace of the independent centers of decisionmaking that competition assumes and demands.” *Copperweld Corp. v. Indep. Tube Corp.*, 467 U.S. 752, 768 (1984). A “functional consideration of how the parties involved in the alleged anticompetitive conduct actually operate” is necessary to determine whether this element is satisfied. *Am. Needle*, 560 U.S. at 191.

3. Unreasonable Restraint of Trade Element

There are generally two standards for reviewing whether a restraint of trade is unreasonable and, therefore, whether the plaintiff can satisfy the second element of an antitrust claim: the *per se* rule or the rule of reason. A determination of what standard of review to apply depends on whether the alleged restraint is horizontal or vertical as well as its substantive terms. A horizontal agreement is between competitors at the same level of the market, where a vertical agreement is between parties that operate at different levels of the supply chain or market.

“The rule of reason is the accepted standard for testing whether a practice restrains trade in violation of” antitrust law. *Leegin Creative Leather Products v. PSKS, Inc.*, 551 U.S. 877, 885 (2007). “Under this rule, the factfinder weighs all of the circumstances of a case in deciding whether a restrictive practice should be prohibited as imposing an unreasonable restraint on competition.” *Continental T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 49 (1977). To succeed on a claim under the rule of reason, a plaintiff will typically be required to establish that the defendant has “market power—that is the ability to raise prices significantly without going out of business—without which the

defendant could not cause anticompetitive effects on market pricing." *Agnew v. National Collegiate Athletic Ass'n*, 683 F.3d 328, 335 (7th Cir. 2012).

However, some restraints are deemed unlawful *per se*, though these are limited to those restraints "that would always or almost always tend to restrict competition or decrease output." *Leegin*, 551 U.S. at 886 (2007) (internal quotation marks omitted) quoting *Business Electronics Corp. v. Sharp Electronics Corp.*, 485 U.S. 717, 723 (1988). "To justify a *per se* prohibition a restraint must have manifestly anticompetitive effects and lack any redeeming virtue." *Leegin*, 551 U.S. at 886 quoting *GTE Sylvania*, 433 at 50 and *Northwest Wholesale Stationers, Inc. v. Pacific Stationery & Printing Co.*, 472 U.S. 284, 289 (1985) (internal quotations omitted). "The *per se* rule, treating categories of restraints as necessarily illegal, eliminates the need to study the reasonableness of an individual restraint in light of the real market forces at work." *Leegin*, 551 U.S. at 886 (internal quotations omitted). "As a consequence, the *per se* rule is appropriate only after courts have had considerable experience with the type of restraint at issue, and only if courts can predict with confidence that it would be invalidated in all or almost all instances under the rule of reason." *Id.* citing *Arizona v. Maricopa County Medical Soc.*, 457 U.S. 332, 344 (1982) (internal citations omitted). Horizontal agreements among competitors to fix prices or divide markets are prime examples of restraints that are *per se* unlawful. *Leegin*, 551 U.S. at 886.

However, under the ancillary restraints doctrine, a horizontal agreement that would otherwise be found *per se* unlawful is "exempt from the *per se* rule" if it is ancillary to a separate, legitimate venture between the competitors. *Rothery Storage & Van Co. v. Atlas Van Lines, Inc.*, 792 F.2d 210, 224 (D.C. Cir. 1986). Rather, these types of "ancillary restraints" are subject to the rule of reason. *Id.*

One specific type of an agreement that may be subject to the ancillary restraints doctrine is a "hub-and-spoke" arrangement. "A traditional hub-and-spoke conspiracy has three elements: (1) a hub, such as a dominant purchaser; (2) spokes, such as competing manufacturers or distributors that enter into vertical agreements with the hub; and (3) the rim of the wheel, which consists of horizontal agreements among the spokes." *In re Musical Instruments & Equip. Antitrust Litig.*, 798 F.3d 1186, 1192 (9th Cir. 2015); *United States v. Apple, Inc.*, 791 F.3d 290, 314 & n.15 (2d Cir. 2015).

There is a third standard of review that is considered a "short form" of the rule of reason analysis – the "quick look." *Illinois Corp. Travel, Inc. v. American Airlines, Inc.*, 806 F.2d 722, 727 (7th Cir. 1986); *NCAA v. Board of Regents*, 468 U.S. 85, 109-10 & n. 42 (1984)). This approach is available when "an observer with even a rudimentary understanding of economics could conclude that the arrangements in question would have an anticompetitive effect on customers and markets, but there are nonetheless reasons to examine the potential procompetitive justifications." *Agnew v. National Collegiate Athletic Ass'n*, 683 F.3d 328, 336 (7th Cir. 2012) (internal citation and quotation omitted); *National Collegiate Athletic Ass'n v. Board of Regents*, 468 U.S. 85, 109-10 n. 42 (1984) ("While the 'reasonableness' of a particular alleged restraint often depends on the market power of the parties involved, because a judgment about market

power is the means by which the effects of the conduct on the market place can be assessed, market power is only one test of 'reasonableness.' And where the anticompetitive effects of conduct can be ascertained through means short of extensive market analysis, and where no countervailing competitive virtues are evident, a lengthy analysis of market power is not necessary.").

B. Antitrust Claims Specific to Franchise Agreements and No-Poach Clauses

1. Can parties to a franchise agreement conspire in violation of antitrust law?

While some franchisors in recent or ongoing No-Poach litigation have argued that franchisors and franchisees simply cannot conspire to satisfy the first element of an antitrust claim, that is not supported by the majority of existing case law. See *Jack Russell Terrier Network of N. Cal. v. Am. Kennel Club, Inc.*, 407 F.3d 1027 (9th Cir. 2005). In *Danforth & Assocs. v. Coldwell Banker Real Estate*, No. C-10-1621, 2011 WL 338798 at *2 (W.D. Wash. Feb. 3, 2011), the District Court did state that "franchisor and franchisee cannot conspire within the meaning of the Sherman Act." However, the case on which that decision relied actually held that this question is a fact-specific inquiry. *Williams v. I.B. Fischer Nevada*, 999 F.2d 445 (9th Cir. 1993); see also *Jack Russell*, 407 F.3d 1027.

2. What Standard of Review generally applies to franchise agreements?

Because franchisor and franchisees usually conduct business at different levels of the market, the relationship is generally viewed as a vertical one. Additionally, to the extent franchisors and their franchisees do compete with each other it is intrabrand competition, and "antitrust laws are designed primarily to protect interbrand competition, from which lower prices can later result." *Leegin*, 551 U.S. at 895. Accordingly, restraints contained in franchise agreements are usually reviewed under the rule of reason. See *Ohio v. Am. Express Co.*, 585 U.S. ___, 138, S. Ct. 2274, 2284 (2018).

3. No-Poach Agreements

It is well-settled that naked No-Poach Clauses between competitors are *per se* unlawful. See DOJ/FTC Antitrust Guidance for HR Professionals October 2016 at https://www.ftc.gov/system/files/documents/public_statements/992623/ftc-doj_hr_guidance_final_10-20-16.pdf. However, No-Poach Clauses between competitors that are reasonably necessary to a separate, legitimate business transaction or collaboration between the companies are governed by the rule of reason, as are No-Poach Clauses between noncompetitors. See *Ohio v. Am. Express Co.*, 585 U.S. ___, 138, S. Ct. 2274, 2284; see also Deputy Assistant Attorney General Michael Murray Delivers Remarks at the Santa Clara University School of Law Santa Clara, CA ~ Friday, March 1, 2019 at <https://www.justice.gov/opa/speech/deputy-assistant-attorney-general-michael-murray-delivers-remarks-santa-clara-university>.

III. Recent Decisions and Filings on No-Poach Clauses in Franchise Agreements

To date, none of the courts that have ruled on defendant franchisor's motions to dismiss the class action complaints filed by former employees alleging damage from the No-Poach Clauses alleged violation of antitrust law have granted the motion to dismiss in its entirety. Nor have any courts found the No-Poach Clause to be *per se* unlawful. Three courts have rendered decisions on motions to dismiss, which are discussed in in this Section.⁴ The DOJ also filed a Statement of Interest in cases that were pending in the Eastern District of Washington, which is also discussed in detailed in this Section.

A. McDonalds - *Deslandes* – Order Denying Motion to Dismiss

Plaintiff argued that the No-Poach Clause in the McDonald's form franchise agreements was unlawful *per se* or reviewable under the quick look analysis, while Defendant argued that for review under the rule of reason, which requires allegations of market power in the relevant market, which Plaintiff had failed to allege.

The Court initially found that McDonald's restaurants do compete and that, while franchise agreements are generally vertical agreements, these agreements that include the No-Poach Clause have horizontal elements as well because they restrain competition for employees among horizontal competitors, the franchisees and the company-owned stores. While the Court noted that naked horizontal agreements to divide a market (here, the labor market), are *per se* unlawful, it also acknowledged that some horizontal restraints may be ancillary to otherwise procompetitive agreements. It found that the franchise agreements at issue here were exactly that, because each new franchise agreement increased the output of the product, which means it was output enhancing and, therefore, procompetitive. Accordingly, the Court rejected Plaintiff's argument that the No-Poach Clause was unlawful *per se*.

The Court then analyzed whether the Plaintiff had plausibly alleged a restraint that may be unlawful under a quick look analysis. Because even "a person with a rudimentary understanding of economics would understand that if competitors agree not to hire each other's employees, wages for employees will stagnate," the Court found that Plaintiff had done so. The Court rejected Defendant's argument that the No-Poach Clause promotes intrabrand competition by encouraging investment in employee training (thus improving the McDonald's brand), noting that in the labor market each McDonald's store is a competing brand and dividing the labor market stifles this interbrand competition.

Not to give the Plaintiff too much comfort, the Court expressly stated that "the evidence at a later stage may not support" a claim for an unlawful restraint under a quick look analysis. It also stated that Plaintiffs decision to not plead a claim under the rule of reason was "unsurprising" because that would require the Plaintiff to meet the

⁴ Specific case information about each of these cases, including court and case number, are set forth in Section IV below. Section III addresses the substantive legal arguments and rulings that have been rendered to date.

high standard of showing the Defendant had market power in a relevant market. Also, because these are mostly low-skill jobs, the relevant market area is likely to cover a small geographic area, which may cut against certification of a nationwide class as proposed by the Plaintiff.

The Court did dismiss the state law claims, but denied the motion to dismiss the antitrust claims finding that the Plaintiff had plausibly alleged an unreasonable restraint of trade under a quick look analysis.

B. Cinnabon – Yi - Order Denying Motion to Dismiss

Plaintiffs asserted that the No-Poach Clause was *per se* unlawful while Defendants argued that the rule of reason analysis should apply. Defendants also argued that franchisor and franchisees cannot conspire in violation of antitrust laws, citing *Danforth & Assocs. v. Coldwell Banker Real Estate*, No. C-10-1621, 2011 WL 338798 at *2 (W.D. Wash. Feb. 3, 2011); *Williams v. I.B. Fischer Nevada*, 999 F.2d 445 (9th Cir. 1993) and *Jack Russell Terrier Network of N. Cal. v. Am. Kennel Club, Inc.*, 407 F.3d 1027 (9th Cir. 2005). The Court rejected Plaintiff's argument that the No-Poach Clause was *per se* unlawful, but did find that the franchise agreements at issue had aspects of both a horizontal and vertical restraint. It also noted the case was similar to the *Deslandes* case, and, consistent with the ruling in that case, found that the Plaintiff had alleged facts sufficient for a review of the No-Poach Clause under the quick look analysis. The Court also rejected Defendants' claim that a franchisor and franchisee cannot conspire as a matter of law, noting that the *Williams* case expressly stated that the particular facts of the case were important, making it premature to rule in reliance on those cases on a motion to dismiss. The Court also dismissed the state law claims.

C. Jimmy John's – Butler - Order Denying Motion to Dismiss

The Court paid special attention to the fact that, in addition to the No-Poach Clause in the Jimmy John's form franchise agreement, there was also a provision that each franchisee was a third party beneficiary of such agreement and had an independent right to enforce the provision. The Court found that, in part because of the third party beneficiary provision, the effect of the No-Poach Clause was felt at the horizontal level even though the underlying franchise agreement was vertical. Accordingly, the Court found that, at "this early stage," the Plaintiff had stated a plausible hub and spoke conspiracy such that the Defendant could be held liable for such a horizontal agreement either under a *per se* unlawful or quick look review, as alleged in the alternative by the Plaintiff.

The Court then went through an analysis of whether the *per se* rule or the quick look approach could apply. The Court did acknowledge that this was different than the typical hub and spoke conspiracy because all of the spokes in this case are in the same brand, and antitrust law is more concerned with *interbrand* restraints than *intra*brand ones. The Court asked "[s]hould the *per se* rule apply to a horizontal price fixing and

group boycott scheme, even though the horizontal agreement is amongst firms dealing in the same brand?” Then it noted that even though the franchisees are all in the same brand they are competitors, and it is clear that the No-Poach Clause has an uncompetitive effect on such labor market.

Ultimately the Court declined to decide, at this stage, which rule would apply. If the evidence shows the franchisees are truly independent, as alleged by the Plaintiff, then the quick look analysis or even a *per se* is likely to apply. However, if the evidence of franchisee independence is weak, or if the Defendant can demonstrate its burden under the quick look approach that there are procompetitive justifications for the No-Poach Clause, then “the rule of reason may rear its head and burn this case to the ground.” The Court denied the motion to dismiss the antitrust claims but did dismiss the state law claims.

D. Department of Justice Statement in Washington State Cases

The DOJ filed a Statement of Interest in three Plaintiff class action cases (consolidated for briefing purposes) in the Eastern District of Washington pending against Arby’s, Auntie Anne’s and Carl Jr’s. to “describe the legal standards governing whether a plaintiff has stated a claim that no-poach agreement in a commercial-franchise relationship violates federal antitrust law.”

The DOJ first cites the standard that “[n]early every...vertical restraint...should be assessed under the rule of reason.” quoting *Am. Express*, 138 S.Ct. at 2284. However, it then notes that some restraints “have such predictable and pernicious anticompetitive effect, and such limited potential for procompetitive benefit” that they could only be unreasonable restraints of trade and are, therefore, unlawful *per se*. *Khan*, 522 U.S. at 10. “Typically only horizontal restraints...qualify as unreasonable *per se*.” *Am. Express*, 138 S.Ct. at 2283-84. Even horizontal restraints are exempt from the *per se* rule if it is “ancillary to a separate, legitimate venture between the competitors.”

The DOJ next addresses the two elements of an antitrust claim that are in dispute in the underlying cases. The first is whether the alleged violation is a “concerted action” that satisfies the first element. The DOJ cites the *Copperweld* and *American Needle* cases (both cited above) as the “relevant authority in considering whether a franchisee and franchisor should be treated as a single entity under the antitrust laws.” The DOJ rejects the idea of a bright-line rule, and suggests that “a court should evaluate how the alleged business relationship operates in practice with respect to the entities’ economic interests.” Specifically, the DOJ cites to *Williams* and *Jack Russell* for the proposition that the specific facts of each case control. The standard provisions in franchise agreements that provide franchisee independence tend to support the position that franchisees and franchisors are “legally capable of concerted action.”

The second element the DOJ addresses is what is the proper standard of review, which starts with a determination of whether the restraint is vertical or horizontal. No-Poach Clauses are *per se* unlawful “unless they are necessary to a separate, legitimate

business transaction or collaboration between the companies, in which case the rule of reason applies.” A naked agreement among competitors to divide a market is a textbook example of a *per se* violation. “No-poach agreements among competing employers have almost identical anticompetitive effects to wage-fixing agreements.” Accordingly, courts have held that No-Poach Clauses among competitors are *per se* unlawful.

Because the franchisor and franchisee typically “conduct business at different levels of the market structure,” restraints imposed by the franchise agreement are “usually vertical” and, therefore, reviewed under the rule of reason. For example, territorial restrictions promote intrabrand efficiencies, which increases interbrand competition. Because such agreements have both procompetitive and anticompetitive effects, the rule of reason and its “balancing approach” should be used. A typical No-Poach Clause in a franchise agreement is a vertical restraint to be reviewed under the rule of reason. However, it could be horizontal if the franchisor and franchisee compete in the same market for employees, even though they do not compete in other aspects. If the complaint alleges direct competition between a franchisor and franchisee to hire employees, the NO-Poach Clause “is correctly characterized as horizontal and, if not ancillary to any legitimate and procompetitive joint venture, would be *per se* unlawful.”

The DOJ next discusses the hub and spoke conspiracy and ancillary restraints doctrine. To assert a valid claim based on a hub and spoke conspiracy, the complaint must allege a horizontal agreement among the spokes (i.e., the franchisees) and the agreement of the franchisor to participate in such agreement. “Allegations of parallel conduct alone do not suffice to satisfy this requirement, and allegations of a defendant’s mere knowledge of others’ agreement does not plausibly plead the defendant’s participation in it.” See *Bell Atl. Corp. v. Twombly*, 550 U.S. 544, 557 (2007); *Musical Instruments*, 798 at 1193. “Moreover, and contrary to the district court’s holding in *Butler*, 331 F.Supp. 3d at 796, the mere fact that one franchisee may enforce no-hire provisions of a vertical franchise agreement against another franchisee does not create an actual agreement among competing franchisees.” See *Twombly*, 550 U.S. at 564.

The key to a hub and spoke conspiracy is the existence of a rim, which is the agreement among the horizontal competitors. “A rimless wheel conspiracy is one in which various defendants enter into separate agreements with a common defendant, but where the defendants have no connection with one another, other than the common defendant’s involvement in each transaction.” *Dickson v. Microsoft Corp.*, 309 F.3d 193, 203. The DOJ does not believe the Plaintiffs have alleged that there is a “rim” to the hub and spoke conspiracy. If not, these parallel but independent vertical agreements are not *per se* unlawful but are subject to the rule of reason. See *Id.* at 205-06.

Further, because the franchise relationship “is itself a legitimate business collaboration in which the franchisees operate under the same brand, the No-Poach Clause would likely qualify as an ancillary restraint and, in such case, would also be subject to the rule of reason.

The DOJ then rejects the application of the quick look analysis that the courts in the McDonald's (*Deslandes*) and Cinnabon (*Yi*) cases held would apply:

When no-poach restrictions within a franchise system warrant rule of reason analysis, a full rule of reason analysis is likely necessary to weigh any anticompetitive effects against potential justifications for these restraints...The “quick look,” however, is not a part of the foregoing analysis. If the plaintiffs have failed to plead any agreement among the franchisees, then the plaintiffs have failed to plead a horizontal agreement—and, as neither side disputes, quick-look analysis does not apply to a vertical agreement between a franchisor and a franchisee. If they have pleaded an agreement among the franchisees, then the *per se* rule applies if the no-poach agreement is a naked horizontal restraint, and the ancillary-restraints doctrine helps to determine whether the horizontal agreement is naked. In the latter situation where a court concludes that the no-poach agreement is ancillary, then, by definition, quick-look analysis is not appropriate. The ‘quick-look analysis’ applies only in rare cases “when the great likelihood of anticompetitive effects can easily be ascertained,” and it is “implausible” that procompetitive benefits would outweigh harm to competition. *Cal. Dental Ass’n v. FTC*, 526 U.S. 756, 770, 775-76 (1999). Franchise no-poach agreements that are ancillary fall outside the scope of this category because they may indeed provide procompetitive benefits and promote interbrand competition. See *Id.* Consequently, they do not fall into the narrow category of restraints for which ‘the experience of the market has been so clear, or necessarily will be, that a confident conclusion about the principal tendency of a restriction will follow from a quick (or at least quicker) look, in place of a more sedulous one.’ *Id.* at 781. To the extent other district courts have found otherwise at the pleading stage, *Yi Order* at 9-10; *Butler*, 331 F. Supp. 3d at 797; *Deslandes*, 2018 WL 3105955 at *7-8, this Court should not follow their reasoning for the reasons set forth herein.”

The DOJ ends its statement with a request that the Court apply the framework set forth in its statement in ruling on the then-pending motions to dismiss.

After the DOJ filed this Statement, the parties settled and the cases were dismissed. The DOJ Statement contradicts the holdings in the *Deslandes* and *Butler* decisions regarding the correct standard of review to apply. It remains to be seen what weight the DOJ’s position that the rule of reason analysis should apply to No-Poach Clauses in franchise agreements will carry with courts in present and future cases. As some of the courts suggested in their decisions, a finding that a rule of reason analysis is appropriate likely spells defeat for the plaintiffs because of the proof required to establish a violation. This is just one of the issues, along with antitrust and class certification considerations, that will determine the outcome of these cases and the use of No-Poach Clauses in franchise agreements going forward.

IV. Government Enforcement Actions

A. Washington Attorney General Settlements

In February 2018, the Washington Attorney General sent his first set of demands to franchisors, all in the fast food industry, requesting information regarding their No-Poach Clauses and threatening to pursue litigation against them if they did not agree to discontinue the use and enforcement of the No-Poach Clauses. In July 2018 he announced the first batch of settlements, pursuant to which each franchisor agreed to not use or enforce their No-Poach Clauses nationwide as memorialized in an Assurance of Discontinuance filed in Superior Court in King County. He announced more settlements in August and September 2018. He then began targeting franchisors outside the fast food industry and, as of February 2019, has entered into legally enforceable agreements pursuant to which they will not use or enforce any No-Poach Clauses nationwide. These franchisors include the following:

Einstein Bros. Bagels, Express Employment Professionals, FASTSIGNS International, Inc., L&L Franchise Inc., The Maids International, Inc., Westside Pizza International, Inc., Zeek's Restaurants, Inc., Quiznos, Massage Envy Franchising, LLC, Frontier Adjusters of America, Inc., Sport Clips, Inc., Arby's, Five Guys, Little Caesars, Auntie Anne's, Buffalo Wild Wings, Carl's Jr., Cinnabon, McDonald's, Applebee's, Church's Chicken, IHOP, Jamba Juice, Panera, Sonic, A&W, Burger King, Denny's, Pizza Hut, Popeyes, Tim Hortons, Wingstop, Anytime Fitness, Baskin Robbins, Circle K, Domino's, Firehouse Subs, Planet Fitness, Valvoline, Batteries Plus Bulbs, Comfort Keepers, Edible Arrangements, La Quinta, Merry Maids, Budget Blinds, GNC, Jack in the Box, Jackson Hewitt, Jiffy Lube, Menchie's, The Original Pancake House, Bonefish Grill, Carrabba's Italian Grill, Management Recruiters International and Outback Steakhouse

B. Washington Attorney General Litigation - *State of Washington v. Jersey Mike's Franchise Systems, Inc., et al.*, Case No. 18-2-25822-7 (Kings County Superior Court)

The State of Washington, through the Washington Attorney General, has commenced litigation against a single franchisor, Jersey's Mike. Prior to the Washington Attorney General's investigation of No-Poach Clauses in franchise agreements, Jersey's Mike had voluntarily decided to stop using and enforcing the No-Poach Clause that was included in prior versions of some of its form franchise agreements. While the State acknowledged that Jersey Mike's had taken this step, it wanted Jersey Mike's to be legally bound to such position and be unable to reverse its decision in the future.

On October 15, 2018, the State commenced litigation against the Jersey Mike's Franchise Systems, Inc. and multiple franchisees. The complaint alleges that the No-Poach Clauses are a *per se* violation of the Washington Consumer Protection Act. Jersey Mike's filed a motion to dismiss, which the franchisee defendants joined. The

court summarily denied the motion to dismiss. The defendants have filed answers to the complaint and discovery is proceeding.

C. Other Enforcement Actions

1. Combined States Attorneys General Settlements

On July 9, 2018, the attorneys general of 10 states and the District of Columbia sent letters to eight franchisors, including Arby's, Burger King, Dunkin', Five Guys, Little Caesars, Panera Bread, Popeyes Louisiana Kitchen, and Wendy's, requesting information regarding the use and enforcement of No-Poach Clauses in their form franchise agreements.

In March 2019, four of those franchisors – Dunkin', Arby's, Five Guys and Little Ceasars -- entered into a settlement with 13 states and the District Of Columbia agreeing to not use or enforce any No-Poach Clauses nationwide going forward. <http://www.marylandattorneygeneral.gov/press/2019/031219.pdf>. The group of states includes Maryland, California, Iowa, Illinois, Massachusetts, Minnesota, North Carolina, New Jersey, New York, Oregon, Pennsylvania, Rhode Island, and Vermont along with District of Columbia.

2. Enforcement Action on the Federal Level

In March 2018, United States Senators Elizabeth Warren and Cory Booker introduced the End Employer Collusion Act, which would essentially prohibit No-Poach Clauses and their enforcement at the federal level. A companion bill was later introduced in the House of Representatives, but the bills were not enacted. On July 12, 2018, Senators Warren and Booker sent letters to over 80 large franchisors requesting information from them regarding any No-Poach Clauses in their form franchise agreements. No public information is available regarding whether certain franchisors responded or any further action taken by the Senators.

V. Plaintiff Class Actions

A. Pending or Recently Dismissed Plaintiff Class Action Cases

In each of the cases identified below, an employee or employees of a franchisee of the named brand alleged that he or she were not hired for a position with another franchisee of the same brand because of the No-Poach Clause in that brand's form franchise agreement. The employees allege that they were damaged by the inclusion of the No-Poach Clause in the form franchise agreement, which all franchisees within a brand know the other franchisees have agreed to as well, and which violate antitrust law. The case information and history, notable or differentiating facts, main arguments, any substantive court orders relevant to the No-Poach Clauses and the current status of each case are detailed below.

1. **McDonald's**

Leinani Deslandes v McDonald's USA, LLC, et al., Case No. 17-cv-4857 (N.D. IL) filed 6/28/17

Defendant(s): Franchisor entities and unknown co-conspirators, including franchisees

Scope of No-Poach Clause: Franchisee may not employ or seek to employ any person who is employed, or has been employed in the last 6 months, at any McDonald's operation, or otherwise induce, directly or indirectly, such person to leave such employment.

Summary of Plaintiff's Position: *Per se* or quick look standard should apply.

Summary of Defendants' Position: Rule of reason standard should apply.

Other Issues: McDonald's-brand restaurants are both franchisee-owned and owned and operated by direct and indirect subsidiaries of the franchisor. McDonald's also franchises McDonald's-brand restaurants. There are no exclusive territories so, per the court, they all compete with each other.

Rulings: While the Court rejected Plaintiff's argument that the No-Poach Clause was unlawful *per se*, the Court denied Defendants' Motion to Dismiss finding that Plaintiff had alleged sufficient facts that required a review of the No-Poach Clause under the quick look analysis. Plaintiff had not alleged facts regarding market power necessary to establish an antitrust violation under the rule of reason. The Court expressly stated that the Plaintiff's claims may not survive under the quick look analysis at a later stage of the case and provided the option for her to amend the complaint to allege facts relevant to a rule of reason analysis. The Court also rejected Plaintiff's state law claims.

Current Status: Plaintiff did not amend the Complaint. Defendants have answered. Discovery is ongoing.

2. **Auntie Anne's, Carl's Jr. and Arby's - Washington**

Same Plaintiff's class action counsel filed three lawsuits against these franchisors, which were informally consolidated for briefing purposes.

Auntie Anne's

Joseph Stigar v. Dough Dough, Inc., et al., Case No. 18-cv-244 (E.D. Wash.) filed 8/3/18

Scope of No-Poach Clause: Franchisee may not employ or seek to employ any person who is employed by franchisor or another franchisee.

Carl's Jr.

Ashlie Harris v. CJ Star, LLC et al., Case No. 18-cv-247 (E.D. Wash.) filed 8/3/18

Scope of No-Poach Clause: Franchisee may not seek to employ any person who is employed, as a shift leader or a higher position, by franchisor or another franchisee.

Arby's

Myrriah Richmond and Raymond Rogers v. Bergey Pullman, Inc. et al., Case No. 18-cv-246 (E.D. Wash.) filed 8/22/18

Scope of No-Poach Clause: Franchisee may not seek to employ any person who is employed by franchisor or another franchisee.

Defendant(s): Franchisor entities and unnamed franchisees

Summary of Plaintiffs' Position: *Per se* or quick look standard should apply.

Summary of Defendants' Position: Rule of reason standard should apply.

Other Issues: Washington State Attorney General filed an amicus brief asserting that state antitrust law did not necessarily have to follow federal antitrust law. DOJ filed a Statement of Interest as detailed above.

Rulings: None

Post-Ruling Activity: All cases were dismissed as a result of settlement. No details of the settlements are publicly available.

Current Status: Closed

3. **Jimmy John's**

Sylas Butler (Donald Conrad) v. Jimmy John's Franchise, LLC, et. al., Case No. 18-cv-133 (S.D. Ill) filed 1/24/18 (Butler terminated)

Defendant(s): Franchisor

Scope of No-Poach Clause: Franchisee may not employ or seek to employ any person who is employed, or has been employed in the last 12 months, by franchisor or other franchisee.

Summary of Plaintiff's Position: *Per se* or quick look standard should apply.

Summary of Defendants' Position: Rule of reason standard should apply.

Other Issues: Form franchise agreement provides that franchisees are third party beneficiaries and can enforce this provision directly.

Rulings: While the Court rejected Plaintiff's argument that the No-Poach Clause was unlawful *per se*, the Court denied Defendants' Motion to Dismiss finding that Plaintiff had alleged sufficient facts that required a review of the No-Poach Clause under the quick look analysis. The Court also rejected Plaintiff's state law claims.

Case Status: Discovery ongoing; final pretrial conference scheduled for 9/2/20.

4. **Cinnabon**

Yi v. SK Bakeries, LLC, Case No. 18-cv-05627 (W.D. Wash.) filed 8/3/18

Defendant(s): Franchisor, franchisee employer and other large franchisees within Washington state.

Scope of No-Poach Clause: Franchisee may not employ or seek to employ any person who is employed by franchisor or another franchisee or attempt to induce such person to leave such employment.

Summary of Plaintiff's Position: No-Poach Clause is *per se* unlawful.

Summary of Defendants' Position: Rule of reason analysis should apply. Also argue that franchisor and franchisees cannot conspire in violation of antitrust laws, citing

Danforth & Assocs. v. Coldwell Banker Real Estate, No. C-10-1621, 2011 WL 338798 at *2 (W.D. Wash. Feb. 3, 2011) (franchisor and franchisee cannot conspire within the meaning of the Sherman Act), *Williams v. I.B. Fischer Nevada*, 999 F.2d 445 (9th Cir. 1993) and *Jack Russell Terrier Network of N. Cal. v. Am. Kennel Club, Inc.*, 407 F.3d 1027 (9th Cir. 2005).

Other Issues: Seeks nationwide class; also asserts state law antitrust claims.

Rulings: The Court denied the Defendants' Motion to Dismiss as to federal antitrust claims, found the quick look analysis would apply and dismissed state law claims.

Case Status: Settled and dismissed with prejudice as to named Plaintiff; dismissed without prejudice as to putative class. Dismissal order entered 4/23/19.

5. **Little Ceasars**

Ogden v. Little Ceasars Enterprises, Inc., et. al.
Case No. 18-cv-12792 (E.D. Mich.) filed 9/7/18

Defendant(s): Franchisor entities and unnamed co-conspirators, including franchisees

Scope of No-Poach Clause: Franchisee agrees not to hire any individual in a management position if they are employed or were employed in the last 6 months by franchisor or another franchisee. Earlier versions of the form franchise agreement (between approximately 2010 and 2015) also included language specifying that other franchisees were third party beneficiaries of this provision.

Summary of Plaintiff's Position: *Per se* rule or quick look analysis should apply.

Summary of Defendants' Position: Rule of reason should be used because the No-Poach Clause is a vertical restraint.

Other Issues: In August 2018, Little Ceasars agreed to an Assurance of Discontinuation with the Washington Attorney General; complaint asserts nationwide class of current or former managers.

Case Status: Motion to Dismiss pending (briefing completed 3/27/19)

6. **Burger King**

Arrington v. Burger King Worldwide
Case No. 18-cv-24128 (S.D. Fla.) filed 10/5/2018

Defendant(s): Franchisor entities

Scope of No-Poach Clause: Franchisee agrees not to hire any individual if they are employed or were employed in the last 6 months by franchisor or another franchisee. No-Poach Clause removed from form franchise agreement in September 2018.

Summary of Plaintiff's Position: *Per se* rule or quick look analysis should apply.

Summary of Defendants' Position: unknown

Other Issues: Asserts nationwide class.

Case Status: Recently consolidated with Case No, 18-cv-24304 (S.D. Fla.) filed 10/18/18; Amended Class Action Complaint filed 3-15-19; Jury trial set for 5/10/21.

7. Jackson Hewitt

Newbauer v. Jackson Hewitt Tax Services, Inc.
Case No. 18-cv-00679 (E.D. Va.) filed 12/20/18

Defendant(s): Franchisor entities and unnamed franchisees

Scope of No-Poach Clause: During the term of the franchise agreement and for 2 years thereafter, franchisee agrees not to solicit or hire any individual for a job position entailing tax preparation, tax preparation management or supervisory duties or tax preparation instruction duties for individuals that were in a management position in a company-owned or franchisee operation in the prior 12 months.

Summary of Plaintiff's Position: N/A

Summary of Defendants' Position: N/A

Other Issues: N/A

Rulings: Order consolidating and transferring 4 cases against franchisor entities to District of New Jersey entered 3-28-19

Case Status: Voluntarily Dismissed Without Prejudice after cases were consolidated and transferred.

8. H&R Block

Maurella v. H&R Block, Inc., et. al., Case No. 18-cv-07435 (N.D. Ill.) filed 11/8/18

Defendant(s): Franchisor entities

Scope of No-Poach Clause: Franchisee is prohibited from recruiting or soliciting employees of franchisor or another franchisee. Franchisor removed the No-Poach Clause from its form franchise agreement in May 2018.

Summary of Plaintiff's Position: *Per se* rule should apply.

Summary of Defendants' Position: Unknown

Other Issues: Asserts nationwide class of employees from 2009 to May 10, 2018.

Case Status: Motion to Compel Arbitration or Dismiss H&R Block, Inc. for Lack of Personal Jurisdiction or Transfer Venue is pending.

9. Pizza Hut

Kristen Ion Butler v. Pizza Hut, LLC, Case No. 17-cv-788 (E.D. Texas) filed 11/3/17

Defendant(s): Franchisor and unnamed franchisees

Scope of No-Poach Clause: Franchisee agrees not to hire any individual in a management position if they are employed or were employed in the last 6 months by franchisor or another franchisee.

Summary of Plaintiff's Position: *Per se* rule or quick look analysis should apply.

Summary of Defendants' Position: *Per se* rule is inapplicable and Plaintiff failed to plead facts necessary for a review under the rule of reason; also challenges Plaintiff's standing because she was a shift manager and the No-Poach Clause only applied to restaurant managers, two-levels of employment higher than shift manager.

Other Issues: Plaintiff seeks a nationwide class, or alternative a state-wide class, of all current and former managers.

Case Status: Motion to Dismiss was pending; voluntarily dismissed without prejudice on 7/16/18.

10. **Dunkin'**

Kayla Marie Avery, Kahari Thomas, Prestige Lawrence v. Albany Shaker Donuts LLC, et al., Case No. 18-cv-9885 (S.D. NY) filed 10/25/18

Defendant(s): Franchisor and Franchisees

Scope of No-Poach Clause: Franchisees are prohibited from soliciting or hiring employees of franchisor or another franchisee.

Summary of Plaintiff's Position: *Per se* rule or quick look analysis should apply.

Summary of Defendants' Position: N/A – no filings

Other Issues: Plaintiff seeks class of former employees of ten largest Dunkin' franchisees in New York; in March 2019, Dunkin' reached settlement with coalition of state attorneys general to cease use and enforcement of the No-Poach Clause.

Case Status: Voluntary dismissed without prejudice on 12/11/18.

B. Certification of Class - Open Issue

To date, the issue of class certification relating to franchisee employees' claims of damage from No-Poach Clauses has not been fully briefed or litigated. However, in cases where a nationwide or state-wide class is alleged, multiple courts have raised the issue of the size of the market in which franchisees would actually be competing for employees. Because the jobs at issue in most of these cases are lower wage jobs, courts have suggested that the market of competition would be relatively small because these are not the type of jobs for which an individual would typically relocate to a different area. This underlying issue raises the question of what would be an appropriate geographic market upon which a class would or could be based, among other issues relevant to class certification.

VI. Pending Legislation

Maine, New Jersey, New York and Washington all have pending legislation to prohibit the use and enforcement of No-Poach Clauses in agreements between employers. Each is expected to pass in the current legislative session, with Washington likely being the first.

The most recent state to introduce such a bill is New York. It is typical of the proposed legislation in all of these states. On February 21, 2019, a bill was introduced in both houses of the New York state legislature titled the “End Employer Collusion Act” that would make unlawful any agreement between employers to restrict the soliciting or hiring of each other’s employees. The proposed act would provide a private right of action for actual and punitive damages in addition to enforcement by the Attorney General.

VII. Conclusion

The amount of activity at the federal and state level and in the private class action arena relating to No-Poach Clauses is showing no sign of slowing down. While several class action cases have survived motions to dismiss, will the DOJ’s recent Statement of Interest asserting that the rule of reason is the proper standard to review No-Poach Clauses in franchise agreements have any effect on those actions? Will it deter future actions from being filed? Will the pending legislation become effective and will additional states introduce legislation prohibiting the use of No-Poach Clauses? Will franchisors continue to use or actively enforce No-Poach Clauses in states where there is no law prohibiting them? Will politicians on the campaign trail in 2019 through 2020 continue to highlight this issue? It will no doubt be interesting to see the answer to many of these questions during the next annual review of this topic.

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2019 Judicial Update

Joint Employer Liability in the Franchisor-Franchisee Context

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I. Background

There has been significant litigation in recent years concerning joint employer liability in the franchisor-franchisee context and whether franchisors exert sufficient control over a franchisee to be considered a joint employer and thus, jointly liable for an employee's claims.⁵

From 1984 through 2015, the joint-employer test established by the National Labor Relations Board ("NLRB") required that a joint employer not only possess the authority to control employees' terms and conditions of employment, but must also exercise that authority, and do so directly, immediately, and not in a limited and routine manner. *TLI, Inc.*, 271 NLRB No. 128 (1984).

In 2015, the NLRB loosened the standard and established a new joint-employer test in *Browning-Ferris Indus. of California, Inc.*, 362 NLRB No. 186 (2015)⁶ by only requiring that an employer have the right to control the other employer's employee:

[W]e will no longer require that a joint employer not only possess the authority to control employees' terms and conditions of employment, but must also exercise that authority, and do so directly, immediately, and not in a "limited and routine" manner. . . . The right to control, in the common-law sense, is probative of joint-employer status, as is the actual exercise of control, whether direct or indirect.

In September 2018, the NLRB announced its proposal to revert back to the pre-*Browning-Ferris* standard, requiring that an employer have the right to control and actually exercise such right to control an employee's terms of employment to be found a joint-employer. See *Federal Register Proposed Rules*, Vol. 83, No. 179 (Sept. 14, 2018).

Even more recently on April 1, 2019, the U.S. Department of Labor ("DOL") proposed a new rule that sets forth a four-factor balancing test derived from *Bonnette v. California Health & Welfare Agency*, 704 F.2d 1465 (9th Cir. 1983). This test considers whether a putative joint employer actually exercises the power to: (i) hire or fire an employee; (ii) supervise and control an employee's work schedules or conditions of employment; (iii) determine an employee's rate and method of payment; and (iv) maintain an employee's employment records.

⁵ The common law test for whether an individual is an employee of joint employers asks (1) whether the "individual renders services to at least one of the employers" and (2) whether "that employer and the other joint employers each control or supervise such rendering of services." Restatement of Employment Law § 1.04(b).

⁶ In December 2017, the NLRB reversed the *Browning-Ferris*, only to effectively reinstate it again in February 2018 after the NLRB found a potential conflict tainted the decision of reversal. At this time, *Browning-Ferris* is still the law.

The NLRB is slated to issue its final rule on joint employer status within the upcoming months, while the DOL is within its 60-day comment period through the end of May 2019. Notwithstanding, jurisprudence in this area reflects that the majority of courts do not view franchisors as a joint employer of its franchisees.

II. A Glance At 2018 Through 2019

1. *Cruz v. MM 879, Inc.*, No. 115CV01563TLNEPG, 2019 WL 266458 (E.D. Cal., Jan. 18, 2019)

Plaintiffs were former employees of Defendant MM 879, Inc. (“MM 879”), a Merry Maids franchisee, and brought hour and wage claims against MM 879 and the franchisor Merry Maids, LP (“Merry Maids”), among others. Plaintiffs alleged that they were jointly employed by Defendants. Upon Defendants’ motion for summary judgment, the court analyzed two main issues: (1) whether the franchisor Merry Maids is deemed a joint employer of Plaintiffs and alternatively, (2) whether Merry Maids can be found liable under an ostensible agency theory. This analysis was performed under California law.

The court first set forth the legal standard for a joint employer analysis, which it pointed out has evolved in recent years under California law. Merry Maids, acting in its capacity of the franchisor, would only be liable to Plaintiffs if it was deemed an employer of the Plaintiffs. As provided by the court:

The Supreme Court of California, examining California Labor Code § 1194, determined “to employ” means (1) “to exercise control over the wages, hours or working conditions,” (2) “to suffer or permit to work,” or (3) “to engage, thereby creating a common law employment relationship.” *Martinez v. Combs*, 49 Cal. 4th 35, 64 (2010). A defendant can be an employer for liability purposes if any one of the three prongs are satisfied.

However, despite the standard set forth above in *Martinez*, the court noted that “[t]he law has developed since *Martinez*” and referenced *Patterson v. Domino’s Pizza, LLC*, 60 Cal. 4th 474 (2014). In *Patterson*, “the court acknowledged that Domino’s had the capacity to exert significant economic influence over franchisees” but since the franchisee was afforded with discretion in the day-to-day decisions, it found in favor of Domino’s on summary judgment. The court’s discussion of the legal standard is significant because it noted that the “effect of *Patterson* on the *Martinez* framework is unclear.” *Martinez* lays out a three-prong test, while *Patterson* focuses on the common law definition of employment, which is analyzed under the third prong of *Martinez*. Since there has yet to be binding precedent, the court accepted (upon the parties’ agreement) to use the *Martinez* standard but still afforded the third prong significant consideration in light of *Patterson*.

Under the first prong of *Martinez*, the court considered whether Merry Maids exercised control over the wages, hours, or working conditions of Plaintiffs. Plaintiffs

argued that the operating manual instructed “franchisees how to present a percentage-based compensation scheme to potential hires during interviews,” set forth procedures for training, and included day-to-day procedures such as the use of uniforms and cleaning kits. They further argued that Merry Maids had a right to terminate the franchisee for failure to adhere to these guidelines. However, the court determined that this evidence was “too thin to establish liability” and that Merry Maids did not have direct control over Plaintiffs’ wages, hours, or working conditions. The lack of direct control was evidenced by the fact that the franchisor’s only recourse for noncompliance was to terminate the agreement.

The second prong focuses on whether Merry Maids was aware of the wage violations but failed to act or prevent it from occurring. Plaintiffs argued that Merry Maids had the ability to know and prevent these wage violations from occurring because it had access to all of the documents outlining the compensation structure. However, the court found that this prong requires actual knowledge of the violations and the power to prevent them from occurring. The owner of the franchisee also testified that he was solely responsible for setting the wages, hours, and working conditions of MM 879 employees. Plaintiffs failed to satisfy this second prong.

The third and final prong “to engage” focuses on whether a common law employment relationship has been created. The court further provided:

Patterson clarified the common law definition of employment in the franchisor context: “A franchisor ... becomes potentially liable for actions of the franchisee's employees, only if it has retained or assumed a general right of control over factors such as hiring, direction, supervision, discipline, discharge, and *relevant* day-to-day aspects of the workplace behavior of the franchisee's employees.” *Patterson*, 60 Cal. 4th at 497–98 (emphasis added).

Plaintiffs rightfully point out that they only had to establish that Merry Maids had the “right to control” certain factors, as opposed to actually exercising that right. However, the court found that nothing in the franchise agreement or operating manual granted Merry Maids the right to set wage and hour policies for MM 879’s employees. And again, the franchise owner testified that he did not bother reading the operating manual and set whichever compensation structure that he desired. Plaintiffs failed to satisfy the final prong and summary judgment was granted in Merry Maid’s favor.

Plaintiffs also offered an alternative theory that Merry Maid is liable because MM 879 became its ostensible agents “Ostensible agency exists where (1) ‘the person dealing with the agent does so with reasonable belief in the agent's authority;’ (2) that belief is ‘generated by some act or neglect of the principal sought to be charged,’ and (3) ‘the relying party is not negligent.’” *Kaplan v. Coldwell Banker Residential Affiliates, Inc.*, 59 Cal. App. 4th 741, 747 (Ct. App. 1997). Plaintiffs were successful on this alternative theory by arguing that Merry Maids created the reasonable belief that the franchisee operated as the agent of Merry Maids by “the uniform system of branding,

trademark, and promotion.” Defendants’ motion for summary judgment was denied as to Plaintiffs’ ostensible agency theory.

2. *In re Domino's Pizza Inc.*, 16CV2492AJNKNF, 2018 WL 4757944 (S.D.N.Y. Sept. 30, 2018)

Plaintiffs filed a putative class action on behalf of employees of several Domino’s franchises owned by several related Defendants, alleging wage violations under FLSA and New York law. The court bifurcated the proceedings to first determine whether Domino’s franchisor defendants were deemed the joint employer of the plaintiffs. In setting out the legal standard for a joint employer analysis, the court provided:

The Second Circuit has identified two sets of factors relevant to this analysis: one to assess formal control, and the second to assess functional control. See *Carter v. Dutchess Community College*, 735 F.2d 8, 12 (2d Cir. 1084) (formal control factors); *Zheng v. Liberty Apparel Co.*, 355 F.3d 61, 72 (2d Cir. 2003) (functional control factors). These factors are not exclusive, and the two sets may have differing applicability “based on the factual challenges posed by particular cases.” *Barfield v. N.Y.C. Health & Hosps. Corp.*, 537 F.3d 132, 142 (2d Cir. 2008).

The court indicated that the Second Circuit has yet to use the above test in the franchisor-franchisee context but other circuits have considered the same factors in consideration of joint employer status. Notably, before the court even began its analysis, it provided “Plaintiffs were unable to point to a single case in which a franchisor was held liable as a joint employer under FLSA . . . The persuasive weight of this precedent notwithstanding, careful analysis of the two sets of factors in light of the evidence in the record is required to determine whether the Domino’s Defendants are joint employers for purposes of FLSA liability.”

A consideration of the formal control factors consisted of “whether the alleged employer (1) had the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records.” The court made the following respective findings. The parties mutually agreed that Domino’s did not receive applications, interview employees, or otherwise directly hire employees and thus found that the franchisor had no power to hire or fire employees. For the second factor, even though the majority of the standards set by Domino’s impact the plaintiffs’ work, there was no evidence that Domino’s controlled the plaintiffs’ work schedules. As for the working conditions, although there was evidence that Domino’s made on-site visits and could place a franchisee in default for noncompliance, this was insufficient to rise to the level of direct control of the employment conditions. For the third factor, the evidence showed that the franchisee set the plaintiffs’ wage rates and issued payments. In arguing the fourth factor, plaintiffs asserted that the franchisor had access to employment records and any employee complaints. However, the court found this to be insufficient evidence based on Second Circuit precedent.

Even if the formal control factors are not met, an employer may exercise sufficient functional control over a worker's environment to meet the FLSA definition of an employer. The functional control factors are "(1) whether the alleged employer's premises and equipment were used for the plaintiffs' work; (2) whether the subcontractors had a business that could or did shift as a unit from one putative joint employer to another; (3) the extent to which [the] plaintiffs performed a discrete line job that was integral to the alleged employers' process of production; (4) whether responsibility under the contracts could pass from one subcontractor to another without material changes; (5) the degree to which the alleged employers or their agents supervised [the] plaintiffs' work; and (6) whether [the] plaintiffs worked exclusively or predominantly for the alleged employers." *Olvera v. Bareburger Group LLC*, 73 F. Supp. 3d 201, 205-06 (S.D.N.Y. 2014).

There was little dispute over the first factor since the franchisee leased and purchased the equipment used in its respective stores. Although Domino's would approve the lease and set standards for purchasing equipment, this was insufficient to find the franchisor assumed ownership or control of the premises. The fifth factor overlapped with the court's analysis of supervision under the formal control factors. The court found the second, third, and sixth factors difficult to analyze in a franchisor-franchisee context but nevertheless, determined that since the amount of product the franchisee produces and sells is unrelated to any request or demand from the franchisor, these factors weighed in Domino's favor. The court weighed the fourth factor in favor of the defendants by reasoning "Plaintiffs could certainly perform the same or very similar tasks if they worked for a different Domino's franchise, but they would have no guarantee of being hired, and their salaries, supervisors, and places of work would differ even if successful."

Plaintiffs also offered an alternative theory of ostensible agency, which was rejected by the court. The court reasoned that "[Plaintiffs] point to no cases in which entities or individuals were held liable under FLSA or the NYLL based on a theory of ostensible agency when a court has found that they are not 'employers' as those statutes and caselaw resulting therefrom define the term." Further, the plaintiffs' complaint was deficient to support this theory. The court did not grant plaintiffs leave to amend and granted summary judgment in favor of Domino's.

3. *Bonaventura v Gear Fitness One NY Plaza LLC.*, 17 CIV. 2168 (ER), 2018 WL 1605078 (S.D.N.Y. Mar. 29, 2018)

Plaintiff was hired as a general manager of a franchised fitness club and medical spa, of which Retrofitness, LLC ("Retrofitness") was the franchisor. Plaintiff alleged that he worked without pay for nine months and asserted an FLSA claim, among others, against the franchisor and franchisee entities. Upon Retrofitness' motion to dismiss, the court set forth the following standard:

In the absence of clear guidance, courts in this Circuit use the general “economic reality” test that the Second Circuit developed to determine whether an employer-employee relationship exists. *E.g., Cano v. DPNY, Inc.*, 287 F.R.D. 251, 259 (S.D.N.Y. 2012); *Olvera v. Bareburger Group LLC*, 73 F. Supp. 3d 201, 206 (S.D.N.Y. 2014). Under this test, courts consider “whether the alleged employer (1) had the power to hire and fire the employees, (2) supervised and controlled employee work schedules or conditions of employment, (3) determined the rate and method of payment, and (4) maintained employment records.” *Herman v. RSR Sec. Servs. Ltd.*, 172 F.3d 132, 139 (2d Cir. 1999).

The plaintiff argued that the Retrofitness executives participated in the interview process along with the franchisee and thus, had input on whether or not to hire him. The court agreed and found “this factor of the economic reality test weighs in favor of finding that Retrofitness was Plaintiff’s employer under the FLSA.”

In support of the second factor, the plaintiff argued that Retrofitness supervised his daily activities, provided him with an employee handbook, and was directly and actively involved in the gym’s day-to-day operations. Retrofitness also led a three-day training to orient the staff on policies and procedures. This was sufficient to provide some indication that Retrofitness had the power to enforce its policies and procedures on the gym employees. Although the complaint did not provide what the potential consequences were for noncompliance, the court found this to be sufficient at the pleading stage.

The court combined its analysis of the final two factors relating to rate of payment and maintenance of employment records and found that the plaintiff sufficiently pled the third factor but not the fourth. Nevertheless, given the foregoing factors that weighed substantially in plaintiff’s favor, the court denied Retrofitness’ motion to dismiss as it related to joint employer liability.

4. *In re Jimmy John’s Overtime Litigation*, No. 14 C 5509, 2018 WL 3231273 (N.D. Ill. June 14, 2018)

Plaintiffs consisted of former assistant store managers of several Jimmy John’s franchisees, who brought FLSA claims against the franchisee and franchisor entities. Upon defendants’ motion for summary judgment, the court utilized the following four-factor test set forth in *Brunner v. Liautaud*, 2015 WL 1598106 (N.D. Ill. 2015): “(1) the power to hire and fire employees; (2) supervision and control of employee work schedules or conditions of payment; (3) determination of rate and method of payment; and (4) maintenance of employment records.” The court noted that these factors were not exhaustive but relevant to the joint employer inquiry.

For the first factor, plaintiffs conceded that the franchisor does not participate in the interview process but argued that it had substantial influence over the process by setting forth extensive guidelines relating to hiring in its operations manual. The court

found that the franchisor did not have the power to discipline or fire franchisee employees despite the disciplinary procedures set forth in the relevant franchise documents.

In support of the second factor, plaintiffs argued that the franchisor exerted control over the franchisee employees through its staffing and scheduling requirements (i.e. requiring managers to work fifty (50) hours per week). However, the record reflected that it was the franchise managers themselves that “were in charge of creating, directing, and managing employee schedules at the store level—not Jimmy John’s.” The court also noted that the franchisor’s influence over staffing requirements as it relates to audit scores and bonuses was insufficient to constitute control.

The third factor, determination of rate and method of payment, was controlled solely by the respective franchisee. Although the franchisee was free to seek advice from the franchisor regarding employee compensation, the franchisor itself did not make these determinations for the relevant employees. There was also little dispute as to the fourth factor. Plaintiffs conceded that their personnel files were kept by the respective franchisee.

Plaintiffs urged the court to consider additional factors, which the court organized into the following three categories: “(1) Jimmy John’s exercises control over human resource matters through employee training and dress code; (2) Jimmy John’s directs day-to-day operations of franchise stores with its extremely detailed Operations Manual and related requirements; and (3) Business Coaches effectively control franchises through their audits and feedback.” The court found that all three factors were necessary for the franchisor to protect the quality of its brand and insufficient to establish direct control, which was effectively exercised by the respective franchisee.

5. *A.H. by and through Hunt v. Wendy’s Company*, No. 3:18-CV-0485, 2018 WL 4002856 (M.D. Pa., Aug. 22, 2018)

Plaintiff was during all relevant times, a minor individual, that filed employment discrimination claims (for sexual harassment and hostile work environment) against the franchisee and franchisor entities. Plaintiff argued that the franchisor exercised sufficient control over the franchisee’s employees to qualify as a joint employer. Upon the defendants’ motion to dismiss, the court first set forth the applicable legal standard. “District courts in [the Third] Circuit consider the following factors in determining whether a joint employer relationship exists:

- (1) [A]uthority to hire and fire employees, promulgate work rules and assignments, and set conditions of employment, including compensation, benefits, and hours;
- (2) day-to-day supervision of employees, including employee discipline; and
- (3) control of employee records, including payroll, insurance, taxes, and the like.”

Hollinghead v. City of York, 11 F. Supp. 3d 450, 463 (M.D. Pa. 2014). No single factor is dispositive, and a weak showing of one factor may be offset by a strong showing on the

other two factors. See *id.* The parties' beliefs and expectations regarding the relationship between the parties are also relevant. See *id.*"

The court found that the plaintiff had pled sufficient facts to support a finding that the franchisor was a joint employer. As for the first factor, upon being hired, the plaintiff was required to sign several policy procedures that identified the procedures as belonging to franchisor entity. Further, the franchise agreement required that the restaurant be in strict conformity with the franchisor's specifications. For the second factor, the court considered the plaintiff's allegations sufficient to support a finding that the franchisor had some supervision over the franchisee's employees through its right to conduct periodic inspections and provide operational assistance. The third factor analyzed the franchisor's right to examine the books, records, and tax returns of the franchisee, which provided at least some support that the franchisor exercised control over employee records.

Plaintiff also offered an alternative agency theory which the court found sufficient to proceed based on the foregoing analysis. The court pointed to specific provisions within the franchise agreement that granted the franchisor "broad discretionary power to impose upon the franchisee virtually any control, restriction, or regulation [they] deemed appropriate or warranted."

III. Conclusion

Franchisors are well aware of the potential litigation that they face by selling franchises and have designed and operated their systems in a way to protect themselves from joint employer liability. Although a plaintiff may survive the pleading stage, it has proven difficult to defeat a franchisor at the summary judgment stage. Nevertheless, there is a bit of hope for plaintiffs in pursuing an agency theory against a franchisor. Plaintiffs typically assert an alternative theory against the franchisor under agency law, which has shown to have a promising outcome than pursuing a joint employer theory. The law continues to evolve in this area but as the law currently stands, franchisors typically have the upper hand when it comes to facing liability from claims brought by their franchisees' employees.

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2019 Judicial Update

Encroachment

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Is *El Pollo Loco* a fledgling revival of dormant encroachment precedents coming home to roost?⁷

Fundamentally, the encroachment doctrine seeks to balance the franchisor's goal of expanding to strengthen its system and brand and the franchisee's goal of avoiding competition. Where these goals conflict, franchisees often bring claims that the franchisor or other franchisees are encroaching upon their rights under franchise agreements or applicable statutes. While encroachment claims by franchisees premised on a breach of the implied covenant of good faith and fair dealing had fallen out of favor over the past 20 years, recent developments portend the possibility of renewed judicial receptivity to such claims under a variety of traditional and novel encroachment theories. By reviewing the development of the contemporary encroachment doctrine and examining trends in recent case law, this essay evaluates the significance of the recent *El Pollo Loco* decision for franchise relationships throughout the United States.

I. An Introduction to Encroachment

A. Early Claims of Encroachment

Encroachment claims first arose alongside the inception of franchisees' exclusive territory rights in the late 1970s and early 1980s. Prior to that period, exclusive territory provisions were considered *per se* violations of the Sherman Act; it was only after a pair of Supreme Court cases endorsed the legality of vertical territory restraints that the incorporation of such provisions in franchise agreements became commonplace.⁸ In the decades since, an array of encroachment theories emerged

The most common claim for violations of territoriality provisions involves "brick-and-mortar" encroachment, whereby a competing franchisee or the franchisor begins operating a business under the same brand in the vicinity of an existing franchisee's location.⁹ Classic hypothetical examples might include Burger King authorizing a new franchisee to establish a Burger King restaurant a few blocks from an existing franchisee, or Holiday Inn building a corporate-owned hotel in the same neighborhood as an existing franchisee under the same name. In both cases, the new business is selling the same products and services to customers near an existing franchisee. Because this is the most recognizable avenue by which encroachment may occur, it is also the easiest to prevent; it has been common practice for decades for franchise agreements to expressly delineate the boundary between a franchisee's right to an exclusive territory and the franchisor's right to expand its franchise system by authorizing new units. Modern franchise agreements often define franchisee's territorial

⁷ The author would like to express her sincere gratitude to Sally Dahlstrom and Wes Dutton, associates at Haynes and Boone, LLP, for their invaluable assistance on this paper.

⁸ J. Dolman, S. Korzenowksi, and E. Wulff, "STOP INVADING MY SPACE: Encroachment Issues in Franchising," International Franchise Association, 51st Annual Legal Symposium, at 1 (May 6-8, 2018).

⁹ *Id.*

protections by reference to established corporate policies, fixed geographic boundaries (such as a county line or minimum radius in miles), or population density.¹⁰

There is also a range of non-traditional encroachment theories based on intra-brand competition, all falling within a general definition of “product or service” encroachment whereby a franchisor distributes products or services under a franchise brand to customers within the exclusive territory of an existing franchisee.¹¹ Territorial encroachment may occur at non-traditional sites, such as where a franchisor authorizes a full-service unit in a mall, airport, military base, sports stadium, etc., near an existing free-standing franchisee location.¹² Likewise, territorial encroachment may occur by non-traditional units at traditional sites or non-traditional sites, such as a partial-service kiosk in a mall, a food truck, a booth or tent at a festival, etc.¹³ Other forms of non-traditional encroachment can be more subtle, such as where a franchisor sells branded goods or services through separate channels of distribution; this category might include sales through an intermediary—such as a pizza restaurant franchisor selling branded frozen pizzas in supermarkets—or direct sales by catalogue or online—such as the same pizza restaurant franchisor taking pizza orders through a franchisor-owned website, baking pizzas in franchisor-owned facilities, and delivering pizzas to customers within the territory of an existing franchisee’s restaurant.¹⁴

Even where a franchisor does not sell identical goods or services in the territory of a franchisee, a franchisor may still encroach via “brand expansion” encroachment, where the franchisor or brand owner licenses a brand to sell products or services different from the products or services sold by an existing franchisee.¹⁵ Whereas “brick-and-mortar” and “product or service” encroachment involve substitute goods or services competing for the same customers under the same brand, “brand expansion” encroachment involves the extension of an existing brand to new products or services—diminishing the value of the existing franchisee’s use of that brand to market existing goods and services.¹⁶ A hypothetical example of “brand expansion” encroachment

¹⁰ *Id.* at 15.

¹¹ *Id.*

¹² D. Coldwell and J. Dienelt, “Gerrymandering: When Is Expansion Encroachment?,” American Bar Association Forum on Franchising, at 1 (October 16-19, 1996).

¹³ *Id.*

¹⁴ *Id.* at 1, 15 (discussing *Carlock v. Pillsbury Co.*, in which a district court rejected a franchisee’s claims for breaches of contract and of the implied covenant of good faith and fair dealing, holding that Pillsbury, as franchisor and owner of the Häagen-Dazs trademark, had the right under the applicable franchise agreement to distribute ice cream products “through not only Häagen-Dazs shoppes but through any other distribution method which may from time to time be established[,]” including via retail stores. See *Carlock v. Pillsbury Co.*, 719 F.Supp. 791, 817-18 (D. Minn. 1989)).

¹⁵ Dolman, et al., *supra* note 2, at 2.

¹⁶ An interesting hybrid of “brand expansion” and “alternative means of distribution” fact patterns occurred in *BJM & Associates v. Norrell*. In that case, the district court held that Norrell breached its agreement with a temporary employment service franchisee by concluding that Norrell’s franchisees could not sell “management services” and creating a wholly-owned subsidiary that provided “management services.” The district court concluded that Norrell’s sale

might involve Dunkin Donuts selling coffee makers and filters in grocery stores under the same brand which existing franchisees use to sell freshly-brewed coffee in traditional franchise restaurants; even if existing franchisees are not competing directly with the franchisor's brand expansion products, such brand expansion might weaken demand for franchisee products and services or otherwise dilute the value of brand trademarks to franchisees.¹⁷

Encroachment concerns can also arise from cross-brand franchise competition, where a single franchisor corporation owns competing brands of franchises. For example, one of the earliest corporations to embrace multi-brand operations was PepsiCo, which at one point simultaneously owned Pizza Hut, KFC, and Taco Bell.¹⁸ There is a potential for a conflict of interest if the franchisor is concerned with the profitability of competing brands of franchises; a franchisor may tip the scales of cross-brand competition to improve the profitability of one brand's franchises to the detriment of franchisees in a competing brand, perhaps by sharing customer information or other trade secrets across brands.¹⁹ While franchise agreements may contemplate territoriality within a brand, they typically do not address cross-brand competition—particularly where the franchisor acquires a competing brand after executing agreements with existing franchisees. Likewise, the handful of state statutes that seek to insulate franchisees from intra-brand encroachment do not apply to cross-brand competition. At present, franchisees' legal recourse for cross-brand competition depends almost exclusively on contract claims under the express or implied terms of the franchise agreement.

B. Good Faith and Fair Dealing and Encroachment

Some of the earliest territorial encroachment claims were made under the implied covenant of good faith and fair dealing. See *Domed Stadium Hotel, Inc. v. Holiday Inns, Inc.*, 732 F.2d 480 (5th Cir. 1984). As noted by the district court in the seminal case of *Scheck v. Burger King*, “[i]t is axiomatic that a contract includes not only its written provisions, but also the terms and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or

of management services through an alternatively-branded subsidiary not only violated the express terms of the applicable license agreement—which prohibited Norrell from operating “any similar type of business” to that conducted by the licensee—by offering services that competed with the franchisee, but that Norrell’s attempt to evade the terms of the license agreement by unilaterally defining exempt management services “smacks of opportunistic behavior that the law will not tolerate.” See *BJM & Associates, Inc. v. Norrell Services, Inc.* (E.D. Ky. 1994), *aff’d*, 1995 U.S. App. LEXIS 33, 118 (6th Cir. 1995); Coldwell, et al., *supra* note 6, at 16.

¹⁷ Dolman, et al., *supra* note 2, at 2 (for example, the authors describe a franchisor licensing one franchisee to use its trademark to operate a retail sunglasses shop, while licensing another franchisee to utilize the same trademark for an eyeglass repair shop; though the businesses are not directly competing, they compete indirectly on brand recognition and ancillary products like lenses and cleaning supplied).

¹⁸ *Id.* at 25.

¹⁹ *Id.* at 26.

spoken.” *Scheck v. Burger King Corp.*, Civil Action No. 89—1281—Civ., 756 F.Supp. 543, 548-49 (S.D. Fla. Jan. 15, 1991). The covenant of good faith and fair dealing was—and still is—utilized in the common law of dozens of states to fill gaps in the express terms of an agreement. Although courts will not imply a covenant which alters the express terms of a franchise agreement, courts will imply a covenant where disputed contract provisions are ambiguous to give commercially reasonable meaning to the relationship between the parties.

In the context of encroachment claims, the covenant of good faith and fair dealing applies in the absence of express language reserving the franchisor’s right to develop new franchises or to sell goods and services within the franchisee’s territory. Likewise, the covenant might apply where the franchise agreement does not unequivocally state that the franchisee is not receiving an exclusive territory. In cases like *Scheck* and *In re Vylene* (both discussed, *infra*) the courts concluded that, even though the franchise agreements clearly did not grant franchisees exclusive territory rights, the agreements also did not expressly grant franchisors unfettered discretion to develop new franchises that competed with existing franchisees. While those early cases seemed to open the door to virtually boundless application of the implied covenant of good faith and fair dealing to limit the effectiveness of non-exclusive territory provisions, the broader judicial consensus was—and remains—that franchise agreement terms expressly denying franchisees exclusive territory rights were logically equivalent to terms expressly reserving franchisors’ rights to develop competing franchises, and that both provisions were sufficiently unambiguous to foreclose application of the implied covenant of good faith and fair dealing.

Nonetheless, prudent franchisors should seek to reserve development rights in franchise agreements—and to deny exclusive territory rights of franchisees—with as much specificity as possible to minimize the risk that a court will perceive a latent ambiguity and allow a franchisee’s encroachment claim to survive summary judgment under the implied covenant of good faith and fair dealing. Additionally, the more specific the terms of the franchise agreement, the less latitude a court will have to construe ambiguities in the contract in favor of the franchisee. Due to the asymmetry in bargaining power between franchisees and much larger franchisor corporations, courts have historically relied on implied covenants and equitable relief to attempt to invalidate or mitigate actions by the franchisor which appear arbitrary or harsh, but which do not otherwise breach a provision of the franchise agreement (which is, itself, often drafted by the franchisor).²⁰

C. Density/population encroachment

Traditional territory provisions in franchise agreements included territorial definitions based on radius in miles, population density, or district boundaries—such as a specific county or metro area.²¹ As in *El Pollo Loco* (discussed *infra*) the scope of territorial rights granted to a franchisee in a franchise agreement often reflects

²⁰ Coldwell, et al., *supra* note 6, at 6.

²¹ Dolman, et al., *supra* note 2, at 15.

underlying assumptions about the population density needed to sustain a successful franchise.²² One advantage of defining a franchise territory by reference to population density is that such measures permit franchisee territories to shift as metro areas expand. In a city like Conroe, Texas—the fastest-growing large city in the country at 7.8% annual growth in 2017—population density might increase in some franchise locations several times over in the span of a decade, restricting development under existing franchise agreements defining territory by reference to radius in miles or other rigid metrics.²³ This can create stubborn development problems for franchisors seeking to capitalize on rapid population growth by binding franchisors to outdated territory definitions in franchise agreements with terms of a decade or more.

Because population densities are constantly shifting, it is not unusual in contemporary franchise agreements for franchisors to reserve the right to restrict a franchisee's exclusive territory if the population within that territory exceeds a certain population density.²⁴ Such terms can often lead to claims of population density encroachment, however, as franchisors argue that a population has grown sufficiently to warrant new franchise development under the terms of the agreement and franchisees disagree. As data on population growth is almost universally based on survey estimates, litigation over population density encroachment can involve disputes regarding sources of population data and various methodologies used to estimate population density.²⁵ The more precise a franchise agreement is in defining the scope of

²² For example, in *El Pollo Loco*, the franchisor's vice president of development testified that "essentially 80% of your business comes from within about a mile and a half of your restaurant[...] and so my opinion is you need 25,000 people in that ring[...] we ultimately changed the franchise agreement for any stores that were developed subsequent to this point in time, when I arrived, to say that the radius should be a mile and a half or 30,000, whichever is less." (Statement of Decision ¶89). The Bryman plaintiffs in *El Pollo Loco* enjoyed a more generous term under an older franchise agreement defining their (non-exclusive) protected territory by population density of 50,000 people—a metric whose radius changed over the course of the agreement and which was disputed in the lawsuit. *Michael D. Bryman, et al. v. El Pollo Loco, Inc.*, Case No. MC026045 (Cal. Super. Ct. Los Angeles Cnty. Aug. 1, 2018) (appeal docketed, *Handlers-Bryman, et al. v. El Pollo Loco*, Case No. B292585 (Ca. Ct. App. Feb. 5, 2019)).

²³ "The South Is Home to 10 of the 15 Fastest-Growing Large Cities," United States Census Bureau Press Release No. CB17-81 (May 25, 2017) <https://www.census.gov/newsroom/press-releases/2017/cb17-81-population-estimates-subcounty.html>.

²⁴ Dolman, et al., *supra* note 2, at 4.

²⁵ Using another example from *El Pollo Loco*, there was significant dispute at trial regarding whether the franchisor was required to notify the plaintiff franchisees of the development of a new corporate-owned restaurant 2.3 miles from franchisees' existing restaurant. The franchise agreement fixed franchisees' territory at a population density of 50,000 people and the 2010 census—the most recent authority available based on the terms of the agreement—estimated the population in a 2-mile radius around the existing franchise location to be approximately 52,895. Even within the same data from the 2010 census, the parties disputed different measures of population density, with plaintiffs attempting to expand the radius of their protected territory and defendant franchisor seeking to restrict the territory as much as possible. Though the defendant ultimately prevailed on the issue of whether its restaurant fell within the plaintiffs' protected territory, the outcome was indisputably close—coming down to a margin of error of

territory by reference to population density—ideally by designating sources and methods for calculating population density—the less likely a franchisor is to face claims of population density encroachment.

D. Internet encroachment

The rise of E-commerce poses unprecedented challenges to the traditional franchise relationship by massively expanding the channels through which goods and services are sold. Many present-day franchise agreements fail to adequately address the reality that sales are less constrained by brick-and-mortar locations, population density, or territorial boundaries than ever before. Whereas franchisees traditionally were—and often still are—limited to operations from a specific brick-and-mortar location or within a defined territory, modern E-commerce affords franchisors virtually limitless opportunities to reach customers around the world, while also introducing new competitive pressures to the relationships between franchisors and franchisees, and among franchisees.

One of the largest drivers of this trend away from the traditional franchise business model is the so-called “Amazon Effect”—the rapid growth of E-commerce and convergence of sales to a handful of massive online retailers like Amazon, and the attendant pressure on sellers of goods and services to “integrate physical stores, websites, and mobile apps, and not treat these different delivery models as different delivery channels.”²⁶ Franchises are actually well-suited, relative to other types of traditional retailers, to capitalize on E-commerce trends by leveraging the enhanced visibility and efficiency of an online presence with brick-and-mortar stores already conveniently located near dense population areas. Whereas 20 years ago most customers ordered a pizza by calling their nearest franchisee, it is now routine for restaurant franchises to encourage customers to order food from a central website and then relay online orders to the nearest brick-and-mortar franchisee for efficient processing and delivery. Such developments have revolutionized customers’ interactions with franchises and altered franchise relationships, themselves.

While the E-commerce trend has vastly enhanced customer convenience, it also presents difficult obstacles for defining the relationship between franchisors and franchisees by blurring—if not obviating, altogether—the territorial boundaries traditionally used to protect franchisees from intra-brand competition from franchisors and other franchisees. For instance, in the absence of express provisions in franchise agreements addressing commerce through non-traditional means (sales via catalog, telephone, the internet, etc.), many of the earliest E-commerce disputes fell under

several thousand people and mere tenths of a mile in a city of 160,000 people in sprawling Los Angeles County. *El Pollo Loco, Inc.*, Case No. MC026045, Statement of Decision at ¶¶104-112.

²⁶ Dolman, et al., *supra* note 2, at 13-14 (noting that Amazon, by itself, accounted for 43% of all online retail sales in the United States in 2016); see also Adam Hartung, “How The ‘Amazon Effect’ Will Change Your Life And Investments” *Forbes* (February 28, 2017), online: <https://www.forbes.com/sites/adamhartung/2017/02/28/how-the-amazon-effect-will-change-your-life-and-investments/#69df8995e76a>.

arbitration provisions.²⁷ Similar to courts interpreting ambiguities in franchise agreements by appeal to the implied covenant of good faith and fair dealing, the arbitrators in these early disputes focused on the expectations of the parties, drawing parallels between the traditional encroachment doctrine and E-commerce analogues. And the outcomes varied by degree to which the challenged electronic sales substituted for sales performed by brick-and-mortar locations.²⁸ Early E-commerce litigation followed a similar pattern, albeit with courts hewing more closely to the language of the applicable franchise agreements than their arbitral relatives.²⁹

Contemporary disputes tend to be governed almost exclusively by franchise agreements, largely because franchisors have adopted contract terms over the past two decades which address E-commerce and other franchise business through nontraditional channels—typically allowing franchisors greater latitude in constructing territory restrictions.³⁰ As E-commerce expands to become the dominant forum for retail sales worldwide, franchisors will inevitably need to continue tailoring agreements to expressly define the role of E-commerce in the franchise relationship, taking care to precisely demarcate the boundaries between the rights of franchisors and franchisees to participate in E-commerce.

II. A Brief History of Encroachment Jurisprudence

By tracing the following cases in chronological order, a pattern emerges of the initial flurry of successful encroachment claims premised on the implied covenant of good faith and fair dealing. This trend began in the early 1990s with *Scheck* and its progeny and ultimately subsided by the end of that decade, as courts increasingly resisted claims to imply a duty not to encroach on franchisors where the franchise agreement expressly denied franchisees an exclusive territory. The following cases define the contours of precedents which resurfaced in 2018 with the plaintiffs' successful encroachment claim in *El Pollo Loco*.

A. *Scheck v. Burger King Corp.*, Civil Action No. 89—1281—Civ., 756 F.Supp. 543 (S.D. Fla.1991).

Perhaps no encroachment case is more famous than *Scheck v. Burger King Corp.* In *Scheck*, the plaintiff franchisee brought action against the defendant franchisor after the defendant authorized the construction of a competing Burger King restaurant two miles from plaintiff's existing restaurant in Lee, Massachusetts. The plaintiff alleged several implied contract claims, including breaches of an implied non-compete agreement, an implied contract created by promissory estoppel, and an implied covenant of good faith and fair dealing. In response to defendant's motion for summary

²⁷ Emily I. Bridges, "Keep Off My (Virtual) Lawn: Encroachment in the Age of the Internet," Fox Rothschild, LLP (April 6, 2017), online: <https://www.foxrothschild.com/publications/keep-off-my-virtual-lawn-encroachment-in-the-age-of-the-internet/>.

²⁸ *Id.*

²⁹ *Id.*

³⁰ *Id.*

judgment, the United States District Court for the Southern District of Florida dismissed all of plaintiff's claims, with the noteworthy exception of plaintiff's claim that construction of the competing restaurant breached the implied covenant of good faith and fair dealing in plaintiff's franchise agreement with defendant. As the court noted in its summary judgment order, "[i]t is axiomatic that a contract includes not only its written provisions, but also the terms and matters which, though not actually expressed, are implied by law, and these are as binding as the terms which are actually written or spoken." *Scheck*, 756 F.Supp. at 548-49. Under Florida law, this included the implied covenant of good faith and fair dealing.

Although defendant acknowledged the existence of an implied covenant of good faith and fair dealing in its motion for summary judgment, defendant argued that authorization of a competing restaurant did not breach the covenant because the franchise agreement expressly declined to "grant or imply" the plaintiff franchisee "any area, market or territorial rights." The District Court disagreed, holding that the franchise agreement's provision expressly denying plaintiff an exclusive territory interest was not so broad as to encompass plaintiff's expectation "that Burger King will not act to destroy the right of the franchisee to enjoy the fruits of the contract." *Id.* at 549 (*citing Photovest Corp. v. Fotomat Corp.*, 606 F.2d 704, 728 (7th Cir.1979)). Pointing to deposition testimony indicating that Burger King had a policy of denying approval of new restaurants in locations deemed to pose a risk of "large sales deteriorations at a nearby existing Burger King," the District Court concluded that defendant's "alleged failure to exercise such discretion" was a sufficient basis for franchisee's claim under the implied covenant of good faith and fair dealing to survive franchisor's motion for summary judgment. *Id.*

B. *Burger King Corp. v. Weaver*, 798 F.Supp. 684 (S.D. Fla. 1992) ["*Weaver I*"].

Weaver I was one of the first federal cases to evaluate the holding in *Scheck*, and involved facts nearly identical to those in *Scheck*. *Weaver*, the franchisee, had owned and operated a Burger King restaurant in Great Falls, Montana, since 1976. *Weaver* subsequently purchased a second Burger King franchise in Great Falls and a third in Kalispell, Montana, in the late 1980s. In 1989, Burger King authorized construction of a competing restaurant on Malmstrom Air Force Base, adjacent to Great Falls. *Weaver* alleged that the competing restaurant caused revenues and profits at both of *Weaver*'s Great Falls restaurants to decline, and *Weaver* responded by ceasing to pay rents, fees, and related charges owed to Burger King under each franchise agreement. Burger King sued and *Weaver* counterclaimed for 16 counts, including for breach of the covenant of good faith and fair dealing. Burger King moved for summary judgment on all counts.

Regarding his claims for breach of the implied covenant of good faith and fair dealing, *Weaver* alleged that Burger King's authorization of the competing restaurant on Malmstrom Air Force Base constituted the very "cannibalization" and "encroachment" against which Burger King had developed specific internal policies and procedures. *Weaver*, 798 F.Supp. at 688. In response, Burger King argued that it had specifically

contracted for the right to place a franchise at any location in both of the applicable agreements, regardless of the cannibalization effect on other Burger King franchises. At the outset of its analysis, the district court noted that “[t]he scope of the implied covenant of good faith and fair dealing is necessarily limited by the express language of the contract[,]” adding that “[c]onduct which is expressly authorized by a franchise agreement, for example, cannot be said to breach the implied covenant.” *Id.* (citing *Coira v. Florida Medical Association, Inc.*, 429 So.2d 23, 24 (Fla. 3d DCA 1983)).

The district court ultimately ruled in favor of Weaver on summary judgment, echoing *Scheck*. While the district court noted that the existence of a “territorial rights” clause which “*affirmatively* grants to [Burger King] the right to place a Burger King restaurant at any location would foreclose a cause of action based on the implied covenant,” the “site specific” clauses in each agreement were not explicit enough in authorizing Burger King to place a restaurant in any location. *Id.* at 688-89. Likewise, citing *Scheck*, the district court concluded that language specifying that the agreements do not “in any way grant or imply any area, market or territorial rights proprietary to franchisee” cannot be said to “affirmatively authorize the placement of a [Burger King] franchise on any site.” *Id.* at 689. In doing so, the district court expressly rejected a then-recent opinion by the Fourth Circuit Court of Appeals in *Fickling*, in which Burger King prevailed on summary judgment against a franchisee claiming that Burger King’s authorization of two competing restaurants on a military base in Fort Bragg, North Carolina, violated the implied covenant. *Id.*; *Fickling v. Burger King Corporation*, 843 F.2d 1386 (4th Cir.1988).

As in *Scheck*, *Weaver I* (from which a chain of conflicting precedents would evolve, *infra*) was notable for distinguishing the express denial of territorial rights to a franchisee from an implied duty for the franchisor to refrain from acting to “destroy the right of the franchisee to enjoy the fruits of the contract.” *Id.* (quoting *Scheck*, 756 F.Supp. at 549). In so holding, the district court expressed concern that a contrary conclusion would erode the effectiveness of the implied covenant of good faith and fair dealing by construing an express withholding of rights to the franchisee as an unambiguous grant of rights to the franchisor; the district court reasoned that, “[t]aken to its logical extreme, [Burger King’s] construction of the franchise agreements would entitle it to set up a competing franchise *next door* to an existing franchise the day after the existing franchise had opened for business[,]” and added that “[i]f that were the plain and intended meaning of the ‘territorial rights’ language contained in the two franchise agreements, this Court entertains serious doubts about whether a rational franchisee would ever enter into a franchise agreement with [Burger King].” *Id.*

C. *Burger King Corp. v. Holder*, 844 F.Supp. 1528 (S.D. Fla. 1993).

In *Holder*, the district court granted Burger King’s motion to dismiss a franchisee’s claim that Burger King breached the implied covenant of good faith and fair dealing. Burger King argued, and the district court agreed, that the implied covenant of good faith and fair dealing is not actionable absent a breach of the contract’s express terms. *Holder*, 844 F.Supp. at 1530. The district court relied on a holding by the Eleventh Circuit Court of Appeals that affirming a grant of summary judgment in favor of

defendant where the plaintiff had not alleged a breach of the contracts express terms, in addition to plaintiff's claims under the implied covenant of good faith and fair dealing. *Alan's of Atlanta, Inc., v. Minolta Corp.*, 903 F.3d 1414 (11th Cir. 1990). In *Alan's*, the Eleventh Circuit explained that "the [implied covenant] is not an independent contract term[;] [i]t is a doctrine that modifies the meaning of all explicit terms in a contract, preventing a breach of those explicit terms *de facto* when performance is maintained *de jure*[...] [b]ut it is not an undertaking that can be breached apart from those terms." *Id.* at 1429. Finally, the *Holder* court held that *Alan's* was consistent with Florida authority on the same issue, citing to a 1986 Florida state intermediate appellate opinion concluding that a Florida statute providing that "[e]very contract or duty within this code imposes an obligation of good faith in its performance and enforcement" did not apply to vary the express terms of a contract regarding the due date of a loan. *Id.* (citing *Flagship Nat'l Bank v. Gray Distrib. Sys., Inc.*, 485 So.2d 1336, 1340 (Fla. 3rd Dist.Ct.App.), *rev. denied*, 497 So.2d 1217 (Fla.1986)). In sum, because Holder failed to allege an express breach of his franchise agreement with Burger King, any claim for breach of the implied covenant of good faith and fair dealing could be resolved in Burger King's favor under Rule 12(b)(6) of the Federal Rules of Civil Procedure.

D. *Burger King Corp. v. Weaver*, CASE NO. 90-2191-CIV-MARCUS (S.D.Fla. Sept. 18, 1995) ["Weaver II"].

On May 19, 1994, District Judge Aronovitz—the judge that denied summary judgment for Burger King in *Weaver I*—recused himself from the case, and the case was reassigned to District Judge Marcus. *Burger King Corp. v. Weaver*, 169 F.3d 1310, 1314 n.2 (11th Cir. 1999). Following the reassignment, Burger King filed a second renewed motion for summary judgment on Weaver's claims for breach of the implied covenant of good faith and fair dealing, and Burger King's motion was granted on September 18, 1995. The court held that Florida courts do not recognize a claim for breach of the implied covenant of good faith and fair dealing absent a breach of an express contractual provision; since Weaver did not allege that Burger King violated any express provision of the franchise agreement in authorizing a competing restaurant on Malmstrom Air Force Base, The court held that Weaver's claims under the implied covenant failed as a matter of law. *Id.* at 1314. The court relied on the earlier holding in *Holder* that the implied covenant of good faith and fair dealing is not actionable absent a breach of the contract's express terms, as well as a 1993 opinion by the Eight Circuit Court of Appeals holding that "under either Minnesota or Florida [law] a cause of action for good faith and fair dealing cannot exist independent of the underlying breach of contract claim." *Barnes v. Burger King Corp.*, 932 F.Supp. 1420, 1439 (S.D. Fla. 1996); *Orthomet, Inc. v. A.B. Medical Inc.*, 990 F.2d 387, 392 (8th Cir.1993) (citing *Kelly v. Gill*, 544 So.2d 1162, 1164 (Fla. 3d Dist.Ct.App.1989), *rev. denied*, 553 So.2d 1165 (Fla.1989), *cert. denied*, 494 U.S. 1029, 110 S.Ct. 1477, 108 L.Ed.2d 614 (1990)). Weaver would ultimately appeal the court's grant of summary judgment to the Eleventh Circuit Court of Appeals in *Weaver III*, discussed *infra*. *Weaver*, 169 F.3d at 1314.

E. *Barnes v. Burger King Corp.*, 932 F. Supp. 1420 (S.D. Fla. 1996).

In *Barnes v. Burger King Corp.*, the United States District Court for the Southern District of Florida rejected the reasoning of *Scheck v. Burger King Corp* and granted summary judgment in favor of Burger King on Barnes' claim that Burger King violated the implied covenant of good faith and fair dealing by authorizing another Burger King restaurant to open in close proximity to Barnes' restaurant. The parties' arguments in *Barnes*—and the district court's analysis—contrasted conflicting district court opinions in *Scheck* and *Weaver II*. Burger King argued that the express terms of its franchise agreement with Barnes permitted Burger King to open additional restaurants in the vicinity of the franchisee's restaurant, and that the recently issued district court decision in *Weaver II* was supported by substantial case law affirming that implied covenants cannot alter the express terms of a contract—and therefore that Burger King should prevail as a matter of law. In contrast, Barnes argued that *Weaver II* was erroneous, *Scheck* was controlling, and that *Scheck* held that territoriality terms in the franchise agreement did not defeat encroachment claims under the implied covenant of good faith and fair dealing.

The court in *Barnes* ultimately sided with Burger King in reiterating that the implied covenant of good faith and fair dealing did not apply where its application would contravene the express terms of the agreement, and where there is no accompanying action for breach of an express term of the agreement. The *Barnes* court concluded that the franchise agreement between Burger King and Barnes expressly authorized Burger King to open competing restaurants, that Barnes asserted no claim that Burger King breached an express provision of the parties' contract (which expressly denied Barnes any territorial or area rights), and therefore that Burger King was entitled to judgment as a matter of law on Barnes's claim for breach of the implied covenant.

F. *In re Vylene Enterprises, Inc.*, 90 F.3d 1472 (9th Cir. 1996).

The franchisee in *In re Vylene* was a Chapter 7 debtor that appealed a district court's declination to adopt the bankruptcy court's proposed findings of fact and conclusions of law regarding the franchisee's claim that the franchisor breached the implied covenant of good faith and fair dealing by building a competing restaurant 1.4 miles from franchisee's restaurant and by refusing to negotiate in good faith for a renewal of the franchise agreement. The bankruptcy court found that good faith negotiation was a condition precedent to the expiration of the franchise agreement and therefore that the franchise agreement was in place at the time the competing restaurant was built by franchisor. The bankruptcy court concluded that the construction of the competing restaurant breached both the express terms of the agreement and the implied covenant of good faith and fair dealing. The district court reversed the bankruptcy court, holding that the bankruptcy judge misinterpreted a right of first refusal clause in the franchise agreement, that Vylene had no right to renew under the agreement, and that, regardless, any finding of breach of the implied covenant was not a "core proceeding" under the bankruptcy code.

The Ninth Circuit Court of Appeals vacated and remanded on all findings, concluding (1) that the bankruptcy court had jurisdiction over the adversary proceedings between the franchisee debtor and the franchisor defendant, (2) that the record supported the bankruptcy court's finding that the franchisor breached the franchise agreement by failing to negotiate the franchisee's proposed extension or renewal of the agreement in good faith, and (3) that the franchisor breached the covenant of good faith and fair dealing by constructing a competing restaurant within a mile and a half from franchisee's restaurant. The Ninth Circuit's analysis relating to the franchisor's breach of the implied covenant is sparse—occupying only a few short paragraphs. The Circuit Court noted that it was undisputed that Vylene had no exclusive territory under the franchise agreement and that the Ninth Circuit had previously held that “[W]here there is no express grant of an exclusive territory in a contract or franchise agreement, none will be impliedly read into the contract.” *In re Vylene*, 90 F.3d at 1477 (quoting *Eichman v. Fotomat Corp.*, 880 F.2d 149, 164 (9th Cir.1989)). Despite this precedent, the Ninth Circuit added that “notwithstanding [the *Eichman* holding], under California law, all contracts have an implied covenant of good faith and fair dealing.” *Id.* Citing *Scheck* for support, the Ninth Circuit held that the franchisor's construction of a competing restaurant in the vicinity of Vylene's restaurant was a breach of the covenant of good faith and fair dealing, even while the Ninth Circuit acknowledged that “Vylene did not have any rights to exclusive territory under the terms of the franchise agreement, and we do not impliedly read any such rights into the contract.” *Id.* The Ninth Circuit reasoned further that the “bad faith character” of the franchisor's move to build a competing restaurant “becomes clear when one considers that building the competing restaurant had the potential to not only hurt Vylene, but also to reduce [franchisor's] royalties from Vylene's operations.” *Id.* On these facts, the Ninth Circuit remanded the case to the district court with instructions to issue orders consistent with the bankruptcy judge's findings—including its finding that Vylene suffered \$2,219,468 in damages from the franchisor's breach of the implied covenant, and that Vylene was entitled to another \$550,000 in attorneys' fees and costs.

G. *Chang v. McDonald's Corp.*, 105 F.3d 664 (9th Cir. 1996).

Just five months after its decision in *In re Vylene Enterprises, Inc*, the Ninth Circuit declined to apply the *Scheck* rationale (that an implied covenant applied despite an express denial of exclusive market area in the franchise agreement), deeming it “compelling” but inconsistent with applicable Illinois law. *Chang*, 105 F.3d at 664. The Ninth Circuit affirmed a district court grant of summary judgment in favor of the franchisor, McDonald's, after finding that Chang had no express or implied contractual rights to an exclusive market area or to renewal under a license agreement with McDonald's. Not only was the license agreement complete and unambiguous—containing both integration clauses and terms denying Chang a right of renewal and right to an exclusive market area—but the very McDonald's policies that Change argued were incorporated into the license agreement by reference also made clear that Chang had no right to renewal or exclusive territory. As the Ninth Circuit noted, the Seventh Circuit had recently reiterated that “[i]n Illinois, the covenant of good faith and fair dealing is not an independent source of duties, but instead ‘guides the construction of

explicit terms in an agreement.” *Id.* at 664 (quoting *Beraha v. Baxter Health Care Corp.*, 956 F.2d 1436, 1443 (7th Cir.1992)).

Whereas Chang argued that McDonald’s conduct was inconsistent with his reasonable expectations under the license agreement, the Ninth Circuit concluded that the express agreement between the parties determines what expectations are reasonable, and that the contract “negates any inference that McDonald’s actions were so far outside the parties’ reasonable expectations as to constitute a breach of the implied covenant.” *Id.* Because the terms of the license agreement clearly and unambiguously provided that McDonald’s had no duty to renew the agreement or refrain from opening competing restaurants, Chang’s reliance on the implied covenant was unavailing.

H. *Camp Creek Hosp. Inns, Inc. v. Sheraton Franchise Corp.*, 139 F.3d 1396 (11th Cir. 1998).

In *Camp Creek Hospitality Inns., Inc. v. Sheraton Franchise Corp.*, the plaintiff franchisee (Camp Creek) argued that, although the franchisor’s establishment of a competing hotel did not violate the express terms of agreements between the parties, the franchisor nonetheless breached the implied covenant of good faith and fair dealing. The Eleventh Circuit Court of Appeals began its analysis of the franchisor’s motion for summary judgment on this claim by stating two general propositions: “(1) when the parties include contract language on the issue of competing franchises the implied covenant will not defeat those terms; and (2) when there is no such language the franchisor may not capitalize upon the franchisee’s business in bad faith.” *Camp Creek*, 139 F.3d at 1403. The Court also referenced *Scheck* as the “seminal case” holding that the implied covenant of good faith and fair dealing applied to territoriality in the absence of express contract language, while noting that “the *Scheck* cases have been criticized, ignored, and distinguished in a number of subsequent opinions.” *Id.* at 1403 n.6 (citing *Barnes* and *Vylene* as conflicting interpretations of the *Scheck* precedent).

The wrinkle at issue in *Camp Creek* was that, although the express terms of the parties’ license agreement allowed Sheraton to authorize competing franchises wherever it wanted—including “directly across the street” from plaintiff’s franchise—Sheraton did not actually establish a franchise. *Id.* at 1404. Rather, Sheraton purchased and operated the competing hotel on its own behalf, and the license agreement was silent with regard to Sheraton’s right to compete directly with the franchisee. In the absence of express contract language, the Eleventh Circuit held that a genuine issue of material fact existed—and that a reasonable jury could reach different conclusions—as to whether Sheraton’s operation of the allegedly-competing hotel 3.5 miles from Camp Creek’s hotel violated Sheraton’s duty of good faith and fair dealing to Camp Creek. In dicta, the Eleventh Circuit suggested that “there can be no doubt” that Sheraton’s operation of a hotel in a different state would warrant summary judgment for the franchisor on the franchisee’s claim for violation of the implied covenant, and conversely that Sheraton’s operation of a hotel “directly across the street” from the franchisee’s hotel would violate the implied covenant. *Id.* at 1404-5.

I. *Burger King Corp. v. Weaver*, 169 F.3d 1310 (11th Cir. 1999) [“*Weaver III*”].

In *Burger King Corp. v. Weaver*, the Eleventh Circuit emphatically rejected the reasoning in *Scheck*, concluding that the *Scheck* court’s “confidence” that Florida law recognized the implied covenant of good faith and fair dealing as an independent cause of action was “misplaced[,]” and that the *Scheck* court’s reasoning was “unconvincing logically[.]” *Weaver*, 169 F.3d at 1317. Specifically, the Eleventh Circuit found the *Scheck* opinion’s “attempt to separate the franchisee’s right from the franchisor’s duty” to be “logically unsound.” *Id.* Whereas *Scheck* held that the franchisee had a valid cause of action for violation of the implied covenant—even absent an express right to exclusive territory under the franchise agreement—because the franchisor had not expressly reserved the right to license additional restaurants in the vicinity, the Eleventh Circuit in *Weaver III* held that that such reasoning was flawed: rights and duties were “different sides of the same coin,” and therefore, “if one party to a contract has no *right* to exclusive territory, the other party has no *duty* to limit licensing of new restaurants.” *Id.* As applied to the facts of *Weaver*, the Eleventh Circuit affirmed the district court’s grant of summary judgment to Burger King, holding that “Weaver’s failure to identify an express contractual provision that has been breached dooms his claim for breach of the implied covenant of good faith and fair dealing.” *Id.* at 1318.

III. Recent Encroachment Cases

Until recently, *Scheck v. Burger King Corp.* and *In re Vylene Enterprises, Inc.* were seen by most practitioners as outliers in establishing encroachment claims based on the duty of good faith and fair dealing, largely because many courts rejected this approach in the intervening decades since those opinions were issued. The recent judgment in *El Pollo Loco*, however, may show a renewed interest in claims asserted under the implied covenant.

A. *Michael D. Bryman, et al. v. El Pollo Loco, Inc.*, Case No. MC026045 (Cal. Super. Ct. Los Angeles Cnty. Aug. 1, 2018) (appeal docketed, *Handlers-Bryman, et al. v. El Pollo Loco*, Case No. B292585 (Ca. Ct. App. Feb. 5, 2019)).

The Judgment and Statement of Decision in *El Pollo Loco*, delivered on August 1, 2018, has been the subject of much discussion within the business law community as the most notable lawsuit in decades in which a plaintiff succeeded on an encroachment theory for breach of the implied covenant of good faith and fair dealing. The surprising verdict in favor of the franchisee plaintiffs and the jury’s award of millions of dollars for damages allegedly caused by the franchisor defendant’s construction of two restaurants in the vicinity of plaintiffs’ restaurant has singlehandedly rekindled the interest of franchise law practitioners and commentators in the viability of encroachment claims under implied covenants. Although the case is currently pending appeal, the trial court record indicates that a franchisor may be found to have breached the covenant of good faith and fair dealing implied in a franchise agreement under California common law by placing a competing company-owned restaurant in close proximity to a franchisee’s

restaurant, even where the franchisee does not have an exclusive territory under the franchise agreement.

In stating the law applicable to the *El Pollo Loco* plaintiffs' encroachment claim, the trial court relied exclusively on a handful of precedents contained in two cases from the mid-1990s, *In re Vylene* (1996) and *Locke* (1997). *Locke* summarized the general concept of the implied covenant of good faith and fair dealing and *In re Vylene* applied that concept to a franchise encroachment claim. As the *Locke* court restated California's common law of contracts, "[w]here a contract confers on one party a discretionary power affecting the right of the other, a duty is imposed to exercise that discretion in good faith and in accordance with fair dealing." *Locke v. Warner Bros.*, 57 Cal. App. 4th 354, 363, 66 Cal. Rptr. 2d 921, 925 (1997) (quoting *Perdue v. Crocker National Bank*, 38 Cal.3d 913, 923, 216 Cal. Rptr. 345, 702 P.2d 503 (1985)). Likewise, *Locke* noted that "in every contract there is an implied covenant that neither party shall do anything which will have the effect of destroying or injuring the right of the other party to receive the fruits of the contract[.]" *Id.* The remainder of the *El Pollo Loco* court's statement of applicable law was an excerpt of the Ninth Circuit's remarkably brief discussion of the defendant's breach of the implied covenant of good faith and fair dealing in *In re Vylene*—which was itself based exclusively on the district court's holding in *Scheck. In re Vylene Enterprises, Inc.*, 90 F.3d at 1477.

These citations were sufficient to allow plaintiffs' encroachment claim to survive to a jury verdict, despite express terms in the franchise agreement providing that the franchisee "is not granted an exclusive territory in the Franchise Agreement," that franchisee "will not receive an exclusive territory under the Franchise Agreement," and that "[t]he Franchise Agreement permits [franchisor] to establish other franchised or company owned restaurants that may compete with [franchisee's] location, including restaurants which may be in the immediate vicinity or adjacent to [franchisee's] Restaurant."³¹ (Statement of Decision, ¶ 86). The jury, finding no breach of the express terms of the franchise agreement, nonetheless found that *El Pollo Loco* breached the covenant of good faith and fair dealing implied in the franchise agreement by constructing two corporate-owned restaurants within the vicinity of plaintiffs' restaurant; the corporate-owned restaurants were located 2.3 miles and "a little over four miles" from plaintiffs' restaurants, respectively. (Statement of Decision, ¶ 141, 147). The jury likewise found that *El Pollo Loco* breached the covenant of good faith and fair dealing implied in the franchise agreement by declining to offer the Brymans the opportunity to purchase and develop each of the corporate-owned restaurant locations.

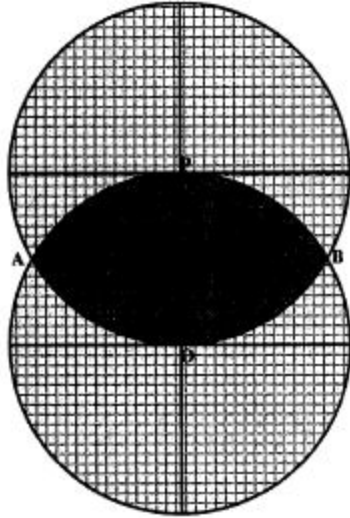
³¹ Plaintiff Michael Bryman even testified, in support of claims that the franchise agreements were contracts of adhesion under California law, that he *did not read* the "boilerplate" of the offering disclosures and franchise agreements because they were "hundreds of pages" long and were presented on a "take it or leave it basis." Bryman added that, in his experience, "signing the Franchise Agreement is really only the beginning of the Franchisor/Franchisee relationship[...] [t]his is a long-term relationship[...] [a]nd in the agreement, there's no way to predict what will happen in the future[...] [s]o you have to depend on the other party's good faith and fair dealing, because it's almost like a family or marriage[...] [t]here has to be honesty and trust and treating the other person fairly." (Statement of Decision ¶ 80).

A bifurcated trial on damages was held several months after the verdict on liability. The jury returned a verdict awarding the Brymans \$2,634,622.00 and \$1,721,978.00 in impact damages, respectively, for each of the two corporate-owned restaurants found to have breached El Pollo Loco's implied duty of good faith and fair dealing. (Judgment at 2). The damages jury awarded an additional \$2,783,921.00 and \$1,697,285.00 in lost opportunity damages for El Pollo Loco declining to offer each restaurant location to the Brymans. (Judgment at 2). Evidence presented on the damages issue focused largely on testimony estimating the population density surrounding plaintiffs' restaurant based on census data, in addition to testimony by El Pollo Loco's former Vice President of Development, indicating that "essentially 80% of [a restaurant's] business comes from within about a mile and a half of [the] restaurant" and that, in his opinion, "you need about 25,000 people in that ring." (Statement of Decision ¶ 89). Plaintiffs alleged that a market study that plaintiffs commissioned after the defendant built the first of the two encroaching restaurants estimated a 36% population overlap in trade areas, with a potential loss of 40% of plaintiffs' sales to the company-owned restaurant. (Statement of Decision ¶ 5). Based on the damages award, the jury appears to have found this testimony persuasive.

One of the most noteworthy portions of the trial court's analysis of the plaintiffs' claims addressed limitations in the plaintiffs' protected territory—referred to in El Pollo Loco franchise documents as the "Notification Radius"—and procedures in the Franchise Agreement for resolving restaurant development disputes. (Statement of Decision ¶¶ 130-51). After considering the above-mentioned testimony of El Pollo Loco's former Vice President of Development regarding the relationship between population density and profitability for franchise restaurants, the trial court concluded that El Pollo Loco's procedures for resolving disputes with existing franchisees regarding the development of new restaurants were both procedurally and substantively unconscionable under California law, unfair under California law, and not "in any sense rational." (Statement of Decision ¶¶ 130-51). The trial court was particularly perplexed by evidence indicating that El Pollo Loco could substantially impact an existing franchisee's profitability by constructing competing restaurants in the vicinity of an existing franchisee's restaurant without violating the express provisions of the franchise agreement.

As the below diagram indicates, a single competing restaurant placed at the edge of the franchisee's 1.5-mile radius protected territory would cause a 39% overlap in surface area within that territory. Based on undisputed evidence that a typical El Pollo Loco franchise draws 80% of its customers from within its 1.5-mile protected territory, the construction of a single competing restaurant along the periphery of the protected territory could decrease revenue to the franchisee by 15.6%, assuming a uniform population density throughout the relevant market area (multiplying 39% by 80% and dividing by two). (Statement of Decision ¶¶ 138-39). The existing franchisee would lose an even greater share of revenue if the competing restaurant overlapped with a portion of its protected territory with a disproportionately high population density. Because the competing restaurant was built outside of the franchisee's protected territory, the franchisee would have "absolutely no recourse" under the terms of the applicable franchise agreement. (Statement of Decision ¶ 146).

138. If the proposed competing restaurant was actually located just outside existing franchisee's notification radius, the two rings would overlap by 39%, calculated as follows:



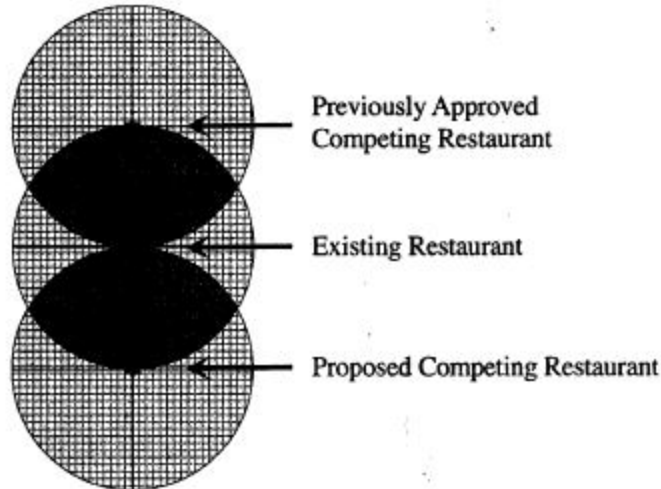
$$\text{Length of line (OM)} = 1.5 \text{ mi} / 2 = 0.75 \text{ miles}$$

$$\cos (\angle \text{BOM}) = \text{OM} / \text{OB} = 0.75 / 1.5 = 0.5$$

⁶ The area of a circle with a radius of 1.5 miles is 7.07 square miles, multiplied times 7,072 residents per square mile, gives a total population of 49,999.

This hypothetical becomes even more lopsided as the number of competing restaurants increases; two competing restaurants could decrease an existing franchisee's revenue by 31% (assuming uniform population density) without violating the terms of the franchise agreement, with additional competing restaurants consuming even greater proportions of an existing franchisee's revenue. Despite the former Vice President of Development's emphatic assurances that "[w]e would never build a location immediately next door [to an existing franchisee, and we] wouldn't allow franchisees to do it to each other[,]" the trial court concluded that provisions of the franchise agreement permitting El Pollo Loco to authorize new restaurant locations with few restrictions are "there for El Pollo Loco to use as a hammer against a Franchisee in the event of a development dispute[,]" and were therefore unconscionable under California's unfair competition law. (Statement of Decision ¶¶ 180-81). The plaintiffs utilized similar arguments when presenting expert testimony estimating that El Pollo Loco's construction of a corporate-owned restaurant 2.3 miles from plaintiffs' existing restaurant caused a 14.8% decrease in year-over-year sales at the existing restaurant. (Statement of Decision ¶ 143).

145. Taking the original hypothetical a step further, assume that the Franchisee has stood by and watched El Pollo Loco open the competing company restaurant immediately to the North of its restaurant, but just outside its Notification Radius circle. For the sake of simplicity, assume El Pollo Loco proceeds to open another competing company restaurant immediately to the South of Franchisee's restaurant. The resulting diagram would look like this:



Another remarkable feature of the *El Pollo Loco* judgment is the scope of injunctive relief ordered by the trial court—effectively deleting entire provisions of the applicable franchise agreements.³² Many of these provisions are commonplace in

³² Noteworthy excerpts from the judgment include orders restraining and enjoining El Pollo Loco from: (1) including any versions of the procedures for resolving disputes with franchisees relating to the development of new restaurants *as part of any franchise disclosure document or franchise agreement* where such terms conflict with the trial court's order and judgment; (2) "[u]sing any mechanism to calculate the population of the territory within the circle around the Franchisee's restaurant that is used to calculate the Notification Radius that is biased towards artificially increasing the population so as to improperly decrease the Notification Radius and thereby improperly decrease the Franchisee's protected territory as demarcated by the Notification Radius circle;" (3) "[i]ncluding in any Franchise Disclosure Document or Franchise Agreement any provision that purports to relieve or release El Pollo Loco, Inc., of and from any future unknown claims;" (4) "[i]ncluding in any Franchise Disclosure Document or Franchise Agreement any provision that purports to relieve or release El Pollo Loco, Inc., of and from any claim for its own willful misconduct or violation of the law;" (5) "[i]ncluding in any Franchise Disclosure Document or Franchise Agreement any provision that purports to require the Franchisee to submit to binding arbitration under procedures that limit the arbitrator's discretion by dictating or limiting the acceptable findings that may be made by the arbitrator;" (6) "[i]ncluding in any Franchise Disclosure Document or Franchise Agreement any provision that purports to require the Franchisee to submit to binding arbitration under procedures that limit the arbitrator's discretion [to award appropriate relief or that dictate or limit methods of calculating relief to be awarded to a successful franchisee];" (7) "[i]ncluding in any Franchise Disclosure Document or Franchise Agreement any provision that purports to permit El Pollo Loco to place a corporate restaurant in the immediate vicinity of or adjacent to the restaurant of a Franchisee;" (8) failing to include in any franchise disclosure document or franchise agreement a

contemporary franchise agreements, indicating that the judgment will pose major challenges to future franchisors operating in California if such broad injunctive relief is affirmed on appeal. Of particular relevance to the encroachment doctrine is a portion of the trial court judgment enjoining El Pollo Loco from including *in any franchise disclosure document or franchise agreement* any provision that purports to permit El Pollo Loco to place a corporate restaurant “in the immediate vicinity of or adjacent to” a franchisee’s restaurant. (Judgment at 7). Such provisions have been boilerplate in franchise agreements for decades as the most direct way to reserve the franchisor’s right to develop new restaurants—and foreclose any right of the franchisee to an exclusive territory—in the express terms of a franchise agreement.

B. Other New Encroachment Cases –

i. *Gre-Ter Enterprises, Inc. v. Mgmt. Recruiters Int’l, Inc.*, 329 F. Supp. 3d 667 (S.D. Ind. 2018).

In *Gre-Ter Enters. Inc v. Management Recruiters, Int’l*, a franchisee sued a franchisor for breach of contract and Indiana statutory claims. In a 1998 franchise agreement the franchisee was given the exclusive right to territory in Boone County, Indiana. The franchise agreement did not restrict the franchisee’s ability to do business outside of Boone County and did not address the right of other franchisees to do business within Boone County from outside of the territory. A 2005 franchise agreement gave the franchisee the same rights for Hamilton County, Indiana, excluding the city of Noblesville, Indiana. The parties amended their agreements several times and in one of the modifications, an easement was granted for another franchise to operate an office at a specific address within the franchisee’s territory and another franchisee was granted a right to operate in the territory.

The franchisee brought a breach of contract claim based on encroachment. The franchisee focused on the franchisor’s website which claimed that its franchisees had “no territory [] or border restrictions.” *Gre-Ter*, 329 F. Supp. 3d at 672. The franchisee alleged that through this statement and other actions the franchisor “allowed other franchisees to locate their offices and operate” within its exclusive territory. *Id.* The franchisor filed a motion to dismiss under Rule 12(b)(6).

The court recognized that the franchisee’s encroachment claim appeared to relate only to the franchisor’s practice of offering franchise agreements without territorial restrictions, rather than to any specific franchisee that was granted a franchise. The court acknowledged that “at most [the franchisor] has invited, rather than committed a breach.” Construing the franchisee’s complaint liberally, as required under Rules 12(b)(6) and 8(a), the court held that even though the franchise agreements were

specification of the sales volume that a franchisee may expect to cause El Pollo Loco to open a competing corporate-owned or franchise restaurant; (9) failing to include in any franchise disclosure document or franchise agreement a description of (i) the geographical areas open for development by franchisees, (ii) the geographical areas reserved for development by El Pollo Loco, and (iii) the geographical areas open for development by both the franchisor and franchisees, if applicable. (Judgment at 6-7).

amended to allow two franchisees to operate in the territory, the franchisee's allegation that the franchisor allowed *other* franchisees to operate in the territory would be a breach of contract. The court stressed, however, that if the franchisor was correct in stating that it had not allowed other franchisees to operate in the territory, then the franchisor would have a good defense and possible grounds for dismissal.

Remarking dryly on the narrowness of its holding the district court noted in its concluding paragraph that, [d]espite its best efforts, *Gre-Ter* has narrowly avoided dismissal of its entire complaint[.]" adding, "we urge a disciplined cabining of discovery on the single remaining question of whether [the encroachment count] presents a triable issue." *Id.* at 684.

ii. *In re Rent-A-Wreck of Am., Inc.*, 580 B.R. 364 (Bankr. D. Del. 2018).

In *In re Rent-A-Wreck*, a franchisee moved to dismiss a bankruptcy case for bad faith filing after Chapter 11 debtors/franchisors, the Rent-A-Wreck corporation and affiliates ("RAWA"), filed a motion to reject seven franchise agreements, including one with the franchisee, David Schwartz. It had been determined in prior litigation that Schwartz had an implied-in-fact royalty and fee-free franchise agreement to run Rent-A-Wreck used car rental businesses in an exclusive territory in the Los Angeles area for his lifetime. Because the agreement was implied, the specific obligations of the parties were largely unsettled, with the exception of numerous court orders spanning a decade of protracted litigation. Pursuant to specific court orders, Schwartz was exempted from fleet requirements applicable to RAWA's typical franchisees, RAWA was required to keep Schwartz's Los Angeles location on RAWA's website, and RAWA's call center "shall in no way attempt to dissuade prospective customers from connecting with [Schwartz's] business or in any way attempt to divert business from Plaintiffs' exclusive business territory to other franchises." *In re Rent-A-Wreck*, 580 B.R. at 370. While it was acknowledged in a prior opinion that "RAWA could exercise *some* control over Schwartz [...] neither the jury nor the district court defined the contours of that control," leaving it to the parties to settle disagreements through private negotiations or state-law breach-of-contract actions. *Id.*

While the bankruptcy court ultimately concluded that RAWA did, in fact, file for bankruptcy in a bad faith attempt to escape unprofitable franchise agreements, *Rent-A-Wreck* is primarily relevant to this judicial update as a recent example of judicial enforcement of a franchisee's implied territoriality rights in the absence of express terms in a franchise agreement. Likewise, though this case was decided under the "good faith" standards of Chapter 11, § 1112(b), of the Bankruptcy Code, the court's analysis of RAWA's efforts to gain access to Schwartz's protected territory—for instance, by diverting Schwartz's customers to corporate-owned locations or attempting to drive him out of business with onerous fleet requirements and vexatious litigation—represent forms of encroachment which would invite scrutiny under traditional analysis under the implied covenant of good faith and fair dealing.

iii. *Sears Home Appliances Showrooms, LLC v. Appliance All., LLC*, 328 F. Supp. 3d 800 (N.D. Ill. 2018).

In *Sears Home Appliances*, the plaintiff franchisors sued to terminate defendant franchisees' franchise agreements based on defendants' breaches of the franchise agreements (among other claims) and defendants argued that termination was unjustified because defendants' alleged breaches were excused by plaintiffs' own prior material breaches. Namely, defendants alleged that plaintiffs breached their contracts by "forcing defendants to compete with other Sears-branded entities" and "fail[ing] to deal with [defendants] in good faith." *Sears Home Appliances*, 328 F.Supp.3d at 814-15. For example, franchisees complained that Sears forced franchisees to compete directly with Sears by requiring franchisees to install "terminals" in their stores that "would allow customers to see online Sears products, but prohibit [franchisees] from price-matching the prices and features that Sears were offering online." *Id.* at 807-8, 815.

The district court granted plaintiffs' motions for summary judgment on each of defendants' counterclaims and likewise found that Sears properly terminated its franchise agreements with defendants. The court dismissed defendants' counterclaims for breaches of the express terms of the franchise agreements, as well as breaches of the implied covenant of good faith. Defendants failed to present any evidence that plaintiff franchisors breached the express terms of the franchise disclosure documents or the franchise agreements by forcing defendants to compete with other favorably positioned Sears entities. As the court noted, all of the agreements "warned Defendants, in unambiguous terms, that they might face competition from other Sears entities." *Id.* at 815. The disclosure documents and franchise agreements each provided expressly that defendants would not receive an exclusive sales territory, that defendants may face competition from other Sears stores owned by Sears or affiliates, and that Sears reserved the right to sell merchandise online and at stores and centers within the territory granted to franchisees; thus, defendants failed to provide any evidence of competition exceeding the scope of competition permitted in the disclosure documents and franchise agreements. *Id.* Likewise, the district court dismissed defendants' counterclaims based on implied covenants because defendants provided no evidence indicating that plaintiffs' decisions to terminate the franchise agreements following multiple instances of default was arbitrary, capricious, or inconsistent with the parties' reasonable expectations—as required by applicable Illinois law. *Id.* at 816 (*citing Beraha v. Baxter Health Care Corp.*, 956 F.2d 1436, 143 (7th Cir. 1992)).

While this case did not directly involve a claim for breach of implied covenants based on an encroachment theory, it is a recent example of the broader trend of courts disfavoring territorial claims for breaches of implied covenants over the past 20 years.

IV. Legislative and other approaches:

A. State Statutory Encroachment Rights

Many states have acted to expand franchisees' protections from territorial encroachment by codifying statutory causes of action and even creating extra-contractual territory rights. These statutes are designed to compensate for the perceived asymmetry in bargaining power between large franchisors and relatively

small franchisees by placing limits on the rights that franchisors can reserve by express terms in a franchise agreement.

Iowa, for example, dedicates a section of its commerce code to providing franchisees with an express cause of action for encroachment. IA Code § 523H.6 (2016). Specifically, the Iowa statute allows franchisees to sue for monetary damages where a franchisor develops or grants another franchisee the right to develop a new location, causing “an adverse effect on the gross sales of the existing franchisee’s outlet or location[.]” IA Code § 523H.6(1) (2016). Statutory exceptions apply (1) where the franchisor offers the existing franchisee a right of first refusal on the new location, (2) where the adverse impact on the existing franchisee’s sales is estimated to be less than 5% of gross annual sales, or (3) where the franchisor has a formal procedure for hearing claims of economic loss by franchisees and a “reasonable formal procedure for awarding compensation or other form of consideration to a franchisee” to offset profits lost to a new franchise outlet or location.

An Indiana statute provides that it is unlawful for any franchise agreement involving a franchisee that is a resident of Indiana or operates a franchise in the state to allow “the franchisor to establish a franchisor-owned outlet engaged in a substantially identical business to that of the franchisee within the exclusive territory granted the franchisee by the franchise agreement; or, if no exclusive territory is designated, permitting the franchisor to compete unfairly with the franchisee within a reasonable area.” IN Code § 23-2-2.7-1 (2017). Unlike the Iowa statute, the Indiana statute does not provide an express cause of action or mandate damages for violations.

A Hawaii statute deems it a *per se* “unfair or deceptive act or practice or an unfair method of competition” for a franchisor to encroach on exclusive territory granted to a franchisee under the franchise agreement. HI Rev Stat § 482E-6(2) (2017). The statute is careful to clarify, however, that it does not apply to “circumstances or conditions prescribed in [the franchise] agreement [.]” and likewise does not prohibit franchisors or other franchisees from soliciting business or selling goods or services to people residing within the geographic territory designated as the existing franchisee’s exclusive territory. HI Rev Stat § 482E-6(2)(E) (2017).

Other states have taken less direct routes to protecting existing franchisees. In Wisconsin, franchisors and manufacturers are prohibited from taking actions that “substantially change the competitive circumstances of a dealership agreement without good cause.” Wis. Stat. § 135.03 (2017). While Wisconsin courts have not yet interpreted the statute in the context of an encroachment claim, the Seventh Circuit recently granted relief to a Girl Scouts franchisee after concluding that the national organization’s alterations of the franchisee’s territorial boundaries amounted to an impermissible attempt to use authority under the franchise agreement to terminate the franchise altogether—a “constructive termination” without the good cause mandated by § 135.03. *Girl Scouts of Manitou Council, Inc. v. Girl Scouts of U.S. of Am., Inc.*, 646 F.3d 983, 989 (7th Cir. 2011). The Wisconsin statute serves as a well-established example of the broader trend of states enacting limited statutory protections for franchisees within existing dealership regulations or deceptive and unfair trade practices

acts, the latter often categorizing franchisees as “consumers” entitled to broad protections.³³

While no state has gone as far as Iowa in protecting territorial interests of franchisees in the absence of an exclusive territoriality provision in the franchise agreement, the extension of consumer protection laws to the franchise relationship could provide a foothold for future encroachment claims. *El Pollo Loco* aside, most modern courts remain content to construe territorial encroachment claims according to the express terms of the franchise agreement. New laws empowering courts to consider the fairness of express terms in franchise agreements, or the fairness of franchisors’ actions pursuant to express terms, could increase the viability of encroachment claims dramatically.

B. Drafting Franchise Agreements to Avoid Modern Encroachment Issues

In the age of E-commerce, encroachment issues abound—subtler yet more pervasive than ever. To avoid costly disputes with franchisees regarding modern forms of encroachment, it is absolutely critical that contemporary franchise agreements include territoriality provisions which address E-commerce concerns expressly and precisely. There are several avenues available by which franchisors may effectively reserve rights to develop internet commerce and other novel channels of distribution.

One of the most tried-and-true methods of avoiding encroachment claims by franchisees is simply to deny franchisees any exclusive territory rights. It may not be enough to deny any and all territorial protections to the franchisee—particularly if the agreement omits to discuss alternative channels of distribution in relation to territory provisions. For instance, a franchisee may attempt to argue that a traditional territoriality clause denying the franchisee any exclusive territory—and reserving the franchisor’s right to develop new franchisees within that territory—does not apply to bar claims for E-commerce encroachment. Franchisors should take care to expressly reserve the right to develop alternative channels of commerce, in conjunction with limiting territorial provisions. In addition to withholding all territorial protections for franchisees as a straightforward means of preventing claims of bad faith competition within a franchisee’s territory, territorial provisions expressly limiting the channels of distribution available to a franchisee—and reserving E-commerce to the franchisor—are a prudent precaution for future-proofing the franchise relationship.

As noted in many of the cases discussed above, any ambiguity in the territoriality provisions of a franchise agreement can create the legal space franchisees need to make claims of encroachment by arguing that intra-brand competition by a franchisor or other franchisees encroaches upon an existing franchisee’s reasonable expectations for developing the market within a defined territory—whether exclusive or not. Franchisors can limit such arguments by defining precise boundaries, not only on the geographic scope of a franchisee’s territory, but on the types of commercial activities which franchisors and franchisees can engage in within a franchisee’s territory. Just as

³³ Dolman, et al., *supra* note 2, at 4-6.

territoriality provisions are increasingly contemplating future shifts in the population density of a given territory, franchise agreements should anticipate that E-commerce will expand both the market for franchise products and the types of products or services which a franchise brand can market.

Using broad language to reserve the franchisor's right to develop nontraditional markets for goods and services, such as reserving all "alternate channels of distribution" to the franchisor and explicitly referencing E-commerce or internet sales, is a good method for limiting the range of encroachment arguments a franchisee might make in a future contract dispute.³⁴ Just as it is best practice to expressly define the positive and negative rights of the parties—such as by denying exclusive territory to a franchisee *and* affirming a franchisor's right to develop new brick-and-mortar locations within a defined territory—contemporary franchise agreements should expressly reserve the rights of franchisors to utilize alternative channels of distribution *and* foreclose franchisees any exclusive rights to engage in E-commerce or other alternative channels of distribution, including within the franchisee's defined territory.

As a compromise position, some franchise agreements provide for some measure of profit-sharing to compensate franchisees for revenue lost to alternative channels of distribution.³⁵ Such provisions likely decrease the chances of E-commerce encroachment disputes arising in the first place, but can also supplement franchisor's arguments that the franchise agreement expressly reserved franchisor's right to develop alternative channels of distribution. For example, in *Party City Corp.*, a franchisor prevailed on a motion to dismiss a franchisee's internet encroachment claim for breach of contract by pointing to terms in the franchise agreement which expressly reserved the franchisor's right to conduct wholesale sales through alternative channels—specifically, through the internet—and which obligated the franchisor to share a portion of revenue from internet sales with the franchisee if the franchisor sold products which were delivered to customers within the franchisee's defined territory. *Newpaper, LLC v. Party City Corp.*, CIV. 13-1735 ADM/LIB, 2013 WL 5406722, at *3-5 (D. Minn. Sept. 25, 2013). While Party City might have prevailed solely due to provisions reserving its right to engage in sales "by or through the internet[.]" the additional terms addressing profit sharing bolstered the court's ultimate conclusion that the contract unambiguously foreclosed the franchisee's encroachment claims. *Newpaper*, 2013 WL 5406722 at *4.

As with traditional encroachment claims, the provisions of the franchise agreement remain a franchisor's best defense against claims for encroachment via alternative means of distribution. By drafting franchise agreements to expressly anticipate the growth of E-commerce as the primary forum for selling goods and services, franchisors can protect their development interests for the foreseeable future.

³⁴ Bridges, *supra* note 21; Dolman, *supra* note 2, at 24.

³⁵ Bridges, *supra* note 21 (discussing *Newpaper, LLC v. Party City Corp.*, a 2013 case in federal court in Minnesota in which a franchisee sued a franchisor on the theory that the franchisor's sales through the internet breached the franchisee's exclusive territory rights; the franchisor prevailed on a motion to dismiss, in part due to contract language including profit sharing for internet sales by franchisor within franchisee's exclusive territory).

V. Is the *El Pollo Loco* case an anomaly or the wave of the future?

While it is impossible to predict with certainty the developments that franchisee encroachment theories may take in the future, *El Pollo Loco* does not, on the face of the decision, herald a dramatic shift in courts' interpretations of encroachment claims in the absence of franchisees' exclusive territory rights. Not only is *El Pollo Loco* currently pending appeal, but the trial court's reliance on *In re Vylene* and *Scheck* as precedents allowing franchisees' encroachment claims to proceed to trial is unlikely to change the consensus which has developed in most courts since *In re Vylene* was decided: that a duty not to encroach cannot be implied where a franchise agreement expressly denies a franchisee an exclusive territory or expressly affirms the right of a franchisor to develop new restaurants in an existing franchisee's territory. Unlike relatively recent cases involving franchisors' deliberate use of encroachment to constructively terminate a franchise agreement, the *El Pollo Loco* decision does not provide much inherent support for the argument that a franchisor's decision to build restaurants multiple miles from an existing franchisee—as expressly authorized by the franchise agreement—is a bad faith abuse of franchisor's "discretionary power affecting the right of the other[.]" *Locke*, 66 Cal. Rptr. 2d at 925.

In sum, *El Pollo Loco* is an intriguing refresh of *In re Vylene*, a Ninth Circuit precedent that has never been outright abrogated or overruled. While the trial court's discussion of the relationship between population density and intra-brand competition provides a thorough analysis of the effects of encroachment on the profitability of existing franchisees, it is unlikely to compel courts to reconsider the duty of franchisors to protect the market of individual franchisees from intra-brand competition in the absence of express contractual terms or statutory provisions creating such a duty. Going forward, the attempts of states like Iowa, Indiana, and Wisconsin to enact new laws protecting franchisees from unfair intra-brand competition offer a much more promising glimpse of the future of franchise encroachment litigation than the revival of bygone encroachment theories under the implied covenant of good faith and fair dealing in *El Pollo Loco*.

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2019 Judicial Update

Selected Termination and Bankruptcy Cases

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Notable Cases Analyzing Whether Termination Was Justified

***IHOP Restaurants LLC v. Moeini Corporation*, 2018 WL 76343, (S.D. Ala. Feb. 7, 2018).**

In 2016, franchisee Moeini Corporation (“Moeini”) operated three IHOP restaurants in Alabama pursuant to a franchise agreement with IHOP Restaurants LLC (“IHOP”). Under the IHOP franchise agreement, franchisees were required to operate in compliance with IHOP’s policies and procedures, including maintaining certain operational standards regarding methods of production and food presentation, standards of sanitization, and appearance and cleanliness of the premises. To ensure compliance, IHOP conducted unannounced operational evaluations and food safety inspections at its franchised locations. In December of 2016, after several departures of experienced personnel, the Moeini restaurants began experiencing operational challenges. These included an inability to hire experienced managers, several failed inspections over a six-month period, and an unusually high level of complaints. In August 2017, IHOP sent a notice of default with a 30-day opportunity to cure to Moeini based on these operational deficiencies. During the cure period, IHOP conducted another inspection. The operational standards had not improved. Accordingly, at the end of the cure period, the franchisor sent a 30-day notice of termination, and demanded that the franchisee de-identify the restaurants within 60 days. On the 29th day, Moeini filed for Chapter 11 protection.

After a successful motion for relief from the automatic stay, IHOP sought a preliminary injunction to enjoin the Moeini restaurants from continuing to use the IHOP name and marks. To prevail on a trademark infringement claim against a franchisee, the *Lanham Act* requires that a franchisor demonstrate that it properly terminated the contract that authorized the use of the marks. 2018 U.S. Dist. LEXIS at 14. Here, Franchisee challenged the termination on two grounds. First, the franchisee claimed that the inspection standards and assessment of the franchised business consultant were unreasonable. Second, the franchisee claimed that because the inspection was conducted during the cure period, instead of at the end of the cure period, it was not sufficient to support the termination.

The court disagreed. The court explained that even if individual deficiencies could be challenged, the sheer number of failures to comply with food safety procedures, and the extremely high customer complaint rate (more than 10 times the system average), suggested that the franchisor was likely to succeed in proving that the termination was valid. Although the court acknowledged that franchisee had made efforts to cure its breaches, had filed bankruptcy in an attempt to reorganize, and sought buyers for the business, the ongoing harm to the IHOP goodwill and marks, and the potential harm to the public if the franchisee was permitted to continue operating as an IHOP, outweighed the hardship to the franchisee.

***Peterbrooke Franchising of America, LLC v. Miami Chocolates, LLC*, 312 F. Supp. 3d 1325 (S.D. Fla Feb. 28, 2018).**

Franchisor Peterbrooke Franchising of America, LLC (“Peterbrooke”), which franchises Peterbrooke chocolatier shops, brought suit against franchisee Miami Chocolates (“Miami”) and its owners for breach of contract, trademark infringement, and unfair competition, after its owners continued to operate a competitive business after Peterbrooke purported to terminate the franchise.

Miami had been a Peterbrooke franchisee since 2007. Under the franchise contract, Miami was required to use and record all sales on the POS system that the franchisor specified in its manual or otherwise. In the franchise contract, Miami acknowledged that those requirements could change under certain circumstances. In particular, the contract provided:

You further understand that it may become necessary for You to replace or upgrade the entire cash register system with a larger system capable of assuming and discharging all the tasks and functions specified by Us. You further understand and agree that as designs and functions change periodically, We may be required to make substantial modifications to Our specifications or to require installation of entirely different systems during the term of this Agreement or during the term of any renewal Franchise Agreement.

The contract contained a general provision that failure comply with any provisions of the franchise agreement or any mandatory specification would be cause for immediate termination. In 2012 or 2013, Peterbrooke sent a notice requiring Miami to change to a new POS system. Miami refused, and Peterbrooke did not take any further action at that time. In 2015, Peterbrooke sent another notice, this time requiring Miami to change to a different new POS system. Miami again refused. Upon the refusal, Peterbrooke sent a notice of termination.

Miami argued that the termination was invalid because the franchisor did not adequately test the POS system before rolling it out to franchisee, the POS system did not meet industry standards and was inferior to the old system, and Miami’s refusal to upgrade its POS was not material. However, the contract only imposed an obligation for franchisor to determine that the new system would be beneficial to Miami. Specifically, the franchise agreement required that *following franchisor’s testing and determination that the new hardware, software, or technology would be beneficial to franchisees*, franchisee agreed to install the addition, changes, and modifications, as franchisor directs “on those dates and within those times specified by [franchisor in its] sole and exclusive discretion....” 312 F. Supp. 3d at 1335. Because of the expansive discretion granted to franchisor under the contract, the court found that the termination was valid.

Notwithstanding the valid termination, the parties had different interpretations of when the franchise agreement required a terminated franchisee to stop using the

marks. When, in Peterbrooke's view, Miami failed to take sufficient steps to de-identify, Peterbrooke sought preliminary injunctive relief. One section of the franchise agreement required the franchisee to stop using the marks "upon the termination" of the agreement. However, the subsequent subsection provided that, for everything other than signage, Miami was to provide evidence of compliance within 30 days of termination. For signage, however, evidence of compliance was only required by the later of 30 days after the expiration of Peterbrooke's 60-day option to purchase, or 30 days after receipt of notice that Peterbrooke did not elect to purchase the location. Despite franchisor's position that all of Miami's use of the marks was required to cease immediately and only notification was permitted later, the court found that a more reasonable interpretation permitted franchisee to wind down its use of the marks generally within 30 days of termination and to wind down its use of signage after it knew that the franchisor was not purchasing the business. Because Peterbrooke did not present evidence that the trademark usage continued beyond this extended deadline, the claim failed.

Finally, the court granted summary judgment in favor of the franchisor on its claims for breach of the noncompetition provision, and unfair competition. It was undisputed that the franchisee continued to operate a competitive business at the former franchise location, and to use Peterbrooke's phone numbers, social media pages, and the shop location after in conjunction with such business.

***Dunkin' Donuts Franchising, LLC v. C3WAIN, Inc.*, U.S. Dist. LEXIS 167682 (D. N.J. Sept. 28, 2018)**

Moothedath Ramachandran, Jr. ("Moothedath") through entities, was the owner and operator of three Dunkin' Donuts franchises. This case arose when Dunkin' Donuts Franchising, LLC ("Dunkin") sought to terminate the franchises owned by Moothedath because it discovered that Moothedath's wife, Raji ("Raji"), had opened a Red Mango franchise in the same mall as one of the Moothedath's Dunkin' Donut/Baskin Robins location with the financial backing and assistance of Moothedath.

Moothedath, through his company, signed his first franchise agreement with Dunkin for a Dunkin Donuts only location in 2005 ("First Location"), and his second in 2006 for a combination Dunkin' Donut and Baskin Robins location ("Second Location"). He had already been operating the two Dunkin' Donuts locations successfully when his wife Raji began looking for a franchised business of her own to invest in. Raji successfully obtained a franchise from Red Mango in 2011. She signed a franchise agreement and began searching for space. She was still considering various real estate options in November 2012 when Moothedath signed a franchise agreement for a combination Dunkin' Donut and Baskin Robins location ("Third Location") to be located in the Freehold Raceway Mall (the "Mall"). Based on Moothedath's encouragement, Raji also began considering real estate in the Mall as it offered a space that could accommodate both her planned Red Mango business and the Third Location. Moothedath and Raji negotiated the leases together and ultimately each executed a lease agreement in the Mall for their respective franchises. The record reflects that Moothedath actively misled Dunkin during the site selection process by disclaiming any

interest or affiliation with Red Mango, despite his wife's ownership and his active support of the venture. For example, Moothedath (a) personally guaranteed the lease for the Red Mango location, (b) obtained a joint \$250,000 loan for Third Location franchisee entity and the Red Mango franchisee entity the businesses (\$150,000 of which was used to construct the Red Mango business), (c) personally guaranteed the joint loan, and (d) pledged the lease of the First Location as collateral for the joint loan.

After learning about Moothedath's relationship to the Red Mango franchise, Dunkin sent notices of termination to each of Moothedath's locations. Dunkin asserted three bases for termination. First the franchise agreements each have terms precluding franchisees from having any interest in any business that sells the same or similar products as a Dunkin Donuts or Baskin Robins, as applicable. Second, the franchise agreements all have anti-fraud provisions that allow for termination if the franchisee or its owners commit a fraud upon Dunkin related to the franchised business. Third, the franchise agreements also contain cross-default provisions which allow Dunkin to terminate all other franchise agreements owned by the same owner if one agreement is terminated for fraud.

After a two-day bench trial, the court confirmed the termination of the Third Location but refused to terminate the First Location or Second Location. However, termination of all three locations would have been a quite harsh result. Termination of First Location or Second Location based solely on their noncompetition clauses would have been unreasonable. First, the trade secret allegations were not well supported. Second, although the Second Location noncompetition clause may have been technically violated, there was no evidence that Dunkin' suffered damages because of it. Moreover, internal policies suggested that Dunkin made exceptions to its rules about competitive ownership, and routinely provided alternatives to termination to avoid divided loyalty concerns. In the court's view, Dunkin' seemed most concerned about the noncompetition elements of the claim and tacked on the fraud claim just to trigger the cross-default. In the court's view, the hard work put in by Moothedath and Raji to develop those locations should not be discounted. Dunkin's stated goal of deterrence could be met by the termination of the Third Location.

***BL Restaurant Franchises LLC v. Park Inc.*, 2108 U.S. Dist. LEXIS 8787595; 2018 WL 2363606 (N.D. Tex. May 24, 2018).**

Franchisor BL Restaurant Franchises LLC ("Bar Louie") is the franchisor of the Bar Louie restaurant system. It brought a breach of contract claim against its franchisees for breach of contract and sought a preliminary injunction to enforce certain terms of the franchise contract for two franchised locations. However, before the motion was ripe, the claims related to one location were resolved out of court, and the franchisee closed the second location voluntarily. Accordingly, the franchisor amended its preliminary injunction motion to simply require the franchisees to comply with pre-termination procedures in the contract before closing the restaurant.

The Bar Louie franchise contract prohibited the franchisee from terminating the franchise agreement other than for a material breach of the franchise agreement by

franchisor. For a franchisee to terminate the franchise contract for cause, the agreement required that the franchisee notify the franchisor of the breach within one year of its occurrence, and provide the franchisor with sixty days to cure. Because its franchisee did not follow this process, Bar Louie sought injunctive relief requiring the franchisee to reopen the closed location and follow this process.

Bar Louie based its request for injunctive relief on the franchise contract, in which the parties agreed that Bar Louie was entitled to injunctive relief if the franchisee engaged in unauthorized or improper use of the proprietary marks. Bar Louie also asserted that it met the four standard factors for injunctive relief – namely a likelihood of success on the merits, irreparable harm, injury outweighing the harm to the opposing party, and the public interest.

The franchisee defended on several grounds. The franchisee claimed the Bar Louie was not likely to succeed on its breach of contract claim because it had itself failed to perform under the agreement by failing to provide the expected levels of training and support. Moreover, the franchisee noted that it had not breached the franchise agreement by not following the termination process because it had not actually terminated the agreement. It had simply closed the restaurant because it was no longer financially viable. The franchisor did not directly refute the franchisee's arguments. Rather it simply pointed out that the support that franchisee sought was not expressly required by the contract.

To obtain a preliminary injunction, Bar Louie needed to show a substantial likelihood of success on the merits. Here, because Bar Louie had not offered evidence to show that it complied with the contract, and did not address the franchisees' claim that they did not have to comply with the termination procedures, the court concluded that the high standard for a preliminary injunction had not been met. Motion for preliminary injunction denied.

***Takiedine v. 7-Eleven, Inc.*, 2018 U.S. Dist. LEXIS 107386, 2018 WL 3141461 (E.D. Penn. June 27, 2018).**

Franchisee Takiedine ("Takiedine") operated and likely continues to operate several 7-Eleven locations under franchise agreements with 7-Eleven, Inc. ("7-Eleven"). While continuing to operate its businesses, franchisee sued 7-Eleven for breach of contract and constructive termination. In particular, Takiedine alleged that 7-Eleven had tried to get him to terminate the franchise by, among other things: (a) telling his employees that his days were numbered, (b) accusing him of breaching the franchise agreements, and (c) changing corporate policies in ways that diminished his profits. The court determined that as a threshold matter, claims for constructive termination were based on a duty of good faith. Thus, the viability of the constructive termination claim "depends on the exact scope of the implied duty of good faith: does it reach situations, like this one, in which a franchisor has allegedly tried – but failed – to force a franchisee to terminate the relationship." 2018 U.S. Dist. LEXIS 107386 at *9. The court concluded that it does not. Under Pennsylvania law, a franchisor's duty of good faith was limited to the context of actual franchise termination. Therefore, even if Takiedine

could establish bad faith in the franchisor's pre-termination dealings, the claim could not be sustained unless the franchisee actually walked away from the franchise. Because constructive termination required that there was an actual termination, and franchisee continued to operate its locations, Takiedine could not succeed on its claim for constructive termination.

**Notable Cases Analyzing the Enforcement of Non-competes
and Use of the Marks after Termination**

***Baskin-Robbins Franchising LLC v. Sweet Blessings Corp.*, 2018 U.S. Dist. LEXIS 217572 (C.D. Cal. June 22, 2018).**

Franchisor Baskin-Robbins Franchising LLC ("Baskin") terminated its franchisee for repeated violations of various laws and nonpayment of required fees under the franchise agreement. In its notice of termination, Baskin requested that the franchisee immediately comply with the post-termination provisions under the franchise agreement. When the now former franchisee continued to operate its Baskin-Robbins shops, Baskin sought a preliminary injunction. The initial request for injunction relief sought to "enjoin Defendants from continuing to operate their former Baskin-Robbins' shops and from continuing to display the Baskin-Robbins trademarks and other indicia of origin," but Baskin later clarified that it only sought to enjoin the use of the marks, not to prevent operation of the entire business. Because (a) the franchisor established a likelihood of success on the merits; (b) the law was well established that a former franchisee's continued use of the marks significantly reduces the franchisor's ability to control the reputation and goodwill of the marks, results in customer confusion, and causes the franchise substantial and irreparable harm; (c) an injunction against continued use of the marks would not prevent the former franchisee from continuing its business; and (d) the public interest would be served by the reduction in confusion; the court granted the injunction.

***Window Gang Ventures, Corporation v. Salinas*, 2018 NCBS LEXIS 18, 2018 WL 1046613 (Feb. 21, 2018).**

Franchisor was entitled to a preliminary injunction against its former franchisee, when franchisee: started a new directly competitive business; emailed the franchisor's customers suggesting that his new business was just an updated version of the old franchised business; represented that the new business used to be the franchised business, changed the Facebook pages it used with the franchised business to reflect the name and information of the old business; represented that reviews and testimonials for the old business applied to his new business; used a gmail account name that included the franchisor's marks; and continued to use telephone numbers associated with the old franchise business.

Two Men & a Truck /International, Inc. v. Gerstner Management Systems, Inc., 2018 U.S. District LEXIS 21469 (W.D. Mich. Feb. 9, 2018).

Franchisor was entitled to a temporary restraining order against its former franchisee and its owners. The franchise agreement was properly terminated and the post-termination covenant prohibited franchisee owners from operating a competitive business. The Franchisors proffered evidence regarding former franchisee owners' establishment of a new moving company which continued to provide services to clients of the former franchisee, representations to customers that the new company was just a name change, and continued use of the franchisor's reservation system to book and divert customers, was sufficient to show a likelihood of success and irreparable harm, and the other factors did not weigh against the grant of an injunction.

New Horizons Education Corporation v. Krolack Technology Management of Syracuse, LLC, 2018 U.S. Dist. LEXIS 180550 (N.D. N.Y. October 22, 2018).

New Horizons, a franchisor of computer training business, was entitled to preliminary injunctive relief when its former franchisee continue to operate a computer training businesses after termination of the franchise agreement, continued to use the New Horizon marks on signage, email, and on business cards, and there was actual evidence in the record of customer confusion.

Brightstar Franchising LLC v. Northern Nevada Care, Inc., 2018 U.S. Dist. LEXIS 150769, 2018 WIL 4424454 (N.D. Ill. Sept. 4, 2018).

Franchisor Brightstar Franchising LLC ("Brightstar") was entitled to an injunction terminating operations of an independent home health business set up by its former franchisee. The former franchisee was unlikely to succeed on its fraudulent inducement claims when it had negotiated portions of the franchise agreement, but nothing in the agreement reflected franchisor's alleged promise to offer franchisee an adjoining territory. Moreover, franchisee's establishment of a new in-home healthcare provider was a clear violation of the non-competition covenants. Among other things, the fact that the new business continued to service some Brightstar clients suggested that franchisor would be irreparably harmed without an injunction. Although shutting down the new business would be a hardship on the former franchisee, "self-inflicted wounds are not irreparable."

Homewatch International, Inc. v. Benson, 2018 Colo. Dist. LEXIS 444 (D.C. Col., Jan. 5, 2018).

Franchisor Homewatch International, Inc. ("Homewatch") offers franchises that provide companionship and personal care services in clients' own homes. The companionship and personal care services that Homewatch franchisees provide are unskilled. No specific licensure or medical background is required. Homewatch franchises typically operated on a "private pay" model, meaning that clients pay out-of-pocket for services, or pay through private insurance. Homewatch franchisees do not typically service Medicare or Medicaid clients.

Franchisee Benson ("Benson") was interested in operating a homecare business providing skilled services such as nursing care to Medicare and Medicaid patients. Benson signed a franchise agreement with Homewatch to service the Colorado Springs market, not realizing that Homewatch franchise focused on a different sector of the homecare market. Although Benson quickly realized her error, Benson decided to try to make the business work anyway. Homewatch did not object to Benson's efforts to get qualified to serve Medicare and Medicaid patients, but also did not provide much assistance as its business model was fundamentally different.

Eventually, when Benson failed to generate the minimum revenues required by the franchise agreement, Homewatch terminated the franchise. Immediately upon termination, Benson establish an independent homecare business, First Class Home Care, with a new name but out of the same physical location. Franchisor claimed the new business violated the non-competition provision of the franchise agreement which prohibited franchisee from operating a Competitive Business after termination. Under the franchise agreement the term "Competitive Business" meant:

"a business which offers companionship, comprehensive personal care and transportation services, or some but not all of these services, or related products and services offered by HOMEWATCH CAREGIVERS Businesses to persons in their home who are aged, disabled, recovering, rehabilitating, convalescing or otherwise in need of personal care services...."

2018 Colo. Dist. LEXIS 444, *10. For its part, Care Services was:

"defined as companionship, personal care, complex personal care, nursing services, where allowed by state law and by [franchisor's] standards, and related services and products Franchisee shall not offer for sale or sell at or through the HOMEWATCH CAREGIVERS Business any Care Services not included in the Operations Manual or otherwise approved in writing by [franchisor], or any other products or services not previously authorized by [franchisor]."

Id. Franchisee argued that its new business was not a competitive business because it focused solely the skilled Medicare and Medicaid market. Franchisor countered that franchisees occasionally provided unskilled services, and franchisee had been permitted to provide skilled services under the definition of Care Services in the franchise agreement.

The court generally agreed with franchisee. Although Benson had provided skilled services to Medicare and Medicaid patients as a Homewatch franchisee, the system was neither set up to support these services nor to process payments from Medicare. In addition, although Benson provided unskilled care through First Class Home Care, the bulk of the unskilled services were provided by skilled professional incidental to the skilled services such professional were already providing. To the extent that First Class Home Care provided skilled services to Medicaid and Medicare

patients (or incidental unskilled services to those same client), First Class Home Care was not a Competitive Business. However, because the court did find that First Class Home Care did serve some private pay clients, it agreed to enjoin such activity as within the scope of the non-competition clause.

Other notable cases relating to termination

***Service Team of Professionals, Inc. v. Folks*, 2018 U.S. Dist. LEXIS 75899, 2018 WL 2051516 (W.D. Mo. May 2, 2018).**

Franchisee William Folks (“Folks”) was a franchisee of Service Team of Professionals, Inc. (“STP”). After a dispute between them, Folks and STP entered into a settlement agreement (“Settlement Agreement”) that terminated the franchise agreement. The Settlement Agreement provided that after termination of the franchise agreement, neither party would “have any remaining obligations or rights thereunder,” except for certain specified obligations related to confidentiality and de-identification (the “Surviving Obligations”).

At some point later, when STP believed that Folks had breached the Settlement Agreement, it filed suit in Missouri -- the forum designated in the franchise agreement. Folks responded with a motion to dismiss or transfer, arguing that he was not subject to personal jurisdiction in Missouri. In response, STP argued that the venue was proper because the forum selection clause survived termination of the Franchise Agreement.

The court agreed with Folks. The court noted that as a general rule, dispute resolution provisions generally survive a contract’s termination. However, the parties are free to negotiate a different outcome. In this case, while negotiating the Settlement Agreement, the parties could not agree on a forum selection clause, but were able agree that the parties would be relieved from all of the terms and conditions of the franchise agreement other than the Surviving Obligations. Because the Settlement Agreement neither specifically included a forum selection clause, nor preserved the forum selection clause in the franchise agreement, the general jurisdiction rules applied. Folks’ other contacts with Missouri were not sufficient to confer jurisdiction, thus the motion to dismiss or transfer was granted.

BANKRUPTCY CASES

***Dine Brands Global, Inc. v. RMH Franchise Holdings, Inc.*, (In re RMH Franchise Holdings, Inc.), 590 B.R. 655 (Bankr. D. Del. Sept. 18, 2018).**

RMH Franchise Holdings, Inc. (“RMH”) operated more than 160 Applebee’s restaurants pursuant to franchise agreements (the “Franchise Agreements”) with franchisor Dine Brands Global, Inc. (“Applebee’s”). In June 2017, RMH stopped making royalty payments to Applebee’s under the Franchise Agreements. In September 2017, Applebee’s sent a default letter to RMH giving it 90 days to cure its nonpayment, and specifically providing that if it failed to cure, the Franchise Agreements would automatically terminate on the 91st day without further notice. RMH did not cure the defaults, but engaged in discussions to try to resolve the dispute. Shortly before the

cure period expired, Applebee's sent a letter to RMH reserving its rights, but extending the cure period by 30 days to allow for further discussion. Applebee's continued to further extend the cure periods through a series of similarly worded extension letters (the "Cure Extensions"). Each Cure Extension specified the date that the cure period would expire, but (unlike the original notice of default) did not specifically state that the Franchise Agreements would automatically terminate on expiration of the cure period. The last Cure Extension expired on April 26, 2018.

In a forbearance letter dated April 25, one day before the expiration of the last cure period, and sent on April 26, Applebee's stated that it would not take any actions to enforce its rights under the Franchise Agreements until May 8, but noted that "[t]his agreement to forbear is not an extension of the cure periods referred to in prior Notices, which have already expired."

On May 8, several things happened all at once. In the early morning, RMH filed for Chapter 11 bankruptcy protection. Later that day, Applebee's sent two letters to RMH, one purporting to terminate the Franchise Agreement for the Arizona and Texas locations (retroactive to April 27, the day after the last cure period), and another forbearance letter agreeing to delay enforcing its termination rights until May 20. That same day, after learning of the bankruptcy proceeding, Applebee's filed suit against RMH in District Court in Kansas seeking damages and injunctive relief.

Applebee's filed an adversary proceeding in the Chapter 11 case seeking a declaratory judgment that the Franchise Agreements had been terminated prepetition. In support of its position that the Franchise Agreements had been terminated, Applebee's claimed that the automatic termination language in the initial notice of default "echoed through each of the subsequent Cure Extensions and effected the termination of the Franchise Agreements when the last cure period ended." 590 B.R. 655 at 660. In contrast, RMH asserted that the Cure Extensions did not discuss termination and therefore did not implicate the automatic termination language in the initial notice of default. RMH also argued the even if the automatic termination language was implied in the Cure Extensions, the forbearance letters delayed the exercise of Applebee's termination rights and thus the Franchise Agreements were not terminated prepetition.

Ultimately, the bankruptcy judge agreed with RMH. Under Kansas law, which governed the Franchise Agreements, termination of a contract must be unambiguous and convey an unmistakable purpose to rescind or forfeit the agreement. 590 B.R. 655 at 660. Because, in the court's view, "Applebee's was aware that it could have included language providing for termination in the Cure Extensions and it choose to omit that language," the Franchise Agreements had not been terminated prepetition and were properly part of the bankruptcy estate. The court also noted that even if the Cure Extensions had provided unambiguous notice of termination, Applebee's decision on May 8 to forbear enforcing its rights under the Franchise Agreement until May 20, postponed the actual termination until after the petition date.

Taylor Investment Partners II, LLC v. Moe's Franchisor, LLC, 811 S.E.2d 62 (Ga. Ct. App. 2018).

Franchisee Taylor Investment Partners ("Taylor") operated two Moe's restaurants. The franchise agreement with Moe's Franchisor, LLC ("Moe's") for the restaurants provided that the franchise agreement would terminate automatically if the franchisee filed bankruptcy. Taylor did file bankruptcy, and Moe's commenced suit against Taylor for breach of contract and trademark infringement. Moe's also sought a TRO to preserve the status quo. At the conclusion of the hearing on the TRO motion, the court granted the TRO motion and asked the parties to brief the question of whether the filing of the bankruptcy petition terminated the franchise agreements. During this period, Taylor also answered the complaint, and alleged counterclaims, seeking, among other things, a declaratory judgment that the bankruptcy termination clause in the agreements was unenforceable. When the court issued its formal order on the TRO motion, it (a) found that the termination-upon-bankruptcy clause was enforceable, (b) found that the franchise agreements had been properly terminated, and (c) required Taylor to shut down and de-identify the Moe's restaurants. On appeal, the court reversed. Without reaching the trial court's legal conclusion, the appeals courts found that the court erred in treating the hearing on the TRO as a trial on the substance. Rather than simply preserving the status quo, the court resolved the ultimate issue regarding the enforceability of the bankruptcy clause, and directed action which gave Moe's most of the relief it sought.

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2019 Judicial Update

Disclosure Violations

Andra J. Terrell
Church's Chicken/Texas Chicken
Atlanta, Georgia

A. Duty to Translate –*Castillo v. CleanNet USA, Inc.*, 358 F. Supp. 3d 912 (N.D. Cal. 2018).

Plaintiff Castillo was a franchisee of Defendant D&G Enterprises, Inc., CleanNet USA's area operator licensed to sell CleanNet USA franchises in the San Francisco Bay Area ("D&G Enterprises"), pursuant to a franchise agreement dated September 26, 2011. Plaintiff Castillo sued Defendant claiming violations of the federal Trafficking Victims Protection Reauthorization Act ("TVPRA"), 18 U.S.C. § 1959, and the California Trafficking Victims Protection Act ("CTVPA"), Cal. Civ. Code § 52.5. Defendant filed a Motion to Compel Arbitration pursuant to the Franchise Agreement Plaintiff Castillo argued that the arbitration agreement was void and unenforceable because he was fraudulently induced to enter into the Franchise Agreement due to his limited understanding of English and reliance upon Vilma Vega's representations about the Franchise Agreement.

The franchise agreement provided if the parties were unable to resolve a dispute between them within 180 days from the date negotiations, the dispute was to be submitted to mediation administered by the American Arbitration Association at its office closest to D&G Enterprises and in accordance with the Commercial Mediation Rules of the AAA. The Franchise Agreement further stipulated that any disputes not settled by mediation be submitted to arbitration administered by the AAA at its office closest to D&G Enterprises and in accordance with the Federal Arbitration Act and Commercial Rules of the AAA, unless otherwise agreed by the parties in accordance with Section XXII.C of the Franchise Agreement. The Franchise Agreement also contained Franchisee's acknowledgement that the Franchise Agreement was written in English, that the Franchisee had an opportunity for translation, and that Franchisee would conduct its business in the English language, which was not an undue burden on the Franchisee.³⁶ Plaintiff Castillo received the Franchise Agreement as part of the "Franchise Disclosure Documents", which included a summary of the provisions of the Franchise Agreement and a "California Addendum to Disclosures Document" that explained the Franchise Agreement required binding arbitration for disputes, and encouraged Plaintiff Castillo to consult private legal counsel to determine the applicability of the California and federal laws.

Plaintiff Castillo asserted that although he signed the Franchise Agreement he did not understand it, and that he especially did not understand that disputes were

³⁶ *Castillo v. CleanNet USA, Inc.*, 358 F. Supp. 3d 912, 920 (N.D. Cal. 2018) (The Franchise Agreement, Section XXI (D) stated: "**English Language:** Franchisee acknowledges that Franchisor's disclosure document and this Agreement are written in the English language. If English is not Franchisee's native language, Franchisee warrants and represents that Franchisee has had the opportunity for translation of the disclosure document and this Agreement; that all aspects of this Agreement have been explained to Franchisee's satisfaction; and that Franchisee understands and accepts this Agreement as written. Franchisee warrants and represents that Franchisee can in fact conduct business in the English language and that conducting business in the English language does not constitute an undue burden on Franchisee.").

subject to mediation and arbitration. His declaration stated, in relevant part, that Spanish was his primary language, that the majority of his conversations with D&G Enterprises and CleanNet representatives were conducted primarily in Spanish, that he relied upon the explanations and “purported translations of CleanNet’s employee Vilma Vega, who, when reviewing the documents with Plaintiff Castillo, would say “this page says this, that page says that” .³⁷

Defendants did not dispute Plaintiff Castillo’s assertions, but instead contended that Plaintiff Castillo had plenty of opportunity to discover the terms of the contract after receiving a copy of the Franchise Disclosure Documents in June 2011, and that Plaintiff Castillo was more business-savvy than he portrayed.³⁸ Plaintiff Castillo signed a Receipt and Acknowledgement of Receipt of the Franchise Disclosure Documents on June 14, 2011. Further, Plaintiff Castillo completed a Franchise Application that is also dated June 14, 2011. Plaintiff Castillo alleged, however, that Vilma Vega, CleanNet’s employee, translated portions of the Franchise Application for him and helped him complete the application. Plaintiff Castillo also alleged that during his meeting on September 26, 2011 with Vilma Vega, he asked if the “thick packet” of documents she gave him could be translated into Spanish, and Vega said she could provide him with oral translations because Spanish translations were not available. During the meeting Vega translated various sections of the Franchise Agreement, again “this means this, that means that”, but did not advise Plaintiff Castillo of the arbitration provision. Plaintiff Castillo also asserted, in his declaration, that he understood some janitorial words in English because of working in the industry for many years, but otherwise had limited English proficiency.

California law provides that a contract is void if there is fraud in the inception of the contract.³⁹ The test for fraud in the inception is: (1) misrepresentation (including by omission); and (2) reasonable reliance on that misrepresentation.⁴⁰ The court heavily relied upon the *Rosenthal* case, in which the test for fraud in the inception could be applied to investors having low English proficiency. Specifically, the *Rosenthal* court ruled

“[i]n light of the plaintiff’s past relationship with GWB, which they were led to believe was also the employer of [the representatives], their limited ability to understand English, and [the representatives’] representations that their oral recitals accurately reflected the terms of the agreement,

³⁷ *Id.* at 923.

³⁸ *Id.* at 924. Defendants contended that Plaintiff Castillo was a savvy business owner and that his English language ability was better than what he asserted in his declaration. In fact, one of D&G’s employees, Andrew Kaska, asserted in his declaration that he observed Plaintiff Castillo speaking to customers in English. Defendants also produced a business card and business registration certificate from Plaintiff Castillo for his company, J&V Maintenance.

³⁹ *Rosenthal v. Great W. Fin. Sec. Corp.*, 926 P.2d 1061 (1996).

⁴⁰ *Id.* at 1076–77.

plaintiffs would not have been negligent in relying on the GWFSC representatives instead of reading the agreement themselves."⁴¹

The court also cited *Ramos v. Westlake Services LLC*, in which the California Court of Appeals also relied upon the *Rosenthal* case.⁴² In *Ramos*, the Plaintiff Alfredo Ramos, who was primarily a Spanish speaker, purchased a used car by signing a "Conditional Sale and Security Agreement" written in English. The employee Ramos worked with to purchase the car conducted the sale in Spanish and provided him a Spanish translation of the Agreement; however, the Spanish translation omitted the arbitration clause. The court in *Ramos* held that "[b]y providing Ramos a translation that did not even reference arbitration, let alone translate the terms of the arbitration agreement, [Defendant] deprived [Ramos] of a reasonable opportunity to learn the character and essential terms of the [arbitration agreement] he signed"⁴³.

The court in *Castillo* notes that the threshold for demonstrating fraud in the inception is high; it is not enough to show that the contracting party is not proficient in English, even if the agreement is only provided in English. Plaintiff *Castillo*, in this case, was clearly not proficient in English and could not understand the Franchise Agreement or other documents provided to him without assistance. Plaintiff *Castillo* requested a Spanish translation of the documents and was told one was not available, thus he relied upon Vega, who purported to provide an oral translation of the Franchise Agreement. Vega also did not encourage Plaintiff *Castillo* to seek counsel or obtain assistance so he could understand the documents but encouraged him to rely upon her translations. Based on those facts, the court ruled that there was fraud in the inception rendering the arbitration agreement void.⁴⁴

What does *Castillo* teach us? That if you provide a translation of a document written in English to someone who is not proficient in English, whether written or oral, make sure the translation includes all provisions and encourage the contracting party to seek counsel or other assistance to make sure they understand the terms of the agreement, perhaps even providing additional time for the contracting party to do so.

B. Effectiveness of Releases for Disclosure Violations – *Trident Atlanta, LLC v. Charlie Graingers Franchising, LLC*, No. 7:18-CV-10-BO, 2019 U.S. Dist. LEXIS 17295, 2019 WL 441187, at *1 (E.D.N.C. Feb. 4, 2019).

Plaintiff Trident Atlanta, LLC ("Trident Atlanta") sued for fraud in the inducement claiming that Defendant Charlie Graingers Franchising, LLC, a predecessor in interest to Defendant Charlie Graingers Franchising, Inc. ("Charlie Graingers"), fraudulently induced it to enter into a franchise agreement to operate a hot dog restaurant featuring

⁴¹ *Id.* at 1081.

⁴² [Ramos v. Westlake Servs. LLC, 195 Cal. Rptr. 3d 34 \(2015\).](#)

⁴³ *Id.* at 46 (quoting *Rosenthal*, 926 P.2d at 1082.).

⁴⁴ *Castillo*, 358 F. Supp. 3d. at 933.

hot dogs, beef brisket, pork barbecue, soup and side dishes,⁴⁵ and that defendants (1) had made intentional and negligent misrepresentations, (2) breached their fiduciary duty and duty of good faith and fair dealing, (3) violated North Carolina's Unfair and Deceptive Trade Practices Act, and (4) violated the Racketeer Influenced and Corrupt Organizations (RICO) Act.⁴⁶

Plaintiff Trident Atlanta was an area representative franchisee in Georgia that received Charlie Grainger's Franchise Disclosure Document ("FDD") between May 2015 and December 2015. The FDD provided Plaintiff Trident Atlanta would have the right to develop and operate Defendant Charlie Graingers franchises and to offer franchises to third parties within the designated area. The FDD also provided Defendant Charlie Graingers would provide "a wide variety of resources and operational support, including the following: an operating manual, site evaluations, advice on selecting a site and negotiating a lease, assistance remodeling and installing equipment and fixtures, help obtaining inventory and supplies, a comprehensive training program, a toll-free support line, marketing and promotional materials, and so on."⁴⁷ Defendant Charlie Graingers also provided Plaintiff Trident Atlanta with written representations stating Defendant Charlie Graingers: (1) had over 350 Franchise Commitments"; (2) would provide "24/7-Social Media Savvy"; (3) had the "[C]leanest Restaurants in America"; (4) defendant North had over forty years of restaurant experience; (5) the Defendant Charlie Graingers franchise was a "low cost-low overhead foolproof restaurant concept" that was "guaranteed to be successful"; (6) touted the strength of their national "concept and system," their supply agreements, their relationships with other brands, their "franchise real estate department" and its "connections across the country"; and (7) lauded the "world-class" and "endless" support that the Plaintiffs would receive.⁴⁸

In the Franchise Agreement, Plaintiff Trident Atlanta acknowledged it had "conducted an independent investigation," that operating a franchise "involves business risk," and that they had "not received any express or implied warranty or guaranty regarding potential volume, profits, or success."⁴⁹ Along with the Franchise Agreement, Plaintiff signed a "General Release" document that provided:

⁴⁵ *Trident Atlanta, LLC v. Charlie Graingers Franchising, LLC*, No. 7:18-CV-10-BO, 2019 WL 441187, at *1 (E.D.N.C. Feb. 4, 2019).

⁴⁶ *Id.* at *2. ("In September 2018, plaintiffs filed an amended complaint with ten causes of action. Plaintiffs bring claims for (1) rescission of their franchise agreements; (2) fraud, intentional misrepresentation, and concealment; (3) negligent misrepresentation; (4) breach of the duty of good faith and fair dealing; (5) breach of fiduciary duty; (6) violation of North Carolina's Unfair and Deceptive Trade Practices Act; (7) acquiring or maintain an interest in an enterprise engaged in interstate commerce through a pattern of racketeering activity, in violation of 18 U.S.C. § 1962(b); (8) conducting an enterprise engaged in interstate commerce through a pattern of racketeering activity, in violation of 18 U.S.C. § 1962(c); (9) conspiring to violate the RICO Act, in violation of 18 U.S.C. § 1962(d); and (10) breach of contract.").

⁴⁷ *Id.* at *1.

⁴⁸ *Id.*

⁴⁹ *Id.* at *2.

"[Franchisee] and its shareholders, officers, and directors does hereby release and forever discharge CHARLIE GRAINGERS FRANCHISING, LLC its, successors, agents, assigns, officers, directors, shareholders, employees, representatives, and any and all other persons, firms and corporations whatsoever, from any and all claims, demands, damages, actions, causes of action, or suits of any kind or nature whatsoever, both known and unknown" ⁵⁰

Defendant Charlie Graingers filed a motion to dismiss, arguing that Plaintiff Trident Atlanta signed a General Release when the Franchise Agreement was executed. Plaintiff Trident Atlanta countered that the General Release was fraudulently induced and thus unenforceable as well as that the General Release violated the Federal Trade Commission's Franchise Rule (the "FTC Rule") ⁵¹, which provides in relevant part that it is "an unfair or deceptive act or practice" to "[d]isclaim or require a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments." ⁵² The court denied Charlie Grainger's motion to dismiss for a variety of reasons, one of which was that the alleged violation of the FTC Rule in and of itself, was enough to establish a claim under [North Carolina's Unfair and Deceptive Trade Practices Act \(UDTPA\)](#) ⁵³, and thus Plaintiff's claims survived dismissal. ⁵⁴

The *Trident Atlanta* case affirmed a release of disclosure claims incorporated into the franchise agreement will not overcome the express prohibition of such a release by the FTC Rule. Although franchise agreement drafters may continue to utilize such releases they will not be effective to extinguish improper disclosure claims.

C. Failure to Register/Outdated Disclosure Documents – *Schulenburg v. Handel's Enterprises, Inc.*, No. 18-CV-513-GPC(WVG), 2018 U.S. Dist. LEXIS 153129, 2019 WL 4282637, at *1 (S.D. Cal. Sept. 7, 2018).

Defendant Handel's Enterprises, Inc. ("Handel's"), franchises ice cream shops bearing the brand name "Defendant Handel's Ice Cream". In October 2015, Plaintiff Kenneth Schulenberg ("Schulenberg") inquired about franchising a Handel's Ice Cream shop and received Defendant Handel's Franchise Disclosure Document around October 15, 2015. Defendant Handel's registered a Franchise Disclosure Document in 2015 and subsequently amended its Franchise Disclosure Document to include material modifications (the "Amended FDD"). California's Department of Business Oversight

⁵⁰ *Id.*

⁵¹ *Id.* at *3 (citing [16 C.F.R. § 436.9\(h\)](#)).

⁵² *Id.*

⁵³ See [N.C. Gen. Stat. § 75-1.1](#).

⁵⁴ *Id.* at *5. Defendants Gregory Bruce George and Jason Matthew Nista moved to compel arbitration of Plaintiffs' claims. On April 4, 2019, the court granted the motion to compel arbitration as to Ms. Binges, Mr. and Mrs. Atkinson, and Mr. Moore. *Trident Atlanta, LLC v. Defendant Charlie Graingers Franchising, LLC*, No. 7:18-CV-10-BO, 2019 U.S. Dist. LEXIS 58174, 2019 WL 1495271, at *1 (E.D.N.C. Apr. 4, 2019).

approved the amendment on January 19, 2016. On December 17, 2015, Plaintiff Schulenberg paid Defendant Handel's a deposit of \$5,000 towards the purchase of the franchise and signed a franchise agreement on January 21, 2016, the same day that a Defendant Handel's agent provided Plaintiff Schulenberg with another copy of the 2015 Franchise Disclosure Document. On January 19, 2016, Schulenberg wired the remaining \$45,000 of the franchise fee. Plaintiff Schulenberg never received a copy of the Amended FDD.⁵⁵

Subsequently the relationship between Plaintiff Schulenberg and Defendant Handel's turned sour, and Plaintiff Schulenberg sued, alleging: (1) violation of California Corporations Code sections 31123, 31107, [31119](#), 31107 and 31300; (2) breach of contract; (3) violation of California's unfair business practices; and (4) seeking declaratory relief. Defendant Handel's and Leonard Fisher and Jim Brown filed a motion to dismiss the first, second and fourth cause of action.

The California Franchise Investment Law ("CFIL") requires a franchisor to file a Uniform Franchise Registration Application ("UFRA") along with a proposed franchise disclosure document ("FDD") with the California Department of Business Oversight ("DBO").⁵⁶ Once the UFRA and FDD have been approved, it becomes effective for one year from the effective date.⁵⁷ A franchisor has a duty to promptly notify the DBO by submitting in writing an application to amend the registration of any material changes in the disclosure.⁵⁸ The DBO "may by rule further define what shall be considered a material change for such purposes, and the circumstances under which a revised offering prospectus must accompany such application."⁵⁹ The CFIL provides an exemption from disclosure requirements while an amendment application is pending if the prospective franchisee receives the following:

- (a) The franchise disclosure document and its exhibits as filed with the commissioner with the application for renewal or amendment.
- (b) A written statement from the franchisor that (1) the filing has been made but is not effective, (2) the information in the franchise disclosure document and exhibits has not been reviewed by the commissioner, and (3) the franchisor will deliver to the prospective franchisee an effective franchise disclosure document and exhibits at least 14 days prior to execution by the prospective franchisee of a binding agreement or payment of any consideration to the franchisor, or any person affiliated with the franchisor, whichever occurs first, showing all material changes from the franchise disclosure document and exhibits received by the prospective franchisee under [subdivision \(a\)](#) of this section.

⁵⁵ *Schulenburg v. Handel's Enterprises, Inc.*, No. 18-CV-513-GPC(WVG), 2018 WL 4282637, at *2 (S.D. Cal. Sept. 7, 2018).

⁵⁶ *Schulenburg*, 2018 WL 4282637, at *3; see also *Cal. Corp. Code* §§ 31111, 31114.

⁵⁷ *Cal. Corp. Code* § [31120](#).

⁵⁸ *Id.* at § 31123.

⁵⁹ *Id.*

(c) The franchise disclosure document and exhibits in accordance with [paragraph \(3\) of subdivision \(b\)](#) of this section.⁶⁰

Defendants argued that the changes in the Amended FDD were not material because the DBO accepted the amendment and "in doing so, declined to find that the changes were material or that a revised offering was required under [section 31123](#)."⁶¹ However, the court held that Section 31123 places the onus on the franchisor to determine if any changes are material and notify the DBO accordingly by filing an amendment. Further, the court held that Section 31200 supported the court's interpretation, because Section 31200 requires the franchisor to make the determination whether there are any material changes, stating:

[i]t is unlawful for any person willfully to make any untrue statement of a material fact in any application, notice or report filed with the commissioner under this law, or willfully to omit to state in any such application, notice, or report any material fact which is required to be stated therein, or *fail to notify the commissioner of any material change as required by [Section 31123](#)*.⁶²

The court opined that the CFIL permitted Defendants to continue discussions with Plaintiff Schulenberg and franchise a unit during the time between the October 15, 2015 FDD and the Amended FDD provided that Defendant Handel's gave Plaintiff Schulenberg a copy of the Amended FDD and proceeded with the normal sales procedures.⁶³ In this case, the court held an offer to Plaintiff Schulenberg was pending after he received the October 15, 2015 FDD and paid his deposit, and when Defendant Handel's applied to amend the FDD in January 2016, it was obligated to provide Plaintiff Schulenberg with a copy of that amended FDD and not close on the sale until the amendment was approved. The court held that on January 21, 2016, the date Plaintiff Schulenberg signed the Franchise Agreement and paid the remainder of the initial franchise fee, the October 15, 2015 FDD was no longer effective and the Amended FDD should have been provided. For those reasons, the court denied Defendants' Motion to Dismiss.

Plaintiff Schulenberg also alleged violations of the Corporations Code [sections 31119](#) and [31107](#) because, contrary to those section of the Corporations Code, Defendants did not wait the required 14 days after providing a copy of the October 15, 2015 Franchise Disclosure Document before signing the franchise agreement and

⁶⁰ Cal. Corp. Code § 31107.

⁶¹ *Id.*; *Schulenberg*, 2018 WL 4282637, at *3.

⁶² Cal. Corp. Code § 31200 (emphasis added).

⁶³ In a bit of circuitous reasoning, Defendants claimed that they could not provide the Amended FDD to Plaintiff Schulenberg because they provided Plaintiff Schulenberg with the October 15, 2015 FDD and the Amended FDD was not approved at that time. See *Schulenberg*, 2018 WL 4282637, at *4.

accepting payment of a fee.⁶⁴ Defendants argued that they provided the October 15, 2015 Franchise Disclosure Document more than 14 days before signing a franchise agreement or accepting payment of a fee. The court, however, held that Defendants “fail[ed] to recognize” that they filed to amend their FDD in January 2016 in which Defendants acknowledged there were material changes to the FDD.⁶⁵ Further, the Amended FDD became effective on the day Plaintiff Schulenberg paid the remaining \$45,000 of the initial franchise fee and 2 days before signing the franchise agreement. Such action, the court reasoned, violated the CFIL’s purpose - to provide prospective franchisees with all the information necessary to make a decision about whether to buy a franchise. For those reasons, the court denied Defendant’s Motion to Dismiss the second cause of action.⁶⁶

D. Licenses Can Be Franchises - *United Studios of Self Defense, Inc. v. Rinehart, et al.*, No. 8:18-cv-01048, 2019 U.S. Dist. LEXIS 37993, 2019 WL 1109682, at *1 (C.D. Cal. Feb. 22, 2019).

⁶⁴ *Schulenberg*, 2018 WL 4282637, at *4.

Section 31119(a) of the California Corporations Code provides:

[i]t is unlawful to sell any franchise in this state that is subject to registration under this law without first providing to the prospective franchisee, at least 14 days prior to the execution by the prospective franchisee of any binding franchise or other agreement, or at least 14 days prior to the receipt of any consideration, whichever occurs first, a copy of the franchise disclosure document, together with a copy of all proposed agreements relating to the sale of the franchise. Section 31107 provides that “(3) the franchisor will deliver to the prospective franchisee an effective franchise disclosure document and exhibits at least 14 days prior to execution by the prospective franchisee of a binding agreement or payment of any consideration to the franchisor, or any person affiliated with the franchisor, whichever occurs first, showing all material changes from the franchise disclosure document and exhibits received by the prospective franchisee under subdivision (a) of this section.”

⁶⁵ *Id.* at *5.

⁶⁶ See *id.* Defendants also moved to transfer the third and fifth causes of action to the Northern District of Ohio, where, on March 5, 2018, Handel’s filed a complaint against Schulenburg, Moonlight101, and Schulenburg’s partner, Juliana Ortiz (“Ortiz”). *Id.* at *4. The Ohio district court also denied Defendants’ motion to dismiss, stay, or in the alternative, to transfer venue to the Southern District of California court, stating that the Ohio court had subject matter jurisdiction, the Defendants had sufficient contacts with Ohio and “equity precluded application of the first to file rule because the California lawsuit was substantially different and even if first to file applied, equity barred its application because the California action was anticipatorily filed following notice of breach from Handel’s.” *Id.* at *6. The Ohio court also denied a motion to transfer to the Southern District of California under [28 U.S.C. § 1404\(a\)](#) because the forum selection clause is enforceable plus the public interest is to have a trial in a forum that is “at home with the state law that must govern the case” and the Ohio court was “certainly capable of applying California franchise law if it were to become necessary.” *Id.* at *6. The Court held that it would entertain further arguments supporting the motion to transfer at an upcoming hearing. *Id.*

Plaintiff United Studios of Self Defense, Inc. ("United Studios"), licenses and franchises martial arts studios under the USSD name, and requires its franchisees and licenses to use billing services provided by its affiliate, United Studios Billing, Inc. ("USB"). United Studios was founded by Charles Mattera ("Mattera"), who, on June 25, 1990, received a cease and desist order from for offering and selling securities without qualification or exemption.⁶⁷ On April 3, 1996, the California Commissioner of Corporations (the "Commissioner"), revoked United Studios' franchise registration due to failure to disclose the cease and desist order, and on May 30, 1996, the Commissioner filed a complaint against Mattera and United Studios for violations of California franchise laws (the "State of California Case").⁶⁸ On June 13, 1996, United Studios and Mattera entered into a permanent injunction, agreeing that United Studios, Mattera and their officers, directors, successors in interest, controlling persons, agents, employees, attorneys in fact and all other persons acting in concert or participating with them were permanently enjoined from the following (the "Permanent Injunction"):

"offering, selling, arranging for the sale, leasing, engaging in the business of selling, negotiating the sale of or otherwise dealing in the offer or sale of franchises unless they are registered and exempt, or of securities unless they are qualified or exempt, filing any application, notice or report with the Commissioner that contains an untrue statement of a material fact or omits to state a material fact, offering or selling a franchise or security by means of an oral communication that contains an untrue statement of material fact or omits to state a material fact and destroying certain documents for four years."⁶⁹

Following that permanent injunction, Mattera began issuing "license" agreements granting the right to operate martial arts studios using the registered marks UNITED STUDIOS OF SELF DEFENSE, USSD, UNITED STUDIOS and UNITED STUDIOS OF SELF DEFENSE OF AMERICA. The License Agreements required licensees to (1) follow United Studios' pricing guidelines, (2) attend United Studios meetings, training programs, and tournaments, (3) adhere to United Studios' operations manuals and guidelines, and (4) make monthly payments and process credit card transactions through USB.⁷⁰

On September 14, 2018, Plaintiff United Studios filed suit against Kristopher Rinehart ("Rinehart"), Brent Murakami ("Murakami"), South Bay Self Defense Studios, LLC ("SBSSD"), Los Angeles Studios of Self Defense LLC ("LASSD"), and SB Ninja, LLC ("SB Ninja"), alleging, among other things, unfair business practices in violation of Cal. Bus. & Prof. Code § 17200 et seq. against all defendants and a declaration of the right to terminate franchise agreements against Rinehart, LASSD and SBSSD (the

⁶⁷ *United Studios of Self Defense, Inc. v. Rinehart, et al.*, No. 8:18-cv-01048, 2019 WL 1109682, at *1 (C.D. Cal. Feb. 22, 2019).

⁶⁸ *Id.* (citing *People of the State of California v. United Studios of Self Defense, Inc. and Charles Mattera*, Case No. BC 150948).

⁶⁹ *Id.*

⁷⁰ *Id.*

“FAC”).⁷¹ Defendants counterclaimed against United Studios, Mattera and USB, asserting affirmative defenses and alleging violation of California Corporations Code § 31220 and unfair business practices in violation of Cal. Bus. & Prof. Code § 17200 et seq.(the “FACC”)⁷² Plaintiffs filed three motions to dismiss seven of the eight counterclaims, motions to strike portions of the FACC and motions to strike some of the affirmative defenses.⁷³

Plaintiffs moved to strike allegations referencing the State of California Case.⁷⁴ The court declined to strike parts of the FACC because motions to strike are generally disfavored and only granted if the allegations could have no possible bearing on the subject matter of the litigation and no essential or important relationship to the claim.⁷⁵ The court held that the “crux” of Defendants claim was that the purported license and franchise agreements were unlawful and unenforceable because United Studios entered into those agreements in violation of the Permanent Injunction.

Plaintiffs then requested the court strike allegations in the FACC that referred to a previous lawsuit, *United Finance LLC and Jody Neal v. William Silliker*, Case No. 1343414. The FACC alleged that Jody Neal and Mattera formed United Finance, LLC to acquire a United Studios license to operate a United Studios franchise in Carpinteria, California, then sold the license to William Silliker. United Finance sued Silliker on May 6, 2010, but the case was referred to arbitration. The arbitrator found the license agreement had all the elements of a franchise set within California Corporations Code e § 31005. *For that reason, the arbitrator* concluded that the transaction constituted an

⁷¹ *Id.* at *2. The First Amended Complaint filed by Plaintiffs alleges twelve claims: (1) breach of the Redondo Beach Franchise Agreement against Rinehart and SBSSD; (2) breach of the Beverly Hills Franchise Agreement against Rinehart and LASSD; (3) declaration of no formation of SB Ninja License Agreement against SB Ninja, Murakami, Rinehart and SBSSD; (4) intentional interference with contractual relations against SB Ninja and Murakami; (5) false designation under 15 U.S.C. § 1125(a) against all defendants; (6) trademark dilution under 15 U.S.C. 1125(c) against all defendants; (7) trademark infringement under 15 U.S.C. § 1114(1) against Rinehart, SBSSD, SB Ninja and Murakami; (8) common law trademark infringement against Rinehart, SBSSD, SB Ninja and Murakami; (9) unfair business practices in violation of Cal. Bus. & Prof. Code § 17200 et seq. against all defendants; (10) accounting against all defendants; (11) declaration that transfers to Murakami are null and void against Rinehart, Murakami, LASSD and SBSSD; and (12) declaration on right to terminate franchise agreements against Rinehart, LASSD and SBSSD.

⁷² *Id.* at *2. The First Amended Counterclaim alleges eight counterclaims: (1) declaratory relief as to right to rescind the Redondo Beach Franchise Agreement; (2) declaratory relief as to right to rescind the Beverly Hills Franchise Agreement; (3) declaratory relief as to the right to rescind the Torrance and Rolling Hills License Agreements; (4) declaratory relief as to the lack of formation of the Redondo Beach Franchise Agreement; (5) breach of the Beverly Hills Franchise Agreement; (6) conversion; (7) violation of [California Corporations Code § 31220](#); and (8) unfair business practices in violation of [Cal. Bus. & Prof. Code § 17200 et seq.](#)

⁷³ *Id.* Plaintiffs also filed motions to strike portions of the FACC; and motions to strike thirteen of the fourteen affirmative defenses in the Amended Answer.

⁷⁴ *Id.* at *3. Plaintiffs also moved to strike allegations referencing *United Finance, LLC and Jody Neal v. William Silliker* (“Silliker Allegations”).

⁷⁵ *Id.*

illegal sale of an unregistered franchise and found that Silliker was entitled to rescission. The court concluded that because the Silliker case and arbitration discussed whether a United Studios license agreement was a franchise that it was related to Defendant's claims, and thus, should not be struck.

United Studios alleged SB Ninja and RHSSD failed to state allege sufficient facts that the Rolling Hills Agreement was the sale of a franchise as defined within Cal. Corp. Code § 31005(a). The CFIL defines a "franchise" as "a contract or agreement, either expressed or implied, whether oral or written, between two or more persons by which:

- "(1) A franchisee is granted the right to engage in the business of offering, selling or distributing goods or services under a marketing plan or system prescribed in substantial part by a franchisor; and
- (2) The operation of the franchisee's business pursuant to such plan or system is substantially associated with the franchisor's trademark, service mark, trade name, logotype, advertising or other commercial symbol designating the franchisor or its affiliate; and
- (3) The franchisee is required to pay, directly or indirectly, a franchise fee."⁷⁶

RHSSD alleged that on March 19, 2018 USSD offered and issued RHSSD a license agreement for operation of a martial arts studio under the trademark UNITED STUDIOS OF SELF DEFENSE in Rolling Hills, California for thirty-six months, and that the license agreement required RHSSD to: (1) follow USSD pricing guidelines, (2) attend USSD training sessions and meetings, (3) participate in USSD marketing efforts and follow USSD operations manuals and guidelines, (4) provide each student with a copy of USSD's student manual (the "Rolling Hills Agreement").⁷⁷ The Rolling Hills Agreement required RSSD to pay United Studios a monthly fee of \$750 during the term of the contract. The court held that because the license agreement offered the right to operate the martial arts studio using United Studios training system and trademark in exchange for a fee that the Rolling Hills Agreement was a "franchise" as defined by Cal. Corp. Code § 31005.⁷⁸

What's in a name? We learn that a franchise, by any other name, is still a franchise as long as a contract exists that grants the right to operate a business in accordance with a system associated with a trademark in exchange for payment of a fee.

E. Large Franchisee Exemption – *Window World of Baton Rouge, LLC*, No. 15 CVS 1, 2018 NCBC LEXIS 218, 2018 WL 6722590, at *1 (N.C. Super. Dec. 19, 2018).

⁷⁶ *Id.* at *7 (citing Cal. Corp. Code § 31005).

⁷⁷ *Id.* at *7–*8. The Operations Manual described martial arts training courses and procedures offered and taught would include USSD's Shaolin Kempo System combined with USSD's "proven methods of professional instruction."

⁷⁸ *Id.* at *8.

Defendant Window World, Inc. and Window World International operate stores that sell windows, doors and siding. It also franchises stores that sell windows, doors and siding under the "Window World" trademarks. Plaintiffs asserted claims of fraud, unjust enrichment and unfair or deceptive trade practices because Window World failed to provide Plaintiffs a Franchise Disclosure Document ("FDD") Window World contended that it did not provide Plaintiffs a FDD because Plaintiffs were large franchisees due to their net worth and thus exempt from the obligation to provide an FDD (the "Large Franchisee Exemption").⁷⁹

During discovery, Window World served Plaintiffs with interrogatories requesting the "individual net worth" of each of the individual Plaintiffs for each year between 2001 and 2018, as well as the "total liabilities, as well as the book value and fair market value of the total assets" of (i) each corporate Plaintiff (the "Corporate Plaintiffs"), (ii) twelve specified non-party entities (the "Specified Non-Party Entities"), and (iii) "any Affiliate or Parent" of each Corporate Plaintiff and of each Specified Non-Party Entity (the "Unspecified Non-Party Entities" and, together with the Specified Non-Party Entities, the

⁷⁹ See [16 C.F.R. § 436.2](#); 16 C.F.R. § 436.8.

- (a) The provisions of part 436 shall not apply if the franchisor can establish any of the following:
- (1) The total of the required payments, or commitments to make a required payment, to the franchisor or an affiliate that are made any time from before to within six months after commencing operation of the franchisee's business is less than \$ 570.
 - (2) The franchise relationship is a fractional franchise.
 - (3) The franchise relationship is a leased department.
 - (4) The franchise relationship is covered by the Petroleum Marketing Practices Act, 15 U.S.C. 2801.
 - (5)
 - (i) The franchisee's initial investment, excluding any financing received from the franchisor or an affiliate and excluding the cost of unimproved land, totals at least \$ 1,143,100 and the prospective franchisee signs an acknowledgment verifying the grounds for the exemption. The acknowledgment shall state: "The franchise sale is for more than \$ 1,143,100--excluding the cost of unimproved land and any financing received from the franchisor or an affiliate--and thus is exempted from the Federal Trade Commission's Franchise Rule disclosure requirements, pursuant to 16 CFR 436.8(a)(5)(i)"; n11 or n11 The large franchise exemption applies only if at least one individual prospective franchisee in an investor-group qualifies for the exemption by investing at the threshold level stated in this section.
 - (ii) The franchisee (or its parent or any affiliates) is an entity that has been in business for at least five years and has a net worth of at least \$ 5,715,500.
 - (6) One or more purchasers of at least a 50% ownership interest in the franchise: within 60 days of the sale, has been, for at least two years, an officer, director, general partner, individual with management responsibility for the offer and sale of the franchisor's franchises or the administrator of the franchised network; or within 60 days of the sale, has been, for at least two years, an owner of at least a 25% interest in the franchisor.
 - (7) There is no written document that describes any material term or aspect of the relationship or arrangement.

"Non-Party Entities") for each year that any such entity has existed."⁸⁰ Plaintiffs failed to respond to the interrogatories and Defendants filed a motion to compel.

Plaintiffs argued the net worth of the Plaintiffs was irrelevant because Defendants could not retroactively invoke the Large Franchisee Exemption, that the Large Franchisee Exemption only pertained to business entities and Plaintiffs produced balance sheets for the business entities, which was sufficient to determine the entities' net worth.⁸¹ The court examined the Franchise Disclosure Rule, which requires that a prospective franchisee receive a Franchise Disclosure Document at least 14 calendar days before signing a binding agreement with, or making payment to, the franchisor.⁸² If, however, the prospective franchisee meets the Large Franchisee Exemption, disclosure does not have to be provided. The parties acknowledged that Window World did not assess Plaintiffs' individual net worth at the time it entered into the franchise agreements and, in fact, sent Plaintiffs a letter acknowledging it "failed to comply with Federal and State Laws by presenting to [Plaintiffs] a Franchise Disclosure Document" prior to entering into the franchise agreements.⁸³ However, the court held Plaintiffs' assertion of fraud, unjust enrichment and unfair or deceptive trade practices were predicated on the idea that Window World had a legal obligation to provide an FDD but failed to do so. The court held that a franchisor can show the Large Franchisee Exemption applied when the franchisor's duty to provide an FDD is challenged even if the franchisor did not invoke the Large Franchisee Exemption when the FDD was provided to the franchisee.⁸⁴

Plaintiffs then asserted that the Individual Plaintiff's net worth and prior experience could not be assessed for purposes of the Large Franchisee Exemption because Individual Plaintiffs conducted their business through business entities. The court again examined the Large Franchisee exemption and found that "entity" was not defined, but a footnote to the exemption states:

"Nothing prevents an "entity" under this provision from being an individual, but most individuals who have been in business for at least five years and have generated an individual net worth of at least \$5 million are likely to have created a corporation or other formal organization through which to conduct business."⁸⁵

For that reason, the court held that the FTC did not intend for the Large Franchisee Exemption to extend to individuals who conducted their business through business

⁸⁰ *Window World of Baton Rouge, LLC v. Window World, Inc.*, No. 15 CVS 1, 2018 WL 6722590, at *1 (N.C. Super. Dec. 19, 2018).

⁸¹ *Id.* at*6.

⁸² *Id.* at *5 (citing 16 C.F.R. § 436.2(a)).

⁸³ *Id.* at *5.

⁸⁴ *Id.* at *6.

⁸⁵ *Id.*

entities, and thus Individual Plaintiffs' net worth was not relevant to the claims in the case.⁸⁶

Plaintiffs then asserted that their balance sheets were sufficient to calculate the net worth of the Corporate Plaintiffs. The court found the FTC stated balance sheets were sufficient to determine net worth and application of the Large Franchisee Exemption.⁸⁷

Finally, Plaintiffs alleged that the net worth of the Specified Non-Party Entities was not discoverable. The court found, however, that the FTC's statement provided "the LFE "makes clear that a franchisor may aggregate commonly-owned franchisee assets in determining the availability of the large entity exemption[.]"⁸⁸ and the court concluded that any net worth of a parent or affiliate of the franchisee is "potentially relevant" to assess applicability of the Large Franchisee Exemption. However, the court found that neither Plaintiff nor Defendant adequately demonstrated the relationship between the Specified Non-Party Entity and the Corporate Plaintiffs but that, in the court's discretion, it would grant the motion to compel the net worth interrogatories as to the Specified Non-Party Entity, albeit narrowly,⁸⁹ and that Plaintiffs should respond to those interrogatories.⁹⁰

The Window World case provides that a determination of whether a prospective franchisee meets the Large Franchisee Exemption does not need to be made at the time of disclosure, but can be determined when, and if, a claim of improper disclosure is made. Further, that a prospective franchisee's net worth can be assessed from a balance sheet of the prospective franchisee and its parent or affiliate.

F. Constructive Termination Resulting from Unregistered FDD - *Bennion And Deville Fine Homes Inc. v. Windermere Real Estate Servs. Co.*, No. ED CV 15-01921-DFM, 2018 U.S. Dist. LEXIS 222458, 2018 WL 4825956, at *1 (C.D. Cal. April 11, 2018).

⁸⁶ *Id.*

⁸⁷ *Id.* (citing 72 FR 15444-01, at n. 846 ("Net worth of an entity can readily be determined from the entity's balance sheet or other financial information, typically submitted as part the application process.")).

⁸⁸ *Id.* at *7.

⁸⁹ *Id.* at *7. (The court held that it would narrow the net worth interrogatories to address their "overbreadth and prevent an improper fishing expedition.").

⁹⁰ *Id.* at *7. (quoting *Goodrich Corp. v. Emhart Indus.*, No. EDCV 04-00759-VAP (SSx), 2005 U.S. Dist. LEXIS 17190, at *9 (C.D. Cal. June 10, 2005) (The court determined that a party must respond with information it has, has within its control or can otherwise obtain. Thus, if the responding corporation can obtain information in the possession of an affiliated corporation it must do so unless the information is truly not available to it, meaning not in its possession nor can the responding corporation exercise control over the information.). Further, this principal has long been recognized by courts, holding "parent is served with an interrogatory, it is no defense to claim that the information is within the possession of a wholly owned subsidiary, because such a corporation is owned and controlled by the interrogee." See *Westinghouse Credit Corp. v. Mountain States Mining & Milling Co.*, 37 F.R.D. 348, 349 (D. Colo. 1965).

Plaintiff Windermere Services Southern California, Inc. (“WSSC”) and Defendant Windermere Real Estate Servs. Co. (“WRESC”) and entered into an Area Representative Agreement in 2004 (the “ARA”). Defendant gave written notice of termination of the ARA without cause in January 2015.

The ARA provided that it could be terminated by mutual agreement, upon 180 days written notice or on 90 days written notice "for cause based upon a material breach of the Agreement described in the notice and not cured within the" 90 day period" or upon a party filing for bankruptcy.⁹¹ The ARA provided that termination without cause entitled the other party to "an amount equal to the fair market value of the Terminated Party's interest in the Agreement" and that the fair market value would be determined by

“... the appraisers without consideration of speculative factors including, specifically, future revenue. The appraisers shall look at the gross revenues received under the Transaction during the twelve months preceding the **termination** date from then existing licensees that remain with or affiliate with the Terminating Party” (the “Termination Obligation”).⁹²

Plaintiff’s damages expert (“Wrobel”), calculated that Plaintiff suffered an estimated \$4,237,999 in damages (the “FMV”).⁹³

Defendants moved for summary judgment, alleging that Wrobel incorrectly estimated the FMV because future revenues should not be included in the Termination Obligation and only revenue from B&D Fine Homes and B&D So Cal should be considered to determine the Termination Obligation. Plaintiff alleged that Defendant had constructively terminated the ARA in 2014 due to Defendant’s failure to register the Franchise Disclosure Document (“FDD”). The court did not rule whether failure to register the FDD was a constructive termination of the franchise agreement, instead granting Defendant’s motion for summary judgment on April 11, 2018 solely on the issue of how the FMV should be calculated. The court reasoned that Wrobel did not follow the unambiguous language of the ARA and instead adjusted his calculations based upon a constructive termination of the ARA due to Plaintiff’s failure to properly register its Franchise Disclosure Document.⁹⁴

⁹¹ *Bennion And Deville Fine Homes Inc. v. Windermere Real Estate Servs. Co.*, No. ED CV 15-01921-DFM, 2018 U.S. Dist. LEXIS 222458, 2018 WL 4825956 (C.D. Cal. April 11, 2018).

⁹² *Id.* at 5 (quoting Section 4.2 of the ARA).

⁹³ *Id.* at 7.

⁹⁴ Wrobel did not calculate FMV based upon Defendant’s value at a specific date, but instead adjusted his calculation for the period 2015 through 2019 “due to the failure of [Defendant] to properly register” its Franchise Disclosure Document” although Section 4.2 of the ARA did not permit such adjustment. Wrobel also did not limit his calculation to gross revenues of franchisees that remained affiliated with the Defendant. *Id.* at 7.

Plaintiff's theory, however, is an interesting one, and perhaps if Plaintiff pled fraudulent inducement like the United Studios case discussed previously, the ARA might have been void, triggering a termination for cause. Constructive termination, however, would have required some unilateral modification to the terms of the ARA, causing significant interference with Plaintiff's rights under the ARA.⁹⁵ Would failure to register a FDD be deemed a unilateral modification to the ARA? Unlikely, but regardless, the calculation of the Termination Obligation would have been the same.

G. Disclosure of Transfer Restrictions - *Picktown Foods, LLC, et al. v. Tim Hortons USA, Inc.*, No. 17-21072-CIV, 2017 U.S. Dist. LEXIS 186107, 2017 WL 9854073, at *6 (S.D. Fla. Nov. 8, 2017).

Plaintiffs brought suit in connection with Tim Hortons' refusal to approve the sale of their restaurants because it did not adhere to the contractually stipulated price. Plaintiffs alleged that none of the FDDs stated that if Plaintiffs sold their franchise the purchase price of the franchise was limited to the value of the used equipment on the premises of the business.⁹⁶ Tim Hortons withheld consent, verbally stating it would only consent if the purchase price to be reduced from \$4.4 million to \$550,000.⁹⁷

Plaintiffs alleged Tim Hortons breached the contract by withholding its consent to transfer, failing to provide a valid basis for rejecting the transfer and placing unreasonable conditions on the transfer not authorized by the agreements or the law. Plaintiffs also alleged Tim Hortons breached the implied duty of good faith and fair dealing by refusing to consider the transfer and placing undue restrictions on the transfer not authorized by the agreements or the law. Additionally, Plaintiffs alleged violation of the Florida Deceptive and Unfair Trade Practices Act (the "FDUTPA")⁹⁸ and violation of the Ohio Business Opportunities Act (the "OBOA")⁹⁹ due to Tim Horton's failure to disclose material information relating to the franchise and misleading statements relating to the franchise.¹⁰⁰ Plaintiffs alleged Tim Hortons tortuously interfered with its sales agreements by willfully and maliciously "destroying" Plaintiffs'

⁹⁵ See *HRCC, Ltd. v. Hard Rock Cafe Int'l (USA), Inc.*, No. 6:14-cv-2004-Orl-40KRS, 2015 WL 3498610, at *1 (M.D. Fla. June 2, 2015).

⁹⁶ *Picktown Foods, LLC, et al. v. Tim Hortons USA, Inc.*, No. 17-21072-CIV, 2017 WL 9854073, at *4 (S.D. Fla. Nov. 8, 2017). Section 11.10 states

In the event that Franchisee . . . wishes to make a transfer . . . during the first five (5) years of the initial term of this Agreement, the seller shall do so only by offering to sell all of the assets of the Franchised Business to Franchisor at a price equal to the depreciated value of all personalty, as depreciated value is defined in Section 12.03 hereof, and for inventory at a price equal to its invoice price. . . . In the event that Franchisor does not exercise its purchase option, the seller must complete the proposed transfer to the third party at the purchase price set out in this Section and in accordance with the provisions of this Article XI.

⁹⁷ *Id.* at *2.

⁹⁸ *Id.* at *1 (citing Fla. Stat. § 501.203).

⁹⁹ *Id.* (citing Ohio Rev. Code § 4165).

¹⁰⁰ *Id.* at *3.

ability to fulfill their obligations under the sales agreements. Finally, Plaintiffs alleged Tim Hortons intentionally and negligently misrepresented material information required in the FDD by failing to disclose the transfer restrictions.¹⁰¹

Defendants countered that the franchise agreements contain acknowledgements that the prospective franchisee read and understood the franchise agreement and had an opportunity to consult with its advisors.¹⁰² Tim Hortons franchise agreement also provided that Tim Hortons could refuse to consent to a transfer arbitrarily, in its sole discretion.¹⁰³ Finally, the franchise agreement included an integration clause stating that the franchisee was not aware of any prior representations that are contrary to the terms of the franchise agreement.¹⁰⁴ The franchise agreement was an exhibit to Tim Horton's FDD, which included, in Item 17, a table summarizing the important provisions of the franchise agreement as required by the FTC¹⁰⁵ and in section m of that table, included the statement "There are further restrictions on sales made within the first five years of the initial term of the Franchise Agreement."¹⁰⁶

Defendant moved to dismiss all the disclosure claims, alleging those claims were barred by a two-year statute of limitations in the franchise agreement or in the alternative, because the FDD was compliant. Defendant also moved to dismiss the breach the contract claim because the franchise agreement provided Defendant could withhold consent in its sole discretion. Further, Defendant moved to dismiss the violation of FDUTPA claim, asserting there cannot be a violation of the FDUTPA if Defendant complied with its disclosure obligations and Plaintiffs read the disclosures

¹⁰¹ *Id.* at *4.

¹⁰² *Id.* at *3. (Article XIX of the agreements includes franchisee's acknowledgement that it has "read and understood this Franchise Agreement, the attachments hereto, and agreements relating thereto . . . and that Franchisee has had the right to consult with advisors of Franchisee's own choosing about the potential benefits and risks of entering into" the agreements.).

¹⁰³ *Id.* at *4. (Regarding restrictions on the transferability of a franchisee's rights, Section 11.02 of the agreements states "[f]ranchisor may arbitrarily withhold its consent to any transfer of this Agreement in whole or in part if it determines in its sole and absolute discretion that the sale or transfer price to be paid by any proposed transferee is inappropriate.").

¹⁰⁴ *Id.*

Section 18.02 states

This Agreement, the Attachments hereto, and the documents referred to herein, constitute the entire and complete agreement between the parties concerning the subject matter hereof, and supersede any and all prior agreements between the parties, no other representations having induced Franchisee to execute this Agreement. Franchisee acknowledges that it is neither aware of nor relying upon any oral or written representation or understanding which is contrary to the terms and conditions of this Agreement or the contents of any document furnished to Franchisee.

¹⁰⁵ *Id.* at *4. (The FDD Compliance Guide, in addressing Item 17 of the amended Rule, states franchisors are required to 'summarize, in the specified tabular format, common provisions of franchisee agreements, including those provisions dealing with termination, renewal, and dispute resolution.').

¹⁰⁶ *Id.* at *4.

and franchise agreements, and also for that reason there could not be a claim of intentional or negligent misrepresentation. Finally, Defendant moved to dismiss the tortious interference claim because there could be no tortious interference if Defendant was the source of the very business opportunity that Plaintiffs allege has been tortiously interfered with.

The court dismissed all of the disclosure claims based on the two-year statute of limitations in the franchise agreement because Plaintiffs received a FDD before August 6, 2004, in the case of Picktown, and August 14, 2004, in the case of QSR. Further, the court explained the standard for shortening the statute of limitations under Ohio law is that the shortened period must be reasonable and clear.¹⁰⁷ In this case, Plaintiffs acknowledged that they understood the terms and conditions of the franchise agreements and had an opportunity to consult with advisors to understand the risks associated with the franchise. Additionally, the court denied Plaintiffs assertion that the two-year statute of limitations should be tolled for the same reason – that Plaintiffs acknowledged they understood the terms and conditions of the franchise agreements and had an opportunity to consult with their advisors. Statutes of limitations should only be tolled if the wrongful act does not immediately result in injury or damage so application of the statute of limitations would lead to an unjust result¹⁰⁸, but not if the Plaintiff “knows, or by exercise of reasonable diligence should know, that he or she has been injured by the conduct of the defendant.”¹⁰⁹

In the present case, the court reasoned that Plaintiffs should have known of the transfer restrictions because of the acknowledgement previously discussed, and that there was no information provided to Plaintiffs in 2016 that was not originally provided in the FDD. Further, Plaintiffs acknowledged the “injury” they allege to have suffered did not take place until 2016 when they requested the transfer of ownership. The court found it disingenuous that Plaintiffs claim to have been misled when their franchise agreement clearly contained the transfer restrictions and Plaintiffs acknowledged that they read and understood the franchise agreement. In fact, the court held “A person of ordinary mind cannot be heard to say that he was misled into signing a paper which was different from what he intended, when he could have known the truth by merely looking when he signed.”¹¹⁰ For those reasons, the court dismissed FDUTPA, OBOPA, ODTPA and intentional and negligent misrepresentation claims.

Plaintiffs also claimed the FDD they received was not compliant with the FTC Rule, but the court did not agree. The FTC Rule requires, in Item 17, for the franchisor to summarize the franchise agreement in tabular format, including provisions dealing with transfer.¹¹¹ The FTC Compliance Guide then requires the franchisor to put in boldface type the following statement at the beginning of Item 17: “[t]his table lists

¹⁰⁷ *Id.* at *7 (citing *Angel v. Reed*, N.E.2d 1179, 1181 (Ohio 2008)).

¹⁰⁸ *Id.* (citing *Jones v. Hughey*, 794 N.E.2d 79, 83 (Ohio Ct. App. 2003)).

¹⁰⁹ *Id.* (citing *Schmitz v. Nat’s Coll. Athletic Ass’n*, 67 N.E.3d 852, 859 (2016) (quoting *Flagstar Bank, F.S.B. v. Airline Union’s Mortg. Co.*, 947 N.E.2d 672, 675-76 (Ohio 2011))).

¹¹⁰ *Id.* at *8 (citing *Ball v. Ohio State Home Servs.*, 861 N.E.2d 553, 557 (Ohio Ct. App. 2006)).

¹¹¹ *Id.* at *9; see also 16 C.F.R. § 436.1.

certain important provisions of the franchise and related agreements. You should read these provisions in the agreements attached.” The court reviewed Tim Horton’s FDD and found it complied with the FTC requirements because: (1) the required tabular summary was included; (2) tabular summary included the statement “[t]here are further restrictions on sales made within the first five years” and (3) the introductory statement previously described was included. The lack of an explicit statement regarding the conditions of transfer was, in the court’s view, not needed, and the court held Plaintiffs’ disclosure claims failed as a matter of law.¹¹² Because Plaintiffs’ disclosure claims failed, the court held that their FDUTPA claims also should be dismissed, as the FDD was compliant.¹¹³

The *Picktown Foods* case makes it clear that if a franchise agreement includes restrictions on transfer, the franchisor must disclose those of transfer restrictions in Item 17 of its Franchise disclosure Document. Provided the franchisor does so, even in the absence of detailed disclosure of the transfer restrictions, a prospective franchisee will not successfully make a claim for a disclosure violation.

H. Private Right of Action for Disclosure Violation- *JTH Tax, Inc. v. Charles Hines*, No. 2:15-CV-558, 2017 U.S. Dist. LEXIS 218756 (E.D. Va. Jan. 18, 2017).

Plaintiff JTH Tax, Inc. d/b/a Liberty Tax Service (“Liberty”), headquartered in Virginia, sells franchises specializing in the preparation of tax returns. In 2012, Defendant Charles Hines (“Hines”), a Maryland resident, signed franchise agreements to operate three Liberty Tax franchises in Maryland and operated two of those businesses from 2012 through 2015 as well as three kiosks located inside of Walmarts for four months in 2014. The franchise agreements included a “Maryland Addendum” that included an arbitration clause.¹¹⁴

Plaintiff Liberty terminated Hines on June 3, 2015 for various breaches of the franchise agreements, including advertising out of Hines’ territory, and failure to pay when due amounts owed to Liberty. Liberty then sued Hines on December 23, 2015, requesting injunctive relief for breach of the franchise agreements and promissory notes, trademark infringement, and past due accounts receivable. Hines counterclaimed that Liberty breached the franchise agreements, committed fraud, violated the FTC Rule and operated a failed system. Liberty countered with a motion to dismiss or in the alternative, to stay the counterclaim pending arbitration.¹¹⁵ The court then denied

¹¹² *Id.* at *5.

¹¹³ *Id.* at *12.

¹¹⁴ *Id.* at 2.

¹¹⁵ The procedural history of the case is intricate. Hines responded to Plaintiff’s initial complaint with a motion to dismiss, motion for change of venue, an answer (which was defective and re-filed on December 12, 2016) and a counterclaim. Liberty filed a motion for default judgement, motion to dismiss and motion to strike. The court denied the motion for default judgement and motion to strike, but granted Liberty’s motion to dismiss without prejudice. Hines then filed an amended counterclaim. Liberty filed a motion to dismiss the amended counterclaim. Hines

Liberty's motion for leave to file a reply brief because Liberty missed the filing deadline and denied Hines' motion to stay or pause the case for 14 days to provide Hines with additional time to oppose Liberty's motion to dismiss.¹¹⁶

The court first held that Virginia law applied to Hines' breach of contract claims and related non-contract claims, although Hines claimed Maryland law was applicable. The court justified application of Virginia law by examining the franchise agreement, which included a choice of law provision clearly choosing Virginia law to apply.¹¹⁷ Hines insistence that Maryland law should apply required that he "establish by clear and convincing evidence that the clause itself, as opposed to the contract as a whole, was the product of impropriety," such as overreaching or fraud.¹¹⁸ While Hines argued that the franchise agreements should be void due to a lack of consideration or invalidated for unconscionability, those arguments did not establish that the choice of law provision did not demonstrate any fraud or overreaching, and for that reason, Virginia law should apply. Further, courts are able to apply a choice of law provision to non-contract claims if the choice of law provision is broad enough to encompass contract-related tort claims. Because the choice of law provision in the franchise agreement stated Virginia law governed "all claims which in any way relate to or arise out of this [Franchise] Agreement", the court held that the choice of law clause was broad enough to enable it to apply Virginia law to Hines non-contract claims.¹¹⁹

As to Hines' claims regarding violations of state statutes, the Franchise Agreement stated the "Virginia Retail Franchising Act does not apply to any claims by or on your behalf if the Territory shown on Schedule A below is outside Virginia" and the Virginia Retail Franchising Act states it does not apply to franchise businesses located outside of Virginia.¹²⁰ Additionally, Hines was a Maryland resident and the franchise was located in Maryland. The Maryland Franchise and Registration Law applies to the sale of a franchise in excess of \$100 and if the franchisee or the franchised business is located in Maryland.¹²¹ On that basis, the court determined Maryland law applied to Hines' allegations that Liberty violated state statutes.¹²²

then filed a second amended counterclaim, which is the counterclaim discussed in this paper. *Id.* at 3-4.

¹¹⁶ *Id.* at 4.

¹¹⁷ Paragraph 15(a) of the franchise agreements states:

This Agreement is effective upon its acceptance in Virginia by our authorized officer. Virginia law governs all claims which in any way relate to or arise out of this Agreement or any of the dealings of the parties hereto. However, the Virginia Retail Franchising Act does not apply to any claims by or on your behalf if the Territory shown on Schedule A below is outside Virginia.

¹¹⁸ *Id.* at 6 (citing [Zaklit v. Global Linguist Sol., LLC, No. 1:14cv314, 2014 WL 3109804, at *7 \(E.D. Va. July 8, 2014\)](#)).

¹¹⁹ *Id.*

¹²⁰ See Va. Code Ann. § 13.1-559 (2009) (The Virginia Retail Franchising Act states it applies "only to a franchise the performance of which contemplates or requires the franchisee to establish or maintain a place of business within the Commonwealth of Virginia.").

¹²¹ Md. Code Ann., Bus. Reg. § 14-203(a)(1992).

¹²² *Id.* at 9.

The court then evaluated Hines' breach of contract claims using Virginia law.¹²³ Hines claimed that Liberty violated the FTC Rule because (1) Liberty failed to cite the FTC Rule in the franchise agreements, notify Hines of his rights and advise Hines that prior Liberty franchisees of his territory had failed; (2) Liberty failed to identify prior owners of the territory Hines franchised and provide contact information for those prior owners; and (3) Liberty resold failed territories and "willingly, purposefully and by calculation" violated the FTC Rule. The Court held that the FTC Rule does not give the prospective franchisee or a franchisee a private right of action to enforce the FTC Rule; only the FTC is empowered to enjoin a franchisor failing to provide the disclosures required by the FTC Rule. The court goes cited several rulings setting forth that a prospective franchisee or a franchisee do not have a private right of action.¹²⁴ For that reason, the court held that Hines' claims that Liberty violated the FTC Rule were dismissed with prejudice.¹²⁵

The *Liberty* case affirms that individuals and business entities do not have a private right of action for violations of the FTC Rule, but that such actions must be brought by the FTC itself, which is charged with enforcing the FTC Rule.

I. Statute of Limitations on Disclosure Claims - *Safe Step Walk In Tub Co. v. CKH Indus., No. 15 Civ 7543 (NSR), 2018 U.S. Dist. LEXIS 161082, 2018 WL 4539656, at *1 (S.D.N.Y. Sept. 20, 2018).*

Plaintiff Safe Step Walk In Tub Company ("Safe Step"), manufactures walk-in bathtubs under the Safe Step trademarks. On May 10, 2009, Defendant CKH Industries, Inc. ("CKH") entered into a "Dealership/License Agreement" with CKH for the right to market the Safe Step tubs in specific counties located in New York and New Jersey (the "Territory").¹²⁶ The Dealership/License Agreement stated CKH was the exclusive licensee in the Territory, and that Safe Step would send leads for the Territory

¹²³ *Id.* at 12 (citing *Sunrise Continuing Care, LLC v. Wright*, 671 S.E.2d 132, 135 (Va. 2009)).

¹²⁴ *Id.* at 14-15. See also [1995 WL 798938, at *7 \(N.D. Cal. Nov. 2, 1995\)](#); John Boudreau, *et al.*, 62B Am. Jur. 2d Private Franchise Contracts § 26 (2d ed. 2014). However, neither the FTC nor the Franchise Rule provide for franchisees to bring suit to enforce the regulations. See *Yumilicious Franchise, L.L.C v. Barrie*, No. 3:13cv4841, 2015 WL 2359504, at *3 (N.D. Tex. May 18, 2015), *aff'd*, [819 F.3d 170 \(5th Cir. 2016\)](#) (holding "no private right of action is available to franchisees under these regulations"); *Bans Pasta, LLC v. Mirko Franchising, LLC*, No. 7:13cv360, 2014 WL 637762, at *12 (W.D. Va. Feb. 12, 2014) ("[N]either the FTC Act nor [\[16 CFR § 436.5\]](#) gives rise to a private cause of action, and numerous courts have so held."); [A Love of Food I, 70 F. Supp. 3d at 382](#) ("no private right of action is available to franchisees under" the Franchise Rule) (collecting cases); *Robinson v. Wingate Inns Int'l, Inc.*, No. 13cv2468, 2013 WL 6860723, at *2 (D.N.J. Dec. 20, 2013) ("It is well settled that there is no private cause of action for violation of the FTC franchise disclosure rules.")(citations omitted); *Vino 100, LLC v. Smoke on the Water, LLC*, 864 F. Supp. 2d 269, 281 (E.D. Pa. 2012) (same).

¹²⁵ *Id.* at 15.

¹²⁶ *Safe Step Walk In Tub Co. v. CKH Indus., Inc.*, No. 15 CIV. 7543 (NSR), 2018 WL 4539656, at *1 (S.D.N.Y. Sept. 20, 2018).

to CKH. As consideration for the Dealership/License Agreement, CKH paid a license fee of \$10,000, and was required to achieve either minimum sales or maintain a specific advertising budget. The advertising budget was set forth in a marketing addendum that included a monthly fee schedule for Plaintiff Safe Step's national and regional marketing activities as well as a monthly fee for the "unique leads" Defendant CKH received as a result of the marketing activities.¹²⁷ The Dealership/License Agreement specifically stated: "Licensee [CKH] [was] an independent contractor and [had] not been granted a franchise."¹²⁸ Defendant CKH subsequently entered into other agreements with Safe Step for other territories, and these agreements are substantially similar, each containing a license of the Safe Step trademarks for a specific territory, a requirement to achieve minimum sales or maintain a specific advertising budget and payment of a license fee of \$10,000.¹²⁹ The New York and New Jersey Dealership/License Agreements expired between May 10, 2014 and February 10, 2015 unless Defendant requested renewal in writing 90 days prior to the end of the term, and Defendant CKH admitted that it did not provide written notice as required.¹³⁰ Plaintiff Safe Step refused to renew the Distributor/License Agreements for New York and New Jersey.

On September 23, 2015, Plaintiff Safe Step filed suit against Defendant CKH for non-payment of fees allegedly owed by Defendant CKH.¹³¹ Defendant CKH answered and counterclaimed against Plaintiff Safe Step, alleging that Plaintiff Safe Step violated the franchise laws of various states, breached the Dealership/License Agreements and engaged in unfair business practices.¹³² Plaintiff Safe Step moved to dismiss Defendant CKH's counterclaims and requested summary judgment on the breach of contract claims.

The court determined, with "little difficulty", that pursuant to the FTC Rule, the relationship between Plaintiff Safe Step and Defendant CKH was that of franchisor and franchisee, however, the court arrived at a similar result as the court in the Liberty Tax case previously discussed – the FTC Rule does not provide a plaintiff with a private right of action. The court then considered the "Little FTC Acts" of Connecticut, New Jersey, New York and Rhode Island, all of which Defendant CKH argued should apply,

¹²⁷ *Id.* at *3.

¹²⁸ *Id.* at 82.

¹²⁹ *Id.* at *2-*3. Plaintiff Safe Step and Defendant CKH entered into the following Dealership/License Agreements: (1) an agreement effective June 10, 2009 for Massachusetts, New Hampshire and Vermont; (2) an agreement effective July 15, 2009 for Albany; (3) an agreement effective July 15, 2009 for Hartford; (4) an alleged oral agreement effective February 10, 2010 for Boston, and the counties of Hampshire and Bristol in Massachusetts.

¹³⁰ See *Safe Step Walk-In Tub Co. v. CKH Indus., Inc.*, No. L 5-CV-07543 NSR, 2015 WL 6504284, at *1 (S.D.N.Y. Oct. 26, 2015).

¹³¹ *Id.*

¹³² *Safe Step Walk In Tub Co.*, 2018 WL 4539656, at *3. Specifically, Defendant CKH counterclaimed for breach of contract; violations of the New York, New Jersey, Connecticut, and Rhode Island state franchise laws; common law fraud; promissory estoppel; unjust enrichment; and injunctive relief.

because Defendant CKH had Safe Step franchises in those states.¹³³ Each Dealership/License Agreement contained a choice of law provision stating that Tennessee law governed. The court found that prior cases clearly established Tennessee would “honor the protections available under the franchise acts of states where Defendant allegedly has franchises.”¹³⁴

The court dismissed the New York Little FTC Act claim – New York’s Little FTC Act has a three-year statute of limitations on for any violation “unless brought before the expiration of three years after the act or transaction constituting the violation.”¹³⁵ In the present case, Defendant CKH entered into a Dealership/License Agreement for New York effective July 15, 2009 but filed its counterclaim alleging disclosure violations in October 2015, more than three years later. For that reason, the court dismissed Defendant CKH’s disclosure violation claim under New York’s Little FTC Act.

Defendant CKH’s claims of failure to renew and constructive termination, however, were not barred by the statute of limitations because the facts and circumstances giving rise to those claims did not surface until 2014 and 2015, when Plaintiff Safe Step refused to renew the Distributor/License Agreements. New York’s Little FTC Act as well as Rhode Island’s Little FTC Act both prohibit failure to renew due to fraud or other unlawful or deceptive practice.¹³⁶ It is unclear in the case whether Safe Step actually *refused* to renew the agreements, but Defendant CKH claimed “[Safe Step] appeared to accept CKH’s request for a renewal of the agreements without actually intending to honor that request”, and the court concluded that allegation was sufficient to allege violation of the Little FTC Acts.¹³⁷ For that reason, the court denied Plaintiff Safe Step’s motion to dismiss Defendant CKH’s counterclaims for failure to renew the Distributor/License Agreements, but granted the motion to dismiss Defendant CKH’s counterclaims for disclosure violations, which are outside of the statute of limitations.

We learn from Safe Step that statutes of limitations in Little FTC Acts may bar disclosure violations, but will not necessarily bar violations of other provisions of the Little FTC Acts, depending upon when the facts giving rise to the claim occurred.

¹³³ *Id.* at *5; see [Conn. Gen. Stat. Ann. § 42-133h](#); N.J. Stat. Ann. § 56:10-4(a)(1); N.Y. Gen. Bus. Law § 681(12); R.I. Gen. Laws Ann. § 19-28.1-4(d).

¹³⁴ *Safe Step Walk in Tub Co. v. CKH Indus., Inc.*, 242 F. Supp. 3d 245, 260 (S.D.N.Y. 2017) (citing *Kinnard v. Shoney’s, Inc.*, 100 F. Supp. 2d 781, 789 (M.D. Tenn. 2000), *aff’d*, [39 Fed. Appx. 313 \(6th Cir. 2002\)](#) in which the court ruled “whereas Tennessee law generally applie[d] to the issues in th[e] case, the plaintiffs’ claims under the Indiana franchise statutes [were] governed by Indiana law.”).

¹³⁵ *Id.* at 261 (citing *Kroshnyi v. U.S. Pack Courier Servs., Inc.*, 771 F.3d 93, 102-03 (2d Cir. 2014) (quoting N.Y. Gen. Bus. Law § 691(4)).

¹³⁶ *Id.* at 262 (citing N.Y. Gen. Bus. Law § 687 (fraudulent and unlawful practices); R.I. Gen. Laws § 19-28.1-17 (fraudulent, deceptive and prohibited practices)).

¹³⁷ *Id.* at 270.

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2019 Judicial Update

Transfer Cases

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This section of the paper recaps case law relating to transfer of a franchise agreement and the variety of legal issues that can arise from this process. Notably, calendar year 2018 produced sparse case law relating to transfers.

I. *Samaca, LLC v. Cellairis Franchise, Inc.*, 345 Ga. App. 368, 813 S.E.2d 416 (Feb. 28, 2018).

In this case, Samaca, LLC (“Samaca”), purchased four franchise units from an existing franchisee, Cell Phone Mania, LLC (“CPM”). CPM sublicensed the locations of the franchises from Global Cellular, Inc. (“Global”) an affiliate of the franchisor Cellairis Franchise, Inc. (“Cellairis”). In connection with this transfer, Samaca and Cellairis, entered into four new franchise agreements for the units, each of which contained an arbitration clause whereby the parties agreed to arbitrate disputes relating to the franchise agreement or any other agreement between the parties. Samaca and Global entered into four new sublicense agreements, all of which contained a similar arbitration provision. Samaca, CPM and Cellairis also entered into an assignment and assumption agreement related to the purchase of the franchises and sub-licensing of the mall space. The assignment and assumption agreement stated that Samaca was required to sign franchise agreements and sublicense agreements, which were attached to the assignment and assumption agreement; however, the attached agreements were never signed. The assignment and assumption agreement included a forum selection provision that stated that the parties consented to a certain court venue for any litigation arising from the assignment and assumption agreement.

In October 2014, Samaca began operating the franchises; however, later that year Samaca was told by the mall that it would not renew the license agreements for the mall spaces where the franchisees operated. In March 2015, Samaca sued Cellairis in state court in Florida seeking to rescind the franchise and sublicense agreements. Samaca subsequently voluntarily dismissed its suit and filed the same claim in Georgia state court. Cellairis filed a motion to dismiss and to compel arbitration. Samaca amended its complaint to argue that the arbitration clauses in the franchise and sublicense agreements were superseded by the court forum selection provision in the assignment and assumption agreement. The trial court rejected Samaca’s argument and granted Cellairis’ motion. Samaca appealed.

The appellate court noted that in order for an agreement to be superseded or discharged, the parties must enter into a subsequent agreement that covers exactly the same subject matter and is inconsistent with the first agreement. The appellate court determined that the assignment and assumption agreement was not successive or inconsistent agreement, “but rather part of a series of documents to effect the purchase and transfer of the CPM franchises.” The court reasoned that the assignment and assumption agreement did not subsume the subject matter embodied in the franchise and sublicense agreements. Instead, the assignment and assumption agreement incorporated the franchise agreements and sublicense agreements by reference. The court further noted that the terms of the assignment and assumption agreement were not inconsistent with the franchise and sublicense agreement because the forum selection provision could be interpreted to solely identify what law to apply to disputes

arising from the agreements. Finally, citing the presence of a delegation provision in the arbitration agreements, the court determined that the arbitrability of the agreements should be decided by an arbitrator. Thus, the appellate court held that the assignment and assumption agreement did not supersede the franchise agreements and the trial court did not err by compelling arbitration.

II. *Byram v. Danner*, 2018 Ill. App. (4th) 170058-U*, 2018 Ill. App. Unpub. LEXIS 621 (Apr. 13, 2018).

The *Byram* case arose from the failed transfer of a Remax franchise and provides a good reminder that any franchisee entering an agreement to sell their franchised business should make sure the purchase and sales agreement addresses any requirement that the franchisor consent to the transfer. Sue and Fred Danner owned and operated Danner 2000, Inc., which operated a Remax franchise. Sue Danner and Danner 2000, Inc. (collectively, “Danner”) entered into an agreement to sell the rights under the franchise agreement with Remax, LLC to Nathan Byram (“Byram”). Under the agreement, Byram was supposed to make installment payments, but he defaulted on the second payment. The parties then entered into a rescission and release agreement that rescinded the original contract. Byram then filed a lawsuit alleging various causes of action, including fraud. The trial court granted the Danner’s motion to dismiss and Byram appealed.

With regard to the fraud claims, Byram alleged that the “Seller’s Warranties” section in the original contract contained a false representation that Danner had the power to sell its rights under the franchise agreement, even though Danner did not have prior written approval for the sale from Remax, LLC as was required under the terms of the franchise agreement. The appellate court noted that the Seller’s Warranties provision stated that the Danner had good title to the assets, “except as herein provided otherwise.” The section of the contract listing the assets stated that Danner would sell its rights under the franchise agreement, but only if the franchisor accepted Byram as a franchisee. The appellate court found that this language clearly indicated that Danner “did not represent that they had unfettered authority to sell the Remax franchise” and, therefore, the appellate court upheld the trial court’s dismissal of the fraud claims.

III. *Saenz v. Gomez*, 899 F.3d 384 (5th Cir. Aug. 7, 2018).

The *Saenz* case is interesting insofar as it shows the importance of common sense due diligence when purchasing a franchise and the lengths that some franchisees will go to in order to complete an unauthorized transfer. In this case, Humberto Saenz, Jr. (“Saenz”) entered into a franchise development agreement with Pizza Patrón and developed four Pizza Patron locations. Jose Maria Gomez (“Gomez”) was introduced to Saenz, who represented himself as a corporate representative of Pizza Patron and offered to sell Gomez one of Saenz’s Pizza Patron locations. In connection with the purchase of the location, Gomez applied for an SBA loan, which required Saenz to provide certain documentation to the bank. Saenz allegedly provided inaccurate income statements as well as a Certification of No Change that had an altered date. The parties closed the sale and Gomez took over the Pizza Patron

location in March 2010. Neither party requested the franchisor's approval for the transfer, even though such approval was required by Saenz's franchise agreement. In order to cover up the unauthorized transfer, Saenz notified Pizza Patron that he had changed his bank account and submitted an authorization form with Gomez's account number so that the franchisor would continue to receive royalties. Gomez further claimed that Saenz discouraged him from attending any corporate training sessions and informed him that franchise owners were prohibited from attending store inspections so that Saenz could attend instead. Gomez operated the Pizza Patron location for approximately one year, but then he developed a health condition that prevented him from being in the kitchen. Due to this health condition and declining sales, Gomez decided to return the keys to the business to Saenz. Saenz operated the business until October 2012.

Gomez subsequently filed suit against Saenz, alleging fraud based upon Saenz providing the inaccurate income statements and representing himself to Gomez as an employee of Pizza Patron corporate. Saenz filed Chapter 7 bankruptcy and Gomez commenced an adversary proceeding seeking an exception to discharge.¹³⁸ The bankruptcy court found in favor of Gomez on the claim for fraudulent misrepresentation and determined that the judgment was excepted from discharge. The district court affirmed the decision and Saenz appealed. On appeal, Saenz claimed that Gomez had submitted insufficient evidence to support his fraud claim. The appellate court found that a review of the record supported the bankruptcy court's determination that Gomez's version of events was "much more plausible" and "fully supported by the documentary evidence." As such, Gomez had sufficiently established that Saenz had provided the false income statements and misrepresented himself as an employee of Pizza Patron corporate. With regard to the element of justifiable reliance, the appellate court agreed with the bankruptcy court's conclusion that Saenz "went to great lengths...to prevent Gomez from questioning his authority to effectuate the franchise transfer" and, therefore, the weight of the evidence supported justifiable reliance. Finally, the appellate court found no error in the bankruptcy court's determination that, but for Saenz's misrepresentations, Gomez would not have sought a loan or completed the purchase of the restaurant. Thus, Gomez' injuries were directly attributable and proximately caused by Saenz's misrepresentations.

IV. *Picktown Foods, LLC v. Tim Hortons USA, Inc.*, 2018 U.S. LEXIS 99203 (June 12, 2018).

The *Picktown* case involved transfer requests from five Tim Hortons franchises Picktown Foods, LLC; QSR Enterprises, LLC; Hepta Foods, LLC; Triad Foods, LLC and Xexa Foods, Inc. (collectively, the "Franchisees"). John Uvira ("Uvira") was the sole owner of franchisees Picktown, QSR and Hepta and Louise Stonehouse ("Stonehouse"), Uvira's mother, was the sole owner of Hexa and Triad. In September 2016, Stonehouse and Uvira, on behalf of the Franchisees, sent the franchisor, Tim Hortons USA, Inc. ("Tim Hortons"), a letter enclosing five Asset Purchase Agreements

¹³⁸ This paper does not address the appellate court's review on the issue of non-dischargeability.

(the “APAs”), one for each store, and requesting Tim Hortons’ consent to transfer the franchise agreements. The APAs stated that the sales price for each of the Franchisees’ Stores was \$880,000 (calculated based on the total purchase price of \$4.4 million divided evenly among the five stores). The Franchisees claimed that on October 4, 2016, Stonehouse spoke with the Senior Manager in Tim Hortons’ finance department and was told that Tim Hortons valued all five stores at \$550,000 (or \$110,000 per store) “based upon the depreciated value of the equipment, or pots and pans.” Franchisees further claimed that, on this call, Tim Hortons agreed to provide more information about the valuation but then never called back. The Franchisees stated that they assumed that Tim Hortons was not going to approve the transfers but did not know the reason for this denial. In contrast, Tim Hortons claimed that, by October 4, 2016, the Franchisees were aware that it would not approve the transfers proposed sales price of \$880,000 for the Hexa and Picktown stores exceeded the valuation formulas set forth in the respective franchise agreements.

The Franchisees subsequently filed a lawsuit against Tim Hortons in September 2017. The court dismissed all of Franchisees’ claims except those for breach of contract and tortious interference with contract. Tim Hortons then filed a motion for summary judgment as to these remaining claims.

With regard to the breach of contract claim, Tim Hortons argued that it was entitled to deny the transfer because the sales price for the Hexa and Picktown stores exceeded the valuation formula set forth in the franchise agreements. Additionally, Tim Hortons pointed out that Stonehouse and Uvira admitted in depositions that the sales price for these two stores exceeded the relevant valuation formula. Pointing to the plain language of the Hexa and Picktown franchise agreements, the court determined that Tim Hortons failed to include the valuation of the inventory for these stores in its sale price calculations. The court also noted that the prior deposition testimony from Stonehouse and Uvira was based on the erroneous assumption that Tim Hortons calculation was done correctly and, therefore, the plaintiffs were permitted to submit subsequent declarations stating that the calculations were actually incorrect. The court found that a genuine issue of material fact existed as to whether Tim Hortons properly applied the calculation in the Hexa and Picktown franchise agreements.

Tim Hortons also argued that another provision of the franchise agreements gave it the sole discretion to deny any transfer; however, the court found that Tim Hortons interpretation of this provision put the provision in conflict with another provision that allowed the franchisee to ask a court to compel Tim Hortons to consent to a transfer. Due to the ambiguity caused by these provisions, the court then analyzed the parties’ intent to determine the meaning of the contract terms. The court noted that Tim Hortons did not offer direct evidence of intent. The court denied summary judgment on the breach of contract claim due to the presence of ambiguity in the franchise agreement and the genuine issue of material fact as to whether Tim Hortons correctly calculated the sale prices.

The court then examined Tim Hortons motion for summary judgment as to the tortious interference with contract claim. Citing *Pasquetti v. Kia Motors Am. Inc.*, 663 F. Supp. 2d. 586 (N.D.Ohio 2009), Tim Hortons argued that that it could not be considered an outsider to the franchise agreement because its consent was required in order for the APAs to be signed. The court agreed and granted Tim Hortons summary judgment on the tortious interference claim, finding that there was no requisite third party interference.

Following trial, the Court ruled in Tim Hortons favor on all of the franchisees' claims, and reached legal conclusions adopting some of the arguments rejected on summary judgment. The Court held that since the franchise agreement provided Tim Hortons "with the sole and absolute discretion" to approve any transfer, it was free to have rejected the deal. Additionally, the Court enforced the language in the franchise agreements limiting the franchisees' ability to sell the restaurants except for the stipulated sales price formula, which was the depreciated value of the equipment. The Court held that the franchisees' claims failed in light of the fact that the proposed price exceeded the limits of the contractual formula.