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**FRANCHISEE LITIGATION PERSPECTIVE:
A PRACTICAL GUIDE TO FRANCHISE LITIGATION**

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FRANCHISEE LITIGATION PERSPECTIVE

By: Carmen D. Caruso

I. WELCOME TO THE FUTURE

This program started as an opportunity for a couple veteran franchisee trial lawyers to share tricks of the trade with a high-power franchisor lawyer standing at the ready to challenge us. We'll do that, but let's also preview issues and arguments on the horizon.

II. INHERENT CONFLICTS OF INTEREST

Franchisees like to think they have unity of purpose with the franchisor to grow the brand and make money. Too few franchisees understand that franchising creates a classic adversarial relationship leaving franchisees vulnerable. Problems arise when franchisors see increased profits for themselves at the franchisees' expense. The lure of short-term profit should never be underestimated since "in the long run we are all dead" as the late economist John Maynard Keynes once explained.¹

Problems begin in the sales process when franchisors (too often aided by lawyers):

- Narrowly construe disclosure obligations, causing materially misleading FDDs that inflate or distort financial performance representations, hide franchise failures, understate costs, *etc.*
- Abuse franchise agreement "no-reliance" clauses seeking immunity from the consequences of deception in the franchise sales process.

Franchise agreements invite future train wrecks when the franchisor strives to circumvent the implied covenant of good faith and fair dealing. Law Professor Gillian Hadfield nailed this problem in a 1990 Law Review article explaining how franchisees are near-completely dependent on the franchisor's wisdom and honesty.² Franchisors emboldened by one-sided franchise agreements may succumb to the temptation to:

¹ http://www.thecommentator.com/article/3689/john_maynard_keynes_in_the_long_run

² See Gillian K. Hadfield, *Problematic Relations: Franchising and the Law of Incomplete Contracts* 42 STAN. L. REV. 927-992 (1990).

- Modify system standards to impose sweeping concept change without demonstrating ROI or imposing costs or obligations never agreed to.³
- Inspect and grade franchised locations dishonestly.
- Pursue shareholder value over franchisee equity, profiting from mandated product purchases, opening encroaching new units, *etc.*
- Engage in deception during the franchise term, *e.g.* dangling the opportunity to renew or expand then saying “no” for pretextual reasons.
- Exercise excessive control over franchised units risking joint employer liability.
- Usurp local goodwill by claiming ownership of franchisee customer lists – a practice facilitated by data mining.
- Engage in conduct that would have *per se* violated the Sherman Act before *Continental T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977).
- Impose overbearing dispute resolution clauses.
- Impose liquidated damages clauses seeking to profit from franchise failure.⁴
- Use arbitration to keep bad practices secret.⁵
- Impose non-disclosure and non-disparagement clauses on departing franchisees (and employees) to keep their bad practices secret.
- Manipulate franchisee advisory councils.
- Marginalize independent franchisee associations.

³ ROI means “return on investment.” Franchisees investing their time in addition to their dollars seek ROI greater than what they might earn in passive investments.

⁴ In a recent arbitration, the Arbitrator concluded a franchisor’s damage claims asserted against former area developers in a declining system were “*disproportionate, unreasonable, unconscionable and grossly oppressive.*” (emphasis added).

⁵ Rejecting the same franchisor’s view that results in arbitration are secret, this author made it a point to discuss the case (naming the franchisor but not its attorney) on Blue MauMau -<https://www.bluemaumau.org/blog/2017/12/11/arbitrator-rejects-tilted-kilts-damage-claim-disproportionate-unreasonable>

- Retaliate against franchisees who speak out in dissent.

But to what end? Your speakers today respectfully submit that franchising is not or should not be like Big Pharma, whereby some casualties and resulting verdicts are assumed as the cost of doing business.

III. TRIAGE

In any new representation of an existing franchisee or dealer, there are cascading concerns (beyond whether the client will be a good fit and the representation makes economic sense). Before diving into the facts of the potential case, we strive to:

1. Understand the brand: Start-up or mature; growing or declining, *etc.*?
2. Understand the potential client: Sophisticated in business, or not?
3. Does the potential client have a defined business goal, starting with: Stay in? Get out?

IV. REPRESENTING INDEPENDENT FRANCHISEE ASSOCIATIONS

Similar triage is necessary to properly represent an independent association, with the caveat that association counsel must be vigilant to avoid conflicts of interest in also representing individual franchisees in the same system.

A. Support the brand

Never forget the association's purpose is to help build equity for its members, which most often means supporting the brand and "reminding" the franchisor its long-term success depends on franchisee success.

B. The Hippocratic Oath applies

The nature of the franchise system will have a substantial effect on your advice to the association on strategy and tactics. Where a brand has substantial value to its franchisees, the utmost care must be taken not to injure that brand. The temptation to speak to the media should be resisted. Legal action, by the assertion of associational standing or supporting test cases, should be a last resort. Hopefully it will be enough that the franchisor knows the association has that capability and adjusts its stance towards its franchisees. The highest value of the proverbial "big stick" is to never have to swing it.

But there are exceptions to every rule ...

C. Protect association members

The franchisor must know the association will protect its members from retaliation and will not tolerate efforts at divide and conquer.

V. CIVIL RIGHTS IN FRANCHISING

Any lawyer representing a minority franchisee, at any stage of the relationship, must have a working familiarity with 42 U.S.C. §1981, an important federal civil rights law enacted by Congress in 1866 at the end of the Civil War.

Section 1981 does not receive the attention given to “Section 1983” which is used to challenge deprivations of civil rights done under color of state law. Section 1981 was enacted to give the newly freed African American slaves many of the rights “enjoyed by white citizens” including the important right to “make and enforce contracts.” In 1991, Congress amended Section 1981 to clarify that “to make and enforce contracts” includes “the making, performance, modification, and termination of contracts, and the *enjoyment of all benefits, privileges, terms, and conditions of the contractual relationship.*” (emphasis added). This language was practically written with franchising in mind and, for minority franchisees, Section 1981 overcomes weak contract language. For example, under Section 1981(b), franchisors may not steer minority franchisees to inferior locations or discriminate against them in any other aspect of the relationship, whether part of the written contract or not.

VI. FRAUD AND DISCLOSURE CLAIMS ARISING IN THE SALES PROCESS

Fraud includes:

Anything calculated to deceive, whether it be a single act or combination of circumstances, whether the suppression of truth or the suggestion of what is false, whether it be by direct falsehood or by innuendo, by speech or by silence, by word of mouth or by look or gesture.⁶

The fraud analysis begins with a thorough review of the FDD followed by a comparison of the FDD to all other known or suspected facts even if arguably barred by limitations because that evidence might still be admissible in court. *See Brinkley–Obu v. Hughes Training, Inc.*, 36 F.3d 336, 346 (4th Cir.1994).⁷

⁶ *Bundesen v. Lewis*, 291 Ill. App. 83, 97, 9 N.E.2d 327, 334 (1937).

⁷ *See also, Kalia v. St. Cloud State Univ.*, 539 N.W.2d 828, 833 (Minn. Ct. App. 1995) (statute of limitation “bars only *claims* for violations that fall outside its applicable period ... [but]

Catching a franchisor in an outright lie in an FDD can happen and when it does, most lawyers will know what to do. Far more common, the claim will be that an FDD was materially misleading even though no bald-faced lie is likely to be proven.

A. State Franchising Acts

Recognizing federal law creates no private cause of action for violations of the FTC Franchise Rule, franchisees do best in states like Illinois that have enacted specific franchisee protection acts derived from Rule 10b-5, the primary anti-fraud weapon in the U.S. securities laws, meaning it is “more than reasonable to look to traditional Rule 10b-5 principles” in construing these anti-fraud provisions. See *Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867, 875–76 (N.D. Ill. 1989), construing the Illinois Franchise Disclosure Act (815 ILCS 705/1 *et seq.*)

For example, the (IFDA) differentiates between Section 5 “prohibited practices” including failing to deliver a properly registered, required disclosure statement “meeting the requirements of this act” and containing no “untrue statement of a material fact” and not “omit[ting] any ...material fact.” 815 Ill. Comp. Stat. Ann. 705/5; and Section 6 “fraudulent practices”:

- (a) employ any device, scheme, or artifice to defraud;
- (b) make any untrue statement of a material fact or omit to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading; or
- (c) engage in any act, practice, or course of business which operates or would operate as a fraud or deceit upon any person.

815 Ill. Comp. Stat. Ann. 705/6.

B. Little FTC Acts

Fraudulent omission is also actionable under most “Little FTC Acts.” See *e.g.* Illinois Consumer Fraud & Deceptive Business Practices Act, 815 Ill. Comp. Stat. Ann. 505/1 *et seq.* which is also analyzed by reference to Rule 10b-5. See *Martin v. Heinold*

does not bar evidence relevant to a timely filed claim, especially otherwise admissible evidence that would assist a fact-finder in ascertaining the truth” [and/or] “where it is offered to establish an element of actionable conduct such as malice.” (citations omitted). And, if you are arbitrating, remember there is persuasive (and sometimes controlling) authority that “arbitration is not an ‘action’ subject to state statutes of limitations” and “state statutes of limitations may not apply to arbitrations absent the parties’ agreement.” *Broom v. Morgan Stanley DW Inc.*, 169 Wash. 2d 231, 244, 236 P.3d 182, 188 (2010).

Commodities, Inc., 163 Ill. 2d 33, 643 N.E.2d 734 (1994).⁸ Determining if franchisees are protected by a consumer fraud or deceptive practice act in the particular jurisdiction is an important inquiry.⁹ Absent statutory language excluding franchisees, or a recent definitive statement by the highest court in the state so holding, we would consider filing a Little FTC Act claim despite older authority suggesting or holding franchisees are not covered because the franchise sale was not viewed as a consumer transaction.

C. Common Law

Fraudulent omission is actionable at common law, which imposes a duty to disclose where an omitted material fact: (1) is known only to the franchisor and is beyond the reach of any buyer exercising due diligence;¹⁰ (2) the franchisor actively conceals the material fact;¹¹ or (3) without disclosing additional facts, the representations made (including those in the FDD) are merely “half-truths.”¹² As one court put it:

⁸ “‘Little FTC Acts’ refers generally to the consumer protection or deceptive trade practices legislation adopted in one form or another by 49 states – some, but not all of which are modeled after the FTC Act.” See *Toward Greater Equality in Business Transactions: A Proposal to Extend the Little FTC Acts to Small Businesses*, 96 Harv. L. Rev. 1621, 1640 (1983). For a fifty state survey, see <http://www.nclc.org/images/pdf/udap/udap-report.pdf>.

⁹ Without limitation, states in which franchisees have “Little FTC Act” standing include: Connecticut (*Bailey Employment System, Inc. v. Hahn*, 545 F.Supp. 62 (D.Conn.1982), aff’d without op. 723 F.2d 895 (2 Cir.1983); Florida (*KC Leisure, Inc. v. Haber*, 972 So. 2d 1069, 1071 (Fla. Dist. Ct. App. 2008); Georgia (*Athlete’s Foot Marketing Assocs., Inc. v. Inner Reach Corp.*), Bus. Franchise Guide (CCH) ¶ 12, 349 (N.D. Ga. 2003); Illinois (*People ex rel. Scott v. Cardet Int’l, Inc.*, 24 Ill. App. 3d 740, 744, 321 N.E.2d 386, 390 (1974)); New Jersey (*Morgan v. Air Brook Limousine, Inc.*, 211 N.J. Super. 84, 100, 510 A.2d 1197, 1205 (Law. Div. 1986)); Ohio (Ohio Rev. Code Ann. § 1345.01-13 expressly includes franchises); and Texas (*Century 21 Real Estate Corp. v. Hometown Real Estate Co.*, 890 S.W.2d 118 (Tex. App. 1994). This list is not exhaustive.

¹⁰ See *Forest Pres. Dist. of Cook Cnty. v. Christopher*, 321 Ill. App. 91, 52 N.E.2d 313, 319-20 (Ill. App. 1st Dist. 1943) (when “the other remains silent when it is within his power to prevent the expenditure of money under a delusion . . . to permit one to take advantage of the mistake of another would be revolting to every sentiment of justice.” The court further stated, “there are times . . . when it becomes the duty of a person to speak, in order that the party he is dealing with may be placed on equal footing with him, and when a failure to state a fact is equivalent to a fraudulent concealment, and amounts to [an] affirmative falsehood.”).

¹¹ “Mere silence in a transaction does not amount to fraud.” *Hirsch v. Feuer*, 299 Ill. App. 3d 1076, 702 N.E.2d 265, 273 (Ill. App. 1st Dist. 1998). However, silence accompanied by deceptive conduct or suppression of material fact, can give rise to concealment and “it is then the duty of the party which has concealed information to speak.” *Id.*

¹² *W.W. Vincent & Co. v. First Colony Life Ins. Co.*, 351 Ill. App. 3d 752, 814 N.E.2d 960, 969 (Ill. App. 1st Dist. 2004) (“A statement which is technically true may nevertheless be fraudulent where it omits qualifying material since a ‘half-truth’ is sometimes more misleading than

[E]ven though one is under no obligation to speak as to a matter, if he undertakes to do so, either voluntarily or in response to inquiry, he is bound not only to state the truth but also not to suppress or conceal any facts within his knowledge which will materially qualify those stated; if he speaks at all, he must make a full and fair disclosure. So it is that if a franchisee raises a question the franchisor must avoid half-truths.¹³

D. The FTC Franchise Rule does not permit fraud by omission

Courts should reject these myths:

- The FTC Franchise Rule ties their hands by restricting what they may disclose.
- An FDD is not actionable if it is “literally true.”

The correct position is that the FTC Franchise Rule establishes a minimal level of disclosure but does not limit disclosure to what is expressly “required” by the Rule (or by a non-preempted state law). The Rule allows franchisors to disclose information “required or permitted” by the FTC Franchise Rule or applicable state law, without delineating or placing limits on what is “required” or “permitted.”¹⁴

There is no “Thou Shall Not Disclose” rule where the effect of non-disclosure would be materially misleading. Since the statutory and/or common law of every state prohibits fraud by omission, the correct view must be that while the FTC Franchise Rule limits disclosure to enumerated categories, it does not (and must not be interpreted as) precluding the disclosure of facts to avoid fraud by omission, *i.e.* to avoid the FDD being materially misleading. An FDD is actionable under state laws modelled after Rule 10b-5 where the franchisor “omit[s] to state a material fact necessary in order to make the statements made, in the light of the circumstances under which they are made, not misleading.” (815 Ill. Comp. Stat. Ann. 705/6).

E. Recent federal court holding rejecting “literal truth” defense

Must a franchisor disclose that in the most recent year, company-owned units lost money where that fact is not apparent from Item 19 Financial Performance

an outright lie.”); *see also The Clearing Corp. v. Fin. And Energy Exch. Ltd.*, 09 CV 5383, 2010 WL 2836717, at *2-5 (N.D. Ill. July 16, 2010) (plaintiff sufficiently alleged a duty to disclose where he alleged facts to show that the defendant's acts contributed to the plaintiff's misapprehension of a material fact and the defendant intentionally failed to correct plaintiff's misapprehension).

¹³ *First Virginia Bankshares v. Benson*, 559 F.2d 1307, 1313 (5th Cir. 1977).

¹⁴ See Statement of Basis and Purpose, page 201, quoting Section 4.36.6(d) of the Rule

Representations or the attached audited financial statements (that might come from a parent company)?

In *Dissette v. Pie Five Pizza Company*, a franchisor moved to dismiss a franchisee’s complaint that the FDD was materially misleading by omission in multiple respects, to which the franchisor argued “*Plaintiffs do not allege that any fact in these FDDs is actually untrue.*”¹⁵ That statement was true but the motion to dismiss was denied. In response to the franchisee’s allegation that Pie Five and RAVE failed to disclose information regarding their financial condition, *i.e.* that company stores were losing money and the franchisor was in financial distress or decline, the franchisor and its corporate parent argued its FDD disclosed extensive financial information in Item 19 and in the audited financial statements and there was “no allegation that any of the information provided is actually false” and “nor does [the parent company’s SEC filings] contradict any identified prior disclosure.”¹⁶

For the franchisee, we argued that the although the franchisor’s parent reported a consolidated loss (“in ways no one could decipher”), the disclosure did not reveal: (i) company-owned Pie Five units were losing money; and (ii) the corporate parent was in “financial decline or distress, meaning it could not support the Pie Five franchise program and would instead become a drain on this franchise program.” The District Court denied the motion to dismiss, holding that whether “company-owned Pie Five units were running losses” was material because “there’s a substantial likelihood a reasonable investor would have viewed the information as having significantly altered the total mix of available information” and denied the defendant’s motion to dismiss.¹⁷ The Court added that the FDD did not “directly contradict” the misleading impression formed by the plaintiff, and the claim would proceed because it was “plausible” that the FDD was misleading.

The pivotal moment came in impromptu oral argument in the District Court, when counsel posed a rhetorical question: *Would the Court allow the offeror of securities to argue it can make an initial public offering materially misleading to investors? And if not, then how could a franchisor be allowed to make that argument?*

F. Are there limits on disclosure?

Franchisors complain there is no limit to claimed omissions, but the test of materiality is “[whether] a buyer would have acted differently knowing the information, or

¹⁵ 16-CV-11389, Dkt. #15, at 1, fn. 3 (emphasis added).

¹⁶ *Id.*, at 4.

¹⁷ *Id.*, Dkt. 39, at 5.

if it concerned the type of information upon which a buyer would be expected to rely in making a decision regarding the purchase of the [franchise].”¹⁸

Returning to state statutes modelled after Rule 10b-5 in the federal securities laws: *Why is the buyer of a franchise entitled to disclosure less than the buyer of securities?* A recent American Bar Association primer on federal securities litigation defines “materiality” exactly as defined by the District Court in *Pie Five* (above):

Generally, information is material where there is a substantial likelihood that a reasonable investor would consider the information important in making an investment decision. Where disclosure of information would have a substantial effect on the price or perceived value of a corporation’s securities, that information is material.¹⁹

The same authors explain that “[a]ssessing materiality is typically a fact-specific inquiry” and that “[m]aterial information ... can relate to any aspect of a corporation’s business” including “*contemplated, proposed or current business plans or operations.*” *Id.* (emphasis added).²⁰ Factors potentially material in a securities purchase could be equally material to a franchise purchase or renewal; and this materiality will only increase as private equity buys more franchise systems, becoming franchisors;²¹ and increasingly

¹⁸ *Wernikoff v. Health Care Serv. Corp.*, 877 N.E.2d 11, 16 (Ill. App. 1st Dist. 2007).

¹⁹ See C. Loewenson, Jr. and R. Smithline, *Insider Trading*, American Bar Association (2017), Chapter 2, *Elements of Insider Trading*, by G. Harris, at 13-14.

²⁰ Additional examples from the same authors include:

- Contemplated, proposed, or current corporate transactions, mergers, acquisitions, purchases or sales of assets, or financial restructuring;
- Unpublished financial reports, projections, earnings, losses, or other financial information;
- Pending or new research and development, products, patents, or inventions;
- Changes in the issuer’s debit, liquidity, or credit standing;
- Changes in the issuer’s important suppliers or customers;
- Changes in the issuer’s senior management;
- Future dividend payments, stock splits, or issuance or redemption of securities;
- Major litigation, investigations, regulatory proceedings, or violations of state or federal laws.

²¹ See J. Mazzero, *Private Equity Is Buying More Franchise Systems*, *Forbes*, (Jan. 14, 2019), available at <https://www.forbes.com/sites/joycemazero/2019/01/14/private-equity-is->

invest in franchised units.²² Franchisees have no less stake in their franchise systems and, as a matter of law, should receive the same level of disclosure.

1. Hypothetical #1

A publicly-traded franchisor unveils significant brand changes in unit design, menu, operations *etc.* The franchisor “persuades” nearly all franchisees to accept these changes and incur substantial debt to fund them. The franchisor touts the claimed unanimous enthusiasm of its franchisees and enjoys a higher stock price. But the brand makeover was rushed, without ordinary due diligence and without confident return on investment (ROI) projections. *This is not disclosed to existing or prospective franchisees or to stock purchasers.* Meanwhile, key corporate officers profit from the enhanced stock prices through their executive compensation plans.

To the extent shareholders can prove the franchisor misrepresented the likely success of its brand makeover plan, the shareholders would likely have viable securities fraud claims. That key officers profit from inflated stock values and money raised by this deception is likely admissible as proof of scienter (though probably insufficient to prove scienter if standing alone. See *Sec. & Exch. Comm'n v. Blackburn*, 156 F. Supp. 3d 778, 791 (E.D. La. 2015); and *Novak v. Kosaks*, 2016 F.3d 300, 307-08) (2^d Cir. 2000).²³

Do new or renewing franchise buyers have comparable fraud and disclosure violation claims? If not, why not?

Do existing franchisees, induced to incur substantial debt during their franchise relationships, have claims too? If not, why not?

[buying-more-franchise-systems-here-are-the-key-legal-issues-they-are-looking-at/#57d9fa881b95](#).

²² C. Modell and N. DeCarlo (Speakers) and S. Hagedorn (Moderator), *Attracting, and Negotiating With, Private Equity Owned Franchisees*, IFA's 45th Legal Symposium (2012), available at https://www.franchise.org/sites/default/files/ek-pdfs/html_page/PE-Owned-Franchisees_0.pdf.

²³ In *Novak*, the Second Circuit held that “[m]otives that are generally possessed by most corporate directors and officers do not suffice; instead, plaintiffs must assert a concrete and personal benefit to the individual defendants resulting from the fraud;” and held further that this requirement was generally met when corporate insiders were alleged to have misrepresented to the public facts about the corporation’s performance or prospects in order to keep the stock price artificially high while they sold their own shares at a profit.” *Id.* providing examples *Stevelman v. Alias Research Inc.*, 174 F.3d 79, 185 (2d Cir. 1999); *Goldman v. Belden*, 754 F.2d 1059, 1070 (2d Cir.1985).

2. Hypothetical #2

Item 19 FPR's do not disclose identifiable traits that determine whether an individual franchisee is likely to be a "top tier" or bottom-tier performer, such as:

- Regional variation across the country
- Certain markets consistently substandard
- Under-capitalized franchisees consistently under-perform
- Units in higher crime areas consistently under-perform
- Units owned by persons of color consistently under-perform

Is there a disclosure violation? Must the discrepancies be statistically significant?

3. Hypothetical #3

A franchise agreement expressly negates a contractual right to acquire more units or to renew the franchise upon expiration. But the franchisor has an established course of dealing whereby franchisees can earn the right to expand or be renewed, subject always to the franchisor's reservation of the contractual right to change the requirements or even to say "no" for any reason or no reason. This course of dealing is essential for the brand, which depends on franchisee's being faithful to system standards and appropriately reinvesting throughout the term.

Should the franchisor be required to disclose its policies that constitute a course of dealing? Should a franchisee that relies on the course of dealing have any remedy if the franchisor denies expandability or renewal?

G. Overcoming Contractual Disclaimers

1. A proposed "Rule of Silence"

There is a short answer in the debate whether a franchisor can immunize itself from liability for false statements made outside the FDD – e.g., oral statements at discovery day -- by the aggressive use of "no reliance" disclaimers: *If franchisors wish to be immunized from liability for anything said in conversation with a prospective franchisee or in written sales materials outside the FDD, then franchisors should be barred from any communication with a prospective franchisee outside the FDD itself.*

Under this proposed rule there would be no discovery day and no franchise sales persons. Franchisees would receive their FDD, conduct whatever independent due diligence they wish, and decide. Ridiculous? Franchisee lawyers respectfully submit it

is more ridiculous to allow franchise sales personnel to engage in sales talk but require the franchisee to acknowledge and agree he or she will not rely on anything said.

Most franchise lawyers know the courts have split on these questions. Good cases for franchisees include *Hanley v. Doctors Exp. Franchising, LLC*, 2013 WL 690521, at *27 (D. Md. Feb. 25, 2013), citing *Randall v. Lady of America Franchise Corp.*, 532 F.Supp.2d 1071 (D.Minn.2007). In other cases, the franchisors won, but those defeats occurred because the franchisee had a weak fraud claim to begin with or the franchisee missed opportunities to make better arguments.

2. The FTC Franchise Rule does not create a “license to lie”

Franchisors misstate the FTC Franchise Rule when they cite the rule at 16 C.F.R. § 436.9(h) barring franchisors from “disclaim[ing] or requir[ing] a prospective franchisee to waive reliance on any representation made in the disclosure document or in its exhibits or amendments” that the Rule supposedly permits every other type of disclaimer they can think of. That argument overlooks the FTC’s Statement of Basis and Purpose which explains that franchisors may include integration clauses²⁴ and disclaimers for *unauthorized* statements by salespersons, along with statements made by other franchisees, or in franchise advertising and marketing materials, or unattributed statements in the trade press and third-party representations.²⁵ The distinction between *authorized* and *unauthorized* representations is vital and follows general laws of agency whereby a principal is liable for misstatements by an agency only where the agent has actual authority, or is cloaked with apparent authority, or where the principal ratifies the agent’s statements. *There is no valid reason to grant franchisors blanket immunity when they commit misrepresentation especially not when the franchisee seeks clarification of questions raised by the FDD.* For example:

- An FDD discloses that ten (10) units failed last year; that eight (8) franchisees sued for fraud and that some stores earned far less than the system-wide average. Upon reading this information a prospective franchise buyer asks the franchisor to explain these failures. At discovery day the franchisor claims, “the problem was the failed franchisees did not follow our system” and asserts that “no one who actually follows our system has ever failed.”
- Another FDD discloses a pizza franchisee must buy the pizza sauce from the franchisor’s distribution arm or an approved supplier and the franchisor may derive

²⁴ Integration clauses address questions of contract interpretation and do not bar fraud claims.

²⁵ 72 Fed. Reg. 15, 444 (Mar. 30, 2007), at 253.

revenue based on franchisee purchases. At discovery day the franchisor denies a request by the franchisee to see a price list, explaining “the past is no guarantee of the future” and “we would not want to mislead you” but “don’t worry, with the size of our system, we have tremendous buying power which gives our franchisees a huge advantage.”

In both hypotheticals the franchisees believed what they were told, but what they were told turned out to be false. There was no “system” to follow to protect the new franchisee from failing. The pizza franchisee later discovered she could buy identical sauce for less somewhere else. Are the “out of FDD” statements not sufficiently tied to statements made in the FTC as purported clarifications, as opposed to outright contradictions, which concededly would be more problematic for a franchisee?²⁶

As always, the ruling on the effect of the disclaimer may turn on the severity of the misrepresentations, the circumstances in which they were made and the exact language of the disclaimer.²⁷ As the district court stated in *Hanley*:

The disclaimer cannot change the historical facts; if the dishonest franchisor made misrepresentations, then he made misrepresentations, no matter what the franchise agreement says.²⁸

3. Disclaimers create questions of fact

When courts correctly reject the argument that a disclaimer is a complete bar, the disclaimer will likely have evidentiary significance permitting a defendant to challenge the franchisee’s claimed reliance.²⁹ More often than not, this is the proper resolution of the disclaimer issue – and as question of fact the franchisee can prevail. Questions to the franchisee along these lines should be considered:

Q. “Sir, when you signed the franchise agreement did you understand that you were giving them the right to lie to you about X?”

²⁶ In *Ellering v. Sellstate Realty Systems Network, Inc.*, the issue was framed as whether the claimed misrepresentation directly contradict the language of the contract or the FDD, including but not limited to the language of the disclaimer? 801 F. Supp. 2d at 844-45.

²⁷ See *Napcor Corp. v. JP Morgan Chase Bank, NA*, 406 Ill App 3d 146, 938 N.E.2d 1181, 1184 (Ill. App. 2d Dist. 2010) (not allowing a general disclaimer of “no representations” to negate proof of reliance on a specific misrepresentation).

²⁸ *Hanley*, 2013 WL 690521 at *28.

²⁹ See *Long John Silver’s, Inc. v. Nickleson*, No. 3:11-CV-93-H, 2013 WL 557258 (W.D. Ky. Feb. 12, 2013); and *Hanley* 2013 WL 690521.

Q. Or to keep you in the dark about Y?

C. If you knew the truth about X or Y would you have bought the franchise anyway?"

4. Side-stepping disclaimers with parol evidence

It is worthwhile to include a contract claim based on the implied covenant of good faith and fair dealing alongside your fraud claim, reserving the right to elect remedies. Where good faith and fair dealing is invoked "to allow redress for the bad faith performance of an agreement even when the defendant has not breached any express term" or "to permit inquiry into a party's exercise of discretion expressly granted by a contract's terms" the court should allow the franchisee to introduce evidence that might otherwise be barred by the integration clause or a no reliance clause:

Because the covenant of good faith and fair dealing is implied by operation of law, the view that the parol evidence rule somehow inhibits plaintiffs' claim is erroneous. ... To determine what is considered a good faith performance, the court must consider the expectations of the parties and the purposes for which the contract was made. It would be difficult, if not impossible, to make that determination without considering evidence outside the written memorialization of the parties' agreement. Therefore, in determining whether a breach of the covenant has occurred, a court must allow for parol evidence ...

Seidenberg v. Summit Bank, 348 N.J. Super. 243, 258–59, 791 A.2d 1068, 1076-7 (App. Div. 2002).

H. Rule 9(b) Particularity

Some courts exclude claims for fraud by omission from the stringent particularity requirements of Fed.R.Civ.P. 9(b) given "the practical matter that omissions cannot be described in terms of the time, place, and contents of the misrepresentation or the identity of the person making the misrepresentation." *Flynn v. Everything Yogurt*, CIV. A. HAR92-3421, 1993 WL 454355, at *9 (D. Md. Sept. 14, 1993) (citation omitted).

I. Reasonable Reliance

There is case law holding that reliance is not an element of a fraudulent omission claim, and that reliance is presumed from materiality. See *Press v. Chem. Inv. Servs. Corp.*, 988 F. Supp. 375, 384 (S.D. N.Y. 1997) *aff'd*, 166 F.3d 529 (2d Cir. 1999).

Relatedly there is authority that reliance is not required in statutory fraud claims (discussed below);³⁰ but that authority is not uniform.

J. Benefit of the bargain damages for fraud

Franchisees might seek “benefit of the bargain” damages for fraud including lost future profits where the franchisor deceptively projected future financial performance. See *Roboserve, Inc. v. Kato Kagaku Co.*, 78 F.3d 266, 274 (7th Cir. 1996) citing Restatement (Second) of Torts § 549 (1977) (“the recipient of a fraudulent misrepresentation in a business transaction is also entitled to recover additional damages sufficient to give him the benefit of his contract with the maker, if these damages are proved with reasonable certainty.”); *but see, Barrett v. Huff*, 6 A.D.3d 1164, 1167, 776 N.Y.S.2d 678, 681 (2004) (benefit of bargain damages not recoverable in New York).

K. Transaction Causation vs. Loss Causation

The Illinois Supreme Court in *Martin v. Heinold Commodities, Inc.*, borrowed from federal court decisions construing Rule 10-b-5, holding that to recover damages for violating the Illinois Little FTC Act, a plaintiff:

“must show two types of causation: (1) transaction causation; and (2) loss causation. ... Transaction causation has been defined as meaning that “the investor would not have engaged in the transaction had the other party made truthful statements at the time required.” ... Loss causation, on the other hand, has been defined as meaning “that the investor would not have suffered a loss if the facts were what he believed them to be.” ... In this regard, loss causation is analogous to proximate cause. It has thus been noted:

³⁰ See Tim A. Thomas, Annotation, *When is it unnecessary to show direct reliance on misrepresentation or omission in civil securities fraud actions under § 10(b) of Securities Exchange Act of 1934 (15 U.S.C.A. § 78j(b))* and see Rule 10b-5 (17 CFR § 240.10b-5), 93 A.L.R. FED. 444 (originally published in 1989).³⁰ See also *Bonfield v. AAMCO Transmissions, Inc.*, 708 F. Supp. 867, 875-76 (N.D. Ill. 1989) acknowledging the link between the antifraud franchise laws and Rule 10(b)-5); *Chicago Male Medical Clinic, LLC v. Ultimate Management, Inc.*, No. 12 C 05542, 2012 WL 6755104, at *3 (N.D.Ill. Dec. 28, 2012), citing *Promios v. Fair Automotive Repair, Inc.*, 808 F.2d 1273, 1276 (7th Cir. 1987) (same)); *Enservco, Inc. v. Indiana Securities Div.*, 623 N.E.2d 416-421-22 (Ind. 1993) (same); *Continental Basketball Ass’n., Inc. v. Ellenstein Enterprises, Inc.*, 640 N.E.2d 705, 707 (Ind. App. 1 Dist. 1994)(same).

“The plaintiff must prove not only that, had he known the truth, he would not have acted, but in addition that the untruth was in some reasonably direct, or proximate, way responsible for his loss.”

163 Ill. 2d 33, 60, 643 N.E.2d 734, 747 (1994).

L. Lost profit claims for the lost opportunity to acquire a franchise

There is substantial and uncontradicted authority that a disappointed buyer might recover lost profits for a franchise that never opened. See *Wilbern v. Culver Franchising Sys., Inc.*, No. 13 C 3269, 2015 WL 5722825, at *31 (N.D. Ill. Sept. 29, 2015) (“In the franchise context ... courts have held that historical data from franchise operations can be a proper yardstick for losses sustained by a potential franchisee who was prevented from going into the franchise business by the wrongful conduct of the defendant”). Proof comes from favorable Item 19 financial performance representations showing that most units in the same brand (and same region) are reasonably likely to generate strong revenues, coupled with favorable Item 20 data showing continuity and growth, and supplemented by unit level profitability data obtained in discovery.³¹

The challenge for these clients is to establish liability. The usual issue is whether a prospective purchaser had an enforceable contract or facts strong enough to invoke promissory estoppel as in the classic decision in *Hoffman v. Red Owl Stores, Inc.*, 26 Wis. 2d 683, 694, 133 N.W.2d 267, 273 (1965), adopting Sec. 90 of Restatement, 1 Contracts (“A promise which the promisor should reasonably expect to induce action or forbearance of a definite and substantial character on the part of the promisee and which does induce such action or forbearance is binding if injustice can be avoided only by enforcement of the promise.”)³² Or, an existing franchisee might challenge a franchisor’s decision it is not eligible for expansion invoking the implied covenant good faith and fair dealing. Or a minority franchisee might validly state a claim for the denial of civil rights under the Civil Rights Act of 1870 (42 U.S.C. Section 1981) if denied the right to purchase a franchise on the same terms as “white citizens.”

³¹ The same court held that “reasonable certainty” to prove lost profits is generally the preponderance of evidence standard.

³² But where a franchisor does not approve a sale by an existing franchisee, most courts hold the disappointed buyer cannot sue the franchisor because the buyer is not in privity with the franchisor and the courts usually reject claims of tortious interference on the grounds a franchisor cannot “interfere” in its own prospective contract. See *Home Repair, Inc. v. Paul W. Davis Sys., Inc.*, No. 98 C 4074, 1998 WL 721099, at *5 (N.D. Ill. Oct. 9, 1998). This rule is not absolute.

M. Emotional distress damages for fraud

There is a split of authority whether emotional distress damages are recoverable when caused by fraud. See *Kilduff v. Adams, Inc.*, 219 Conn. 314, 324, 593 A.2d 478, 484 (1991) (surveying cases).

VII. RELATIONSHIP ISSUES

“Relationship issues” arising during the franchise relationship (after the sales process and before terminations or post-termination controversies) are most likely to generate system-wide controversy and spur activity by independent franchisee associations. These cases are driven by the facts: Franchisees are most likely to prevail when there is proof the franchisor’s conduct was not merely unreasonable but outrageous and where there is evidence of selfish motive. There is no exact formula.

Absent a state law governing the relationship issue, and there are few that do, franchisees might challenge perceived abusive conduct during the relationship under”

- Contract law including the implied covenant of good faith and fair dealing.
- Little FTC Acts, which are not limited in scope to franchise sales.
- Common law fraud, in more limited circumstances; and
- Antitrust law, but much less so since *Continental T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977).

VIII. GOOD FAITH AND FAIR DEALING

Most relationship cases are litigated under the much-maligned implied covenant which strives to regulate discretionary contract performance:

[A] covenant of good faith and fair dealing is implied in every contract absent express disavowal... Problems relating to good faith performance are most common where one party to an agreement is given wide discretion, and the other party must hope the discretion is exercised fairly. ... *When one party to a contract is vested with contractual discretion, it must exercise that discretion reasonably and with proper motive, and may not do so arbitrarily, capriciously or in a manner inconsistent with the reasonable expectations of the parties.*

Interim Health Care of N. Illinois, Inc. v. Interim Health Care, Inc., 225 F.3d 876, 884 (7th Cir. 2000) (emphasis added).

In *Interim*, the Seventh Circuit refused to find an implied territorial restriction on dual distribution competition, then reached almost the same desired result by finding the implied covenant restricted the franchisor's ability to withhold referrals of account leads to the franchisee, accounting for most of the damages at issue:

We do not think that in allowing or initiating cross-border servicing of patients Interim–National violated the duty of good faith because the terms of the contract permitted this activity. But the contract is far less conclusive on the subject of referring account leads—the parties agree that Interim–National may decide to withhold some account leads, but the contract is vague about which leads it may withhold, and what justifies withholding. Interim–National had wide discretion, and its exercise of that discretion was governed by a duty of good faith.

Id. at 884.

A. The *Restatement* is persuasive

Beyond researching state law, franchisees invoking good faith and fair dealing should cite to the Restatement (Second) of Contracts § 205 (1981) (“Every contract imposes upon each party a duty of good faith and fair dealing in its performance and its enforcement”) and to cases in the particular jurisdiction citing the Restatement with approval. The Restatement comments provide broad definitions allowing franchisees to craft good faith & fair dealing arguments tailored to almost any fact pattern in which the franchise agreement is structured to allow franchisors to exercise discretion or even “sole discretion.”³³

Comment (a) to Restatement (Second) Section 205:

³³ See also *Charlotte Broad., LLC v. Davis Broad. of Atlanta, L.L.C.*, 2015 WL 3863245, at *7 (Del. Super. June 10, 2015) (“The implied covenant particularly applies where the contract permits a party to exercise sole discretion.”), *aff’d sub nom. Davis Broad. of Atlanta, L.L.C. v. Charlotte Broad., LLC*, 134 A.3d 759 (Del. 2016); *CC Fin. LLC v. Wireless Props., LLC*, 2012 WL 4862337, at *5 n.53 (Del. Ch. Oct. 1, 2012) (“A contract which grants one party sole discretion with respect to a material aspect of the agreement may, through the implied covenant of good faith and fair dealing, require that the exercise of discretion be in good faith.”)

- a. *Meanings of “good faith.”* Good faith is defined in Uniform Commercial Code § 1-201(19) as “honesty in fact in the conduct or transaction concerned.” “In the case of a merchant” Uniform Commercial Code § 2-103(1)(b) provides that good faith means “honesty in fact and the observance of reasonable commercial standards of fair dealing in the trade.” The phrase “good faith” is used in a variety of contexts, and its meaning varies somewhat with the context. *Good faith performance or enforcement of a contract emphasizes faithfulness to an agreed common purpose and consistency with the justified expectations of the other party; it excludes a variety of types of conduct characterized as involving “bad faith” because they violate community standards of decency, fairness or reasonableness.* The appropriate remedy for a breach of the duty of good faith also varies with the circumstances.

Comment (d) to Restatement (Second) Section 205:

- d. *Good faith performance.* Subterfuges and evasions violate the obligation of good faith in performance even though the actor believes his conduct to be justified. But the obligation goes further: bad faith may be overt or may consist of inaction, and fair dealing may require more than honesty. A complete catalogue of types of bad faith is impossible, but the following types are among those which have been recognized in judicial decisions: evasion of the spirit of the bargain, lack of diligence and slacking off, willful rendering of imperfect performance, abuse of a power to specify terms, and interference with or failure to cooperate in the other party's performance.

B. Establish the franchisee’s “justified expectations”

Because good faith and fair dealing seeks to protect the parties’ “justified expectations” it is imperative to win the debate on what “expectations” were justified. This means presenting parol evidence of the parties’ negotiations. *Seidenberg v. Summit Bank*, 348 N.J. Super. 243, 258–59, 791 A.2d 1068, 1076-7 (App. Div. 2002).³⁴

³⁴ Be careful, because the franchisees’ claimed expectations cannot be in direct contradiction of an express contract term. See *Cook v. Little Caesar Enterprises, Inc.*, 210 F.3d 653, 657 (6th Cir. 2000) (“Cook could not employ the implied covenant of good faith and fair dealing to override the express term of the franchise agreements which allowed Little Caesar Enterprises to license franchises outside of Cook’s one-mile exclusive territories.”)

C. Subjective bad faith is important

Courts disagree whether a breach of the implied covenant requires subjective bad faith. See *Fleetwood v. Stanley Steamer Int'l*, 446 F. App'x 868 (9th Cir. 2011) (“‘actual dishonesty’ or actions outside accepted commercial practices required to show bad faith” – suggesting that either subjective or objective bad faith can carry the day); see also *In re Sizzler Restaurants Int'l, Inc.*, 225 B.R. 466, 474 (Bankr. C.D. Cal. 1998), also framing the required proof as an alternative between objective and subjective bad faith:

The inquiry into Sizzler's decision-making process is not an inquiry that looks to results, but more appropriately should examine the actual decision-making process to determine whether it was legitimate, i.e., honest **or** within accepted commercial practices. This court declines to second-guess the result reached, as long as the decision-making process was honest **or** was within accepted commercial practices.

These cases suggest that “commercial negligence” alone could establish a breach of the implied covenant, but most courts require dishonesty or other subjective bad faith before allowing a franchisee to challenge a franchisor’s decision-making as lacking diligence or failing to meet industry standards of reasonableness. See *Svela v. Union Oil Co. of California*, 807 F.2d 1494, 1501 (9th Cir.1987) (court cannot second-guess franchisor's economic decisions *if made in good faith*) (emphasis added); *Agad, supra*, 941 F.Supp. at 1222 (implied covenant of good faith and fair dealing cannot be used to second-guess franchisor's *legitimate* business decisions) (emphasis added).³⁵

D. Dual distribution

Franchisors engaged in dual distribution risk being held in breach of the implied covenant where they favor company-owned units. *Interim*, 225 F.3d at 884 (franchisor routing of national account leads to company-owned outlet instead of to franchisee created triable question of fact); see also *Bryman v. El Pollo Loco, Inc.* (2018).³⁶

³⁵ See also *Clark v. America's Favorite Chicken Co.*, 110 F.3d 295, 297–99 (5th Cir.1997) (no breach of the implied covenant despite fact franchisor's national marketing strategy and concept made individual franchisee less competitive and resulted in loss of business); see also *Vaughn v. General Foods Corp.*, 797 F.2d 1403, 1413 (7th Cir.1986) (no protection against dissatisfaction of franchisee with the degree of success it achieved as a result of franchisor's attempts to create a viable franchise system). Missing from these decisions was subjective bad faith.

³⁶ As reported by *Franchise Times*:

IX. FRAUD DURING THE FRANCHISE RELATIONSHIP

Claims for fraud in franchising typically arise in the franchise sales process, but possible fraud during the relationship should not be overlooked. Whenever a franchisee contends the franchisor acted in bad faith, the alleged bad faith will probably contain an element of fraud presuming the franchisor was pretending to act in good faith and did not voluntarily reveal its bad motives or other grounds to find bad faith. This raises the possibility a franchisee can establish fraud, overcoming the franchisor's possible success negating the implied covenant.

For example, in both *Chang v. McDonald's Corp.*, 105 F.3d 664 (9th Cir. 1996), and *Zuckerman v. McDonald's Corp.*, 35 F. Supp. 2d 135, 136 (D. Mass. 1999), the courts rejected claims that McDonald's breached the implied covenant by refusing to renew franchise agreements (a practice called "rewrite" in that system) because the franchise agreement unambiguously stated there is no contractual right to renew. That McDonald's does offer rewrite to many (most?) of its franchisees and has articulated written policies stating when a franchisee might be eligible for rewrite did not override the express contract language negating a right to renew. It would seem, therefore, that McDonald's found the perfect legal formula for allowing a franchisor to make a discretionary decision (to rewrite or not) with no opportunity by the franchisee to argue the denial is a breach of contract. That is McDonald's intent, to preserve the ability to say "no rewrite" free from challenge except in the minority of states offering statutory protection against non-renewal.

But in *Darling v. McDonald's Corp.*, 2006 WL 164986, (Cal. Ct. App. Jan. 24, 2006), the franchisee proved McDonald's committed fraud in leading a multi-unit franchisee to believe it would rewrite her most profitable restaurant as it approached end of term while secretly planning to not rewrite that restaurant as part of a larger plan to drive her out of the system. In reliance on fraud, the franchisee invested substantial sums to improve her restaurant(s) to stay eligible for the rewrite she believed she had been promised. Darling won a substantial verdict against McDonald's (\$6.5 million compensatory damages and \$10 million punitive) when a jury found McDonald's guilty of fraud. *Darling* is an outlier, but it identifies a winning path for franchisees deceived into believing the franchisor will make a favorable decision.

"The jury found that El Pollo Loco Inc. was encroaching on the Brymans' territory by building company-owned restaurants in the same area, in Lancaster, California, and not giving the Brymans the right of first refusal to run the company-owned stores. Those stores siphoned revenue from the Brymans' location."

<https://www.franchisetimes.com/news/May-2018/El-Pollo-LoCo-Verdict-Makes-New-Law-Attorney-Says/>

A. Little FTC Act Claims during Relationship

Too often overlooked, in states where franchisees have standing under the Little FTC Act, those statutes can protect franchisees from bad faith, predatory or “unfair” conduct that may, or may not, breach the franchise agreement. “The concept of unfairness is even broader than the concept of deceptiveness, and it applies to various abusive business practices that are not necessarily deceptive.” *Tucker v. Sierra Builders*, 180 S.W.3d 109, 116–17 (Tenn. Ct. App. 2005). From this Tennessee appellate court construing that state’s Little FTC Act:

In the 1994 legislation reauthorizing the Federal Trade Commission, Congress undertook to codify the Commission's policy statement on unfairness by stating that an act or practice should not be deemed unfair “unless the act or practice causes or is likely to cause substantial injury to consumers which is not reasonably avoidable by consumers themselves and not outweighed by countervailing benefits to consumers or to competition.” 15 U.S.C.A. § 45(n). Following the mandate of Tenn. Code Ann. § 47–18–115, we will use this description of unfairness to guide our interpretation of Tenn. Code Ann. § 47–18–104(a).

In *Century 21 Real Estate Corp. v. Hometown Real Estate Co.*, 890 S.W.2d 118, 127 (Tex. App. 1994), writ denied (Sept. 14, 1995), a Texas appellate court affirmed a franchisor’s statutory liability for committing a deceptive trade practice by engaging in an “unconscionable action or course of action” [defined as] an act or practice that, to a person's detriment, takes advantage of the person's lack of knowledge, ability, experience, or capacity to a grossly unfair degree, or that results in a gross disparity between the value received and consideration paid, in a transaction involving the transfer of consideration. ...” The court held Century 21 committed a deceptive trade practice because it violated its established “*unwritten policy*” was to not allow the opening of a nearby competing agency if the existing franchisee had sufficient market share.³⁷ Course of dealing has consequences.³⁸

³⁷ In *Century 21 v. Hometown*, the franchisor waived its contention the franchisee lacked as a “consumer” under the Texas DPTA. *Id.* at 124. Subsequent “Texas courts have held that a franchise may be a good or service under the DTPA.” *Carroll v. Farooqi*, 486 B.R. 718, 726 (N.D. Tex. 2013).

³⁸ *But see Abraham v. WPX Prod. Prods., LLC*, 184 F. Supp. 3d 1150, 1208 (D.N.M. 2016): (“even if the language of the contract appears to be clear and unambiguous, “a court may hear evidence of the circumstances surrounding the making of the contract and of any relevant usage

As decisions on expandability, renewal or termination are typically made based on, or substantially influenced by franchisor inspection and grading of the franchisee's units, we are likely to see increased challenges to franchisor grading under Little FTC Acts. See *Dayan v. McDonald's Corp.*, 125 Ill. App. 3d 972, 998, 466 N.E.2d 958, 977 (1984), where the franchisor established good cause for terminating a franchisee by refuting the franchisee's contention "he was in substantial compliance with QSC standards and that McDonald's had manufactured a case against him in order to recapture the Paris market." If that proof had gone the other way, and the franchisee proved McDonald's had unfairly applied QSC or deceptively claimed the franchisee failed to meet QSC, and then used the claimed QSC failure to terminate, deny expandability, or deny rewrite, a similar Little FTC Act claim would arguably be sustainable.

X. THE ANTITRUST GAP

Once upon a time, franchisees enjoyed substantial protection under Section 1 of the Sherman Act, 15 U.S.C. §1, from unlawful restraints of trade such as abusive tying arrangements, where as a condition of buying the franchise, franchisees must buy necessary supplies from the franchisor or its designated suppliers on unfavorable terms.

That changed when the Supreme Court in *Continental T. V., Inc. v. GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549, 53 L.Ed.2d 568 (1977), held that in most Section 1 cases, a restraint of trade (such as a tying arrangement) is not unlawful unless the franchisor has "market power" "to force a purchaser to do something that he would not do in a competitive market" -- "the ability of a single seller to raise price and restrict output" ... [and holds that market power] is ordinarily inferred from the seller's possession of a predominant share of the market." *Eastman Kodak Co. v. Image Tech. Servs., Inc.*, 504 U.S. 451, 464, 112 S. Ct. 2072, 2080–81, 119 L. Ed. 2d 265 (1992) (citations omitted).

The wisdom of the Supreme Court's antitrust jurisprudence in an era where companies "too big to fail" have caused tremendous damage to our economy is beyond our scope. But the concern shared by franchisee lawyers is obvious: The Supreme Court asks if the franchisor has the "power" to injure the end consumers making them pay higher prices or "do without" ignoring franchisees caught in the middle. Franchisees take the bullet when franchisors engage in conduct formerly condemned as *per se* antitrust violations but have no antitrust remedy precisely because they cannot sufficiently raise prices to end consumers. The Supreme Court sees no injury to competition when franchisees take the bullet, but that view leaves franchisees at the mercy of franchisors, whose incentive is to squeeze franchisee margins, stopping just short of where *all* franchisees are driven out of business.

of trade, course of dealing, and course of performance," in order to decide whether the meaning of a term or expression contained in the agreement is actually unclear.")

From Dr. Eric Forister, an experienced economist that has testified on antitrust issues for this author and who adds this commentary:³⁹

There is a view sometimes espoused that antitrust should only be concerned with harm to end-consumers. From an economic perspective, this view has a blind spot when it comes to market power arising from franchise agreements. Franchise agreements often include terms that give the franchisor market power over their franchisees. This is true even if the franchisor lacks market power in a more broadly defined upstream market. At the same time, a franchisee may operate in a retail market that is very competitive, where they would not be able to pass through small but significant cost increases that are not market-wide. In such a situation, the franchisor could use its market power to raise prices to a franchisee without causing price increases (i.e., harm) to end consumers.

This situation creates a potential economic inefficiency. If franchisees don't have adequate protection against the franchisor exercising its market power, then this will deter franchisee investment (e.g., in new franchise locations). This effect could be broadly felt across the retail marketplace. Although franchisors have an incentive to ensure a level of franchisee investment that maximizes franchisor profits, this may not align with the level of investment that would occur absent the franchisor's exercise of market power.

Applying antitrust law to franchises is not inconsistent with the goal of protecting consumers and protecting competition. Franchisees are the customers, not competitors, of the franchisor. If the downstream market is competitive then the middle-men (franchisees) get squeezed when the upstream supplier (franchisor) exercises the market power they have in the upstream market. The lack of downstream market power nixes all the examples of consumer harm that readily come to mind, because the franchisee can't lower quality or raise prices.

One could talk about the economic inefficiency this situation creates. If franchisees don't have adequate protection against the franchisor exercising its market power, then this will deter investment in new franchise

³⁹ See <https://www.econone.com/staff-member/eric-forister/>. Dr. Forister is with EconOne in Los Angeles.

locations. This would be broadly felt across the retail marketplace. This is simply be a blind spot in terms of antitrust policy.

The franchisee is a customer of the franchisor. On a related note, antitrust law is intended to protect competition and not competitors. Applying antitrust law to franchises would be consistent with this, because the franchisee is not a competitor of the franchisor.

Dr. Eric Forister, PhD.

One day franchisees will find the right facts to establish that systematic weakening of most franchisees in a brand harms competition hopefully persuading the Supreme Court to review its position. Until then, absent protection under the antitrust laws, franchisees may challenge anti-competitive conduct as a breach of the implied covenant of good faith and fair dealing (foregoing the potential for treble damages);⁴⁰ or as violations of Little FTC Acts that protect against unfair or deceptive conduct (as opposed to protecting competition, the focus of the antitrust laws). There is little precedent, but Little FTC Act claims alleging both “unfair or unconscionable” and “fraud or deception” theories of liability have been pled as additional counts in major pending antitrust cases.⁴¹ Franchisees must win the argument that “harm to competition” and “antitrust injury” are not required elements of a Little FTC Act claim.

XI. ROBINSON-PATMAN MISCONSTRUED

The Robinson-Patman Act (“RPA”), 15 U.S.C. §13(a) expresses “Congressional intent to protect individual competitors, not just market competition, from the effects of price discrimination.” *Chroma Lighting v. GTE Products Corp.*, 111 F.3d 653, 657-8 (9th Cir. 1997); *see also, Williams v. Duke Energy International, Inc.*, 681 F.3d 788, 799 (6th Cir. 2012).⁴² But despite clear Congressional intent, the RPA inspires seemingly endless

⁴⁰ *See Matthis v. Exxon Corp.*, 302 F.3d 448 (5th Cir. 2002), where fifty-four (54) franchised gasoline dealers alleged the franchisor attempted to drive them out of business by taking away their margins, intending to replace them with lower price jobbers. The franchisees abandoned claims under the Sherman and Clayton Acts, and the Petroleum Marketing Practices Act, and went to trial on a common law claim that the franchisor had breached a duty of good faith, imposed by the Texas Uniform Commercial Code, in setting price, which was an “open term.” The dealers won their contract claim and the verdict was affirmed.

⁴¹ *See Sergeants Benevolent Ass'n Health & Welfare Fund v. Actavis, plc*, No. 15 CIV. 6549 (CM), 2018 WL 7197233, at *35–36 (S.D.N.Y. Dec. 26, 2018) and *In re Packaged Seafood Prod. Antitrust Litig.*, 242 F. Supp. 3d 1033, 1072 (S.D. Cal. 2017).

⁴² “The RPA was enacted in response to the comparative competitive advantage of large purchasers, who could induce advertising allowances, rebates, and special services from sellers due to their size. Small independent stores were at a “hopeless competitive disadvantage”

hostility inspiring judges and arbitrators to invent novel ways to reject claims that ought to be meritorious.⁴³ In *Volvo Trucks N. Am., Inc. v. Reeder-Simco GMC, Inc.*, 546 U.S. 164, 180–81, 126 S. Ct. 860, 872, 163 L. Ed. 2d 663 (2006), the Supreme Court confirmed that “a permissible inference of competitive injury may arise from evidence that a favored competitor received a significant price reduction over a substantial period of time.” *Id.*, 546 U.S. at 177, 126 S. Ct. at 870, citing *FTC v. Morton Salt Co.*, 334 U.S. 37, 49–51, 68 S.Ct. 822, 92 L.Ed. 1196 (1948) etc. Significantly, the “*Morton Salt*” inference re-affirmed in *Volvo* does not require a franchisee or dealer to prove that the franchisor has “market power” or there is *actual injury* to end consumers – and this is a very substantial distinction from the Supreme Court’s view of most “restraint of trade” cases under Section 2 of the Sherman Act since *GTE Sylvania Inc.*, 433 U.S. 36, 97 S.Ct. 2549.

But then the *Volvo* Court stated: “we continue to construe the Act ‘consistently with broader policies of the antitrust laws’ [and] ‘we would resist interpretation geared more to the protection of existing *competitors* than to the stimulation of *competition*.’” *Volvo*, 546 U.S. at 181, 126 S. Ct. at 873.

We respectfully submit no one, not even the Supreme Court, can have it both ways. Either the RPA as enacted in 1936 was a “small business protection law” (and it was) or it wasn’t. Whether franchisees and dealers should enjoy legislative and regulatory protection remains vital today. Advocates for franchisees must convince courts (starting with the U.S. Supreme Court in its antitrust and RPA jurisprudence), FTC regulators, and legislatures that franchisees continue to need (and deserve) protection from abusive practices. *Or if not, is the franchise business model sustainable?*

XII. THE EMPLOYER vs. CONTRACTOR DEBATE

That the Ninth Circuit has reversed the district court and reinstated the claim by 7-Eleven franchisees that 7-Eleven misclassified them as independent contractors rather

compared to large stores and thus the RPA was enacted “to eliminate these inequities.” *Id.*, citing *FTC v. Simplicity Pattern Co.*, 360 U.S. 55, 69 (1959).”

⁴³ To succeed on a RPA secondary line claim, a franchisee or dealer alleging price discrimination must prove that: (1) at least one sale at issue crossed state lines; (2) each sale was for the use or resale in the United States; (3) the products sold were physical items; (4) the sales were made by Company about the same time; (5) the products sold were of like grade and quality; (6) Company “discriminate[d] in price between purchasers of commodities of like grade and quality” (the threshold Robinson-Patman inquiry. 15 U.S.C. §13(a); (7) there is a reasonable possibility that the discriminatory pricing caused harm to competition; and (8) the dealer was injured. See *Model Jury Instructions in Civil Antitrust Cases*, American Bar Association, 2016 Ed., Ch. 5, Section A.2. (electronic publication version).

than employees in violation of the Fair Labor Standards Act and the California Labor Code is beyond our scope. *Haitayan v. 7-Eleven, Inc.*, No. 18-55462, 2019 WL 968927, at *1 (9th Cir. Feb. 27, 2019). For our purposes:

- No franchisee should want to be an employee instead of a business owner in a contract relationship with the franchisor.
- This lawsuit is born out of desperation, that the franchisees perceive the relationship is so far out of balance this drastic remedy must be pursued.
- All franchisees in every brand must root for the 7-Eleven franchisees to succeed not because any franchisee wants to be an employee but because this case may lead to broader relationship throughout franchising and spur the enactment of further legislative and regulatory protections.

XIII. CONCLUSION

Regardless of which side of this great debate you find yourself, remember we are all very privileged to practice in an area with so many good lawyers with the opportunity to make many good friends across the country.

Thank you for your kind attention.

Structuring Causes of Action to Fit Unique Fact Patterns

By: Robert Zarco

I. Introduction: The Obligation of Good Faith

Claims that a franchisor breached its implied contractual duty to act in good faith are among the most prevalent operational claims. The contours of the doctrine, like the relationship statutes, vary from state to state. In basic terms, all contracting parties are expected to behave honestly, fairly and with good faith intentions in connection with the execution of contractual rights and obligations vis-à-vis the other party. The purpose of the contract and the parties' reasonable expectations are among a court's chief evidence of whether the obligation of good faith duty has been breached.⁴⁴ To that end, this doctrine is not used to expand or contradict the express contractual terms and will not operate to add obligations where there would otherwise not be any. Instead, it operates as a gap filler or a counterbalance, where the contract expressly affords one party discretion, as is often the case with franchise claims relating to the breach of a franchisor's good faith obligations.

This type of claim arises in a variety of factual contexts.⁴⁵ A franchisee can present evidence that the franchisor was acting in bad faith, contrary to the established course of performance between the parties, or is somehow otherwise acting unreasonably in a way that affects the franchisee's business. A franchisor will generally defend relying on its business judgment and to show that a particular franchisee cannot establish that the franchisor acted with deliberate bad faith as to that particular franchisee or location.

II. Disputes Over Territory: When is Close, Too Close

We often see strain between franchisee and franchisor as to territorial rights where a franchisor wishes to expand into a profitable area close to a high performing franchisee. These claims are sometimes referred to as encroachment claims. While the franchisor may want to increase its footprint, a franchisee may see the new unit as unwanted competition (be it through a corporate or franchisee owned location).⁴⁶ In short, although franchisees have an interest in the franchisor's growth, which in turn expands brand recognition, a franchisee understandably wants to protect its franchised business in its

⁴⁴ See, e.g., *Wyndham Hotel Group Int'l, Inc. v. Silver Entm't LLC*, 15-CV-7996 (JPO), 2018 WL 1585945, at *10 (S.D.N.Y. Mar. 28, 2018) (issues of material fact barred summary judgment on claims that franchisor breached its duty of good faith to provide services).

⁴⁵ Claims for improper termination or tortious interference can be parsed as breaches of the implied covenant of good faith and fair dealing. See, e.g., *Burger King Corp. v. H&H Restaurants, LLC*, No. 99-2855, 2001 WL 1850888, at *5 (S.D. Fla. Nov. 30, 2001) (franchisor did not unreasonably withhold its consent to a proposed transfer because it had the "sole discretion" to approve or deny the transfer).

⁴⁶ More rarely, franchisees complain when a franchisor is not expanding the brand.

geographic area against loss of revenue from other franchisees (or the franchisor) competing in the same area. Generally, franchisees welcome the franchisor's expansion, so long as it is not too nearby.⁴⁷

Territorial rights are one aspect of the franchise relationship that may be subject to state relationship statutes or disclosure statutes. Territorial rights are generally delineated in the franchise agreement and franchisees may also bring claims for breach of contract or breach of the implied covenant of good faith and fair dealing. Many franchisors include a "reservation of rights" clause in franchise agreements to permit some flexibility for future growth. Territorial encroachment claims are fact specific.

Territorial encroachment continues to be a hot button issue where franchisors must strike a balance between granting its franchisees certain exclusive rights while not infringing on those rights by encroaching on the protected territory. This was the case in *Bryman v. El Pollo Loco, Inc.*, a case formerly pending in the Superior Court of California, Los Angeles County, Case No. MC026045. The circumstances in *Bryman* were unique since the franchise agreement at issue did not expressly grant the Brymans exclusive territory rights. Thus, the franchisee needed to establish that the franchisor's actions (of building corporate stores in the immediate and/or adjacent vicinity) defeated the entire purpose of the parties' franchise relationship. The *Bryman* case involved numerous key franchise issues, primarily relating to the implied covenant of good faith and fair dealing, which led to issues dealing with inadequate disclosure, encroachment, unconscionability, and significant corrective remedies. Using *Bryman* as an illustrative case study in relation to the doctrine of good faith and fair dealing, we explore:

1. How the failure to comply with federal and state franchise disclosure requirements can result in a breach of the implied covenant of good faith and fair dealing.
2. How the conduct of the parties impacts the findings in a claim for breach of the implied covenant of good faith and fair dealing.
3. How the unconscionability of franchise agreements and other franchise disclosures impacts franchisees both retroactively and prospectively.

The *Bryman* franchisees owned and operated an El Pollo Loco ("EPL") restaurant in the Lancaster, California area since 1999. They were granted a twenty-year renewal in 2009, extending the franchise relationship through 2029. The renewal agreement presented to the Brymans was a preprinted form and proposed on a take-it-or-leave-it basis. However, the agreement granted the Brymans the right and ability to develop additional stores.

As a result of EPL's conduct, the Brymans ultimately asserted the following five claims against EPL: (1) breach of the covenant of good faith and fair dealing; (2)

⁴⁷ Territory disputes may also arise where a franchisor offers its products direct to consumers in the form of mail, catalog, internet or other retail sales. Think of the times that you may have seen Dunkin' Donuts coffee products in your local grocery.

intentional interference with prospective business; (3) reformation; (4) unfair business practices under Cal. Bus. & Prof. Code § 17200; and (5) declaratory relief.

a. Transforming Non-Actionable Disclosure Failures to Actionable Claims

It is well known that there are several disclosure guidelines that a franchisor must comply with when offering franchises for sale.⁴⁸ However, a franchisee cannot simply sue a franchisor for violation of the FTC Rule because there is no private right of action. The FTC has enforcement authority to issue cease and desist orders and other remedies, but a franchisee cannot alone take benefit of such remedies. Some states have their own statutory franchise disclosure rules as noted above and these statutes often authorize private lawsuits. For other states, unfair trade practices statutes or “Little FTC Acts” may provide a cause of action.⁴⁹ Unlike common law claims, claims under these acts do not generally contain a scienter requirement and liability may be found irrespective of intent to deceive or proof of reliance. The type of disclosure violations that give rise to statutory claims depend on the jurisdiction.⁵⁰ Other actionable claims may arise from Item 19 violations of financial performance representation. Such representations may have a legal basis for common law fraud and negligent misrepresentation or for claims seeking rescission, enabling a franchisee to cancel the contract and preserve status quo.⁵¹

⁴⁸ 16 C.F.R. §§ 436 – 437.

⁴⁹ See, e.g., Ill. Stat. § 505.1 *et. seq.*; Tex. Bus. & Com. Code § 17.50; *Morgan v. Air Brook Limousine, Inc.*, 211 N.J. Super. 84, 103, 510 A.2d 1197, 1206 (N.J. Law. Div. 1986) (franchisor’s failure to comply with the FTC is per se deceptive or unconscionable commercial conduct in violation of New Jersey’s Consumer Fraud Act).

⁵⁰ A franchisor may defend against Little FCT Act claims by arguing that a franchisee is not a consumer under the statute. The available defenses to Little FTC Act claims also depend on the jurisdiction.

⁵¹ In these circumstances, franchisors often defend against financial performance representation claims by relying on integration and merger language contained in the franchise agreement.⁵¹ Some franchisors have also included franchise questionnaires specifically inquiring whether FPRs were made during the sale and disclosure process. The usefulness of such provisions or questionnaires depends on the language and the forum. Some state disclosure statutes have anti-waiver provisions which prohibit franchisors from relying upon the protections of contractual waiver provisions. See, e.g., *Emfore Corp. v. Blimpie Assocs., Ltd.*, 51 A.D.3d 434, 435, 860 N.Y.S.2d 12, 14 (N.Y. 2008) (where the court held that a “franchise disclosure questionnaire” completed at the time of the franchise sale, in which the franchisee did not identify any earnings information that the franchisor provided outside of the FDD, could not be used to bar the franchisee from pursuing claims under the anti-fraud provisions of the New York Franchise Sales Act); *Cousin Subs Sys. Inc. v. Better Subs Dev. Inc.*, No. 09-C-0336, 2011 WL 4585541, at *8 (E.D. Wis. Sept. 30, 2011) (where the court held that a “no reliance” clause in the franchise agreement could not be used to bar claims under the anti-fraud provisions of the Wisconsin Franchise Investment Law and the Indiana Franchise Disclosure Act); *Randall v. Lady of Am. Franchise Corp.*, 532 F. Supp. 2d 1071, 1089 (D. Minn. 2007) (holding that “[f]ranchisors cannot use contractual provisions to protect themselves from being sued for misrepresentation under the Minnesota Franchise Act”).

In *Bryman*, the franchisor's inadequate disclosures in its FDD became a highlight of the dispute. EPL failed to provide adequate disclosures under Items 3 and 12, which are discussed in turn. Item 3 requires franchisors to make certain disclosures related to litigation. The *Bryman* court analyzed the discrepancy between the Item 3 disclosure relating to "unfair and deceptive practices" and EPL's Procedures for Resolving Disputes to the Development of New Restaurants ("Dispute Procedures"). The Dispute Procedures limited an arbitrator to making one of the following three findings:

- (a) A decision that the New Restaurant has not directly or proximately caused a reduction in the annual gross sales of the Objecting Franchisee's restaurant; or
- (b) A decision that no compensation is due an Objecting Franchisee based on a finding that the Objecting Franchisee has failed to prove that the New Restaurant has directly or proximately caused a reduction in the annual gross sales of the Objecting Franchisee's restaurant in an amount in excess of the Allowable Transfer Factor, if any; or
- (c) A decision that compensation is due the Objecting Franchisee based on a finding that the Objecting Franchisee has proven that the New Restaurant has directly or proximately caused a percentage reduction in the gross sales of the Objecting Franchisee's restaurant in excess of the Allowable Transfer Factor, if any.

Based on the three permissible findings above, the remedies and damages to be calculated by an arbitrator were then further limited to lost profits for a maximum of eight years. These limitations on both the findings and remedies in the event of a development dispute were designed by EPL to prevent an arbitrator from ever making a finding of an unfair or deceptive business practices claim, and thereby evaded the disclosure requirements under 16 CFR § 436.5(c).

Item 12 was at issue for EPL's failure to adequately disclose the Brymans' protected territory. Under the FTC's requirements, Item 12 requires disclosure of, in relevant part:

- (1) Whether the franchise is for a specific location or a location to be approved by the franchisor.
- (2) Any minimum territory granted to the franchisee (for example, a specific radius, a distance sufficient to encompass a specified population, or another specific designation).
- (3) The conditions under which the franchisor will approve the relocation of the franchised business or the franchisee's establishment of additional franchised outlets.
- (4) Franchisee options, rights of first refusal, or similar rights to acquire additional franchises.

- (5) Whether the franchisor grants an exclusive territory.
- (i) If the franchisor does not grant an exclusive territory, state: "You will not receive an exclusive territory. You may face competition from other franchisees, from outlets that we own, or from other channels of distribution or competitive brands that we control."
 - (ii) If the franchisor grants an exclusive territory, disclose:
 - (A) Whether continuation of territorial exclusivity depends on achieving a certain sales volume, market penetration, or other contingency, and the circumstances when the franchisee's territory may be altered. Describe any sales or other conditions. State the franchisor's rights if the franchisee fails to meet the requirements.
 - (B) Any other circumstances that permit the franchisor to modify the franchisee's territorial rights (for example, a population increase in the territory giving the franchisor the right to grant an additional franchise in the area) and the effect of such modifications on the franchisee's rights.

16 C.F.R. § 436.5(1).

The circumstances were unique in *Bryman* because the franchise agreement did award the Brymans a specified protected territory demarcated by a circle around the franchise location with a radius sufficient to encompass a minimum population of 50,000 people ("Notification Radius"). Although the territory was not expressly defined as "exclusive," it was treated as such and the agreement provided the franchisee with a mechanism to object to any EPL store that would be constructed within its Notification Radius. The territory was also treated by EPL as exclusive as noted in the Court's Statement of Decision. As testified by Jeffrey Little, EPL's Vice President of Development from January, 2013, until February of 2016:

Q. [By Mr. Adams] Now, when you joined El Pollo Loco, what did you understand El Pollo Loco's abilities to be with respect to placement of new restaurants in proximity to existing restaurants?

Athe contractual side of the brand at that point was that every -not every restaurant, but largely speaking, the franchise agreement had a 50,000 [population] radius ring around them. So from wherever that restaurant was built, you couldn't build another restaurant in a ring until you got outside of 50,000 people.

* * * *

Q. [By Mr. Adams] And if you had concluded that the Costco site was within the Brymans' [Plaintiffs'] notification radius [the 50,000 population ring], would you have done it [built the Costco company restaurant]?

A. No.

* * * *

Q. [By Mr. Zarco] And in fact, that population, as you understood it, was a total population of the area that would be, quote, unquote, protected, right?

A. That was an existing residential population.

Despite EPL's acknowledgement that it granted the Brymans an exclusive territory, its 2009 FDD failed to state so under Item 12. Rather, EPL's 1998 FDD stated the following under Item 12: "We will not grant exclusive development rights in geographical areas which we target in our business plan." This was only slightly revised in the 2009 FDD as follows: "We will not grant exclusive development rights in geographical areas which we target in our business plan for company development." These Item 12 disclosures were clearly inadequate and in direct conflict with the expressly defined Notification Radius that all parties believed were protected and exclusive to the Brymans under the franchise agreement. This not only constituted a failure by EPL under the FTC Rule but was also actionable under California law by violating the unlawful and unfair prongs of California's unfair competition law.⁵²

b. The Conduct of the Parties

Franchise agreements commonly include provisions that permit franchisors to act in their "sole discretion." This can take many forms, ranging from how advertising funds are spent and maintained to a franchisee's ability to assign or transfer its rights in the franchise location. Franchisees and their attorneys alike are often discouraged by this language when assessing the strength of a claim. However, in *Bryman*, EPL's arbitrary criteria and pretextual reasoning that it provided the franchisee in preventing it from developing additional stores proved to be actionable under California's unfair competition law. This was especially true because EPL rejected the Brymans' proposals for two store locations, and instead later developed them as corporate stores.

Both the 1998 and 2009 versions of EPL's FDD granted the Brymans the right to develop additional stores. The Brymans had initially submitted a proposal to EPL in as early as 2001 to open a new location at a Wal-Mart shopping center that was being developed at the intersection of Avenue J and 20th Street East in Lancaster, California. The proposal was rejected with the reasoning that it was "too green" to support an additional EPL restaurant. In reality, EPL had previously changed its development plans

⁵² Cal. Bus. & Prof. Code § 17200, *et seq.*

so that all future development of Los Angeles county was reserved for corporate stores, a fact not disclosed to the Brymans. The Brymans were ultimately granted clearance to pursue the Avenue J and 20th Street location but were unable to secure the site within the timelines set by EPL due to delays within the Wal-Mart shopping center. EPL's VP of Development, Jeffrey Little, encouraged the Brymans to look into alternative sites. However, the testimony of Mr. Little (and that of other EPL representatives) revealed that efforts undertaken by EPL in preventing the Brymans from developing the 20th Street store were so EPL could develop it as a corporate store.

Q. [By Mr. Zarco]: In your view, there was no intention at all by El Pollo Loco to allow the Brymans to operate the store on 10th and L [the Costco Center location]; is that correct?

A. I think at the end of the day we had concluded that we did not see Mike developing and operating that store, no.

Q. And the reason that you did not see Mike opening and developing that store is because corporate wanted that store for themselves, correct?

A. I think we were fairly frustrated at that point with Mike's lack of ability to get stuff done.

Q. The frustration you're describing ... that El Pollo Loco had as a result of the Brymans' failure to develop a store in Lancaster was because they were unable to proceed to sign a lease on 20th [Street East] and [Avenue] J; is that correct?

A. The frustration was based on the fact that they were so focused on 20th and J that had we waited - look, had we waited for them to develop 20th and J, which just opened a month ago, we would have been sitting around with no other store for anyone in Lancaster other than the one they had for three years past the time we had conversations about it.

After EPL's refusal to grant the Brymans any further extensions on the 20th Street location, EPL opened a competing corporate store at a Costco Center, which substantially overlapped with the Brymans' population circle. As mentioned above, the Brymans' Notification Radius covered a minimum population of 50,000 people, which was to be calculated by placing a circle with a one-mile radius around the franchisee's restaurant. Under the 1998 FDD, if the circle did not contain 50,000 people, the ring would be increased by one-half mile increments until the population reached 50,000 people. However, under the 2009 FDD, the ring would only be increased by one-eighth mile increments under the same circumstance. Despite this stark difference, the 2009 FDD falsely represented that there had been no changes made to the Dispute Procedures since the issuance of the 1998 FDD.

This became a significant issue because the Costco Center store was located 2.3 miles from the Brymans' store and under the population methodology employed in the 1998 FDD, the Brymans' Notification Radius would encompass 2.5 miles of protected territory, whereas under the 2009 FDD, it would only encompass 2.125 miles of protected territory. EPL's VP of Development, Mr. Little conceded that had the Costco Center location been located within the Brymans' Notification Radius, the store would never have been constructed.

Q. Okay. And with respect to just the notification radius [the 50,000 population ring], did you conclude whether or not this Costco location was inside or outside the Brymans' [Plaintiffs'] notification radius?

A. It was outside the 50,000 population radius of Mike's [Plaintiffs'] store.

Q. And if you had concluded that the Costco site was within the Brymans' [Plaintiffs'] notification radius [the 50,000 population ring], would you have done it [built the Costco company restaurant].

A. No.

Regardless of whether the Costco Center store was located within or outside of the Brymans' Notification Radius, the most salient point was the fact that EPL had represented that its Dispute Procedures remain unchanged since the issuance of the 1998 FDD. That misrepresentation alone violated the unlawful, unfair, and fraudulent prongs under California's unfair competition law.

Another factor which assisted in establishing EPL's fraudulent concealment was the fact that it had a "soft cap" on the profits that a franchisee's restaurant would be permitted to earn before EPL would open a competing restaurant. The FDD and franchise agreements represented that the "suitability of the Restaurant site and the success of the franchise business depends upon a number of factors outside of the Company's control including, but not limited to, the Franchisee's operational abilities, site location, consumer trends and such other factors that are within the direct control of the Franchisee." Yet, the *Bryman* court noted that "nowhere does El Pollo Loco disclose countervailing factors within El Pollo Loco's control, including that if, in El Pollo Loco's estimation, the franchisee becomes successful enough to achieve sales in excess of \$50,000 per week, then El Pollo Loco would endeavor to place a competing restaurant in an adjoining trade area and thereby diminish that success." This failure consisted a violation of California's unfair competition law.

c. Unconscionability of Franchise Agreements

EPL relied on a "reservation of rights" clause in justifying its conduct of building corporate stores that encroached on the Brymans' protected territory. The clause read in relevant part, to allow EPL to "open and/or operate, restaurants in the immediate vicinity of or adjacent to the [franchisee's] Restaurant." Prior to trial and upon the parties' motions

for summary judgment, the court determined that the provision was unconscionable and unenforceable to the extent that it purported to permit EPL to place a corporate restaurant “in the immediate vicinity of or adjacent to the [franchisee’s] restaurant.” This precluded EPL from using the “reservation of rights” clause as a defense at trial.

The *Bryman* court’s analysis of the “reservation of rights” clause for unconscionability is particularly helpful in the franchise context given the common standard form franchise agreements that are presented to franchisees on a take-it or leave-it basis. California courts like many others analyze contract provisions for both procedural and substantive unconscionability. *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1280 (9th Cir. 2006). In California, the “prevailing view” is that procedural unconscionability and substantive unconscionability need not both be present to the same degree. *Id.* (quoting 15 Williston on Contracts § 1763A, at 226–27 (3d ed.1972)) (“Essentially a sliding scale is invoked which disregards the regularity of the procedural process of the contract formation ... in proportion to the greater harshness or unreasonableness of the substantive terms themselves.”) “In other words, the more substantively oppressive the contract term, the less evidence of procedural unconscionability is required to come to the conclusion that the term is unenforceable, and vice versa.” *Id.* Procedural unconscionability analysis on the basis of oppression looks to the inequality of bargaining power that results in no real negotiation and the absence of meaningful choice. *Id.* Because unconscionability is a contract defense, the party asserting the defense bears the burden of proof. *Sonic II, supra*, 57 Cal.4th 1109, 1148 (2013).

Generally, the threshold inquiry in California’s unconscionability analysis is whether the agreement is adhesive. *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1281. Certain jurisdictions like California have long recognized that franchise agreements have some characteristics of contracts of adhesion because of the “vastly superior bargaining strength” of the franchisor. *Id.* at 1282 (internal citation omitted). “The relationship between franchisor and franchisee is characterized by a prevailing, although not universal, inequality of economic resources between the contracting parties.” *Id.* (citing *Postal Instant Press, Inc. v. Sealy*, 43 Cal. App. 4th 1704, 1715 – 1716 (1996)). “The agreements themselves tend to reflect this gross bargaining disparity. Usually they are form contracts the franchisor prepared and offered to franchisees on a take-it or leave-it basis. When such contracts so one-sided, with all the obligations on the franchisee and none on the franchisor, it may be deemed legally unenforceable. *Sealy*, 43 Cal. App. 4th at 374.

In *Bryman*, the court noted that even though certain basic terms may be negotiated (i.e. length of renewal term), this does not mean the agreement was not one of adhesion as to the other “boilerplate” provisions that made up the bulk of the franchise agreement. Reasonable inferences that a contract is one of adhesion included whether the “boilerplate” terms are the same in all franchise agreements offered nationwide. Put another way, even if the franchise agreement was not deemed a contract of adhesion as to each and every term, this would not end analysis of unconscionability as to the contractual terms at issue. The *Bryman* court noted that under Cal. Civ. Code § 1670.5,

courts have the power to determine whether a contract or a clause contained therein was unconscionable at the time it was made by considering the “commercial setting, purpose, and effect” of the terms at issue.

Substantive unconscionability focuses on the terms of an agreement and whether those terms are so one-sided as to shock the conscience. See *Abramson v. Juniper Networks, Inc.* (2004) 115 Cal.App.4th 638, 657. The *Bryman* court found that the provision, which permitted unfair competition as a matter of law, to be so one-sided as to shock the judicial conscience. Some of the factors considered by the court were the lower cost structure for a company restaurant than a franchisee (i.e. no continuing royalties or franchise fees) and EPL’s access to a franchisee’s confidential sales data. This placed EPL at such a competitive advantage (when it opened its company stores) as to constitute unfair competition and implicate anti-trust principles.

Procedural unconscionability focuses on the manner in which the contract was negotiated and each parties’ bargaining power at such time. An element of either oppression or surprise must be demonstrated. The surprise element arises when the disputed terms are hidden in a lengthy preprinted text by the party seeking to enforce them but where an adhesive contract is oppressive, no surprise element is required to be shown. See *Keating v. Superior Court*, 31 Cal.3d 584, 593–594 (1982), *overruled on other grounds by Southland Corp. v. Keating*, 465 U.S. 1 (1984) (finding that standard franchise agreements imposed and drafted by the party with superior bargaining power on a take or leave it basis were contracts of adhesion and that “[C]alifornia Legislature has determined that franchisees are in need of special protection in dealing with franchisors.”). Further, even if a franchisee is highly sophisticated, whether it be from a business standpoint or strictly financial, this is not determinative of procedural unconscionability. *Nagrampa v. MailCoups, Inc.*, 469 F.3d 1257, 1283 (9th Cir. 2006) (“[T]he potential availability of other franchise opportunities alone does not defeat [a party’s] claim of procedural unconscionability” nor does “the sophistication of a party, alone, cannot defeat a procedural unconscionability claim.”). In *Bryman*, due to the degree of substantive unconscionability of Section 23.13, the Brymans only needed to establish a negligible amount of procedural unconscionability, which was easily met.

d. Remedies: What Does a Franchisee Stand to Gain?

Franchisees have a variety of available remedies, including monetary damages, injunctive relief and rescission. Franchisees may also be entitled to restitution, declaratory relief and specific performance. Sometimes, a franchisee simply wants to turn the clock back and make it as if they never entered into the franchise system to begin with. Fourteen states permit rescission and relief through restitution.⁵³ Often, rescission is permitted when the franchisor has failed to provide the required disclosure document or if the information contained in the disclosure document is false or misleading. The particular relief available to a franchisee may depend on whether there is a choice of law

⁵³ See, e.g., Cal. Corp. Code § 31300 (2004); Fla Stat. § 817.416 (3).

provision contained in the franchise agreement and whether such a provision will be deemed enforceable. After litigation commences, litigants sometimes look for an exit strategy. Litigation is expensive and a franchisee who has already made a significant investment in the brand wants to consider the upside of a fight with the franchisor, which may ultimately end their relationship.⁵⁴ A brief look at what the Brymans stood to gain is illustrative.

The claims asserted in *Bryman* resulted in violations of California's Unfair Practices Act and California's unfair competition law. The scope of punishable conduct under the Unfair Practices Act is narrower, focusing on protecting the public "against the creation or perpetuation of monopolies and to foster and encourage competition by prohibiting unfair, dishonest, deceptive, destructive, fraudulent and discriminatory practices by which fair and honest competition is destroyed or prevented. However, the consequences can be quite severe and include criminal sanctions. A prevailing plaintiff may be entitled to treble damages and attorneys' fees. *Cel-Tech Commc'ns, Inc. v. Los Angeles Cellular Tel. Co.*, 20 Cal. 4th 163, 179 – 181 (1999). In contrast, California's unfair competition law punishes a broader scope of conduct but generally limits remedies to injunctive relief and restitution.⁵⁵ The unfair competition law is independent of the Unfair Practices Act and other laws and its remedies are cumulative.

As for monetary damages, the jury awarded lost opportunity and impact damages in the amount of \$8,837,806, with respect EPL's conduct as to the 20th Street and Costco Center stores. The injunctive relief was a unique and defining aspect of the *Bryman* award. EPL was enjoined from, *inter alia*, the foregoing conduct (i.e. failing to disclose the franchisee's protected territory, using a mechanism to calculate the Notification Radius that is biased and improper, failing to include the sales volume of a restaurant that would cause EPL to facilitate opening a competing restaurant, failing to include a description of the geographical areas that are to be developed by franchisees and that reserved by EPL, including any provision in any FDD or franchise agreement that purports to permit EPL from constructing a corporate store in the immediate vicinity of any franchisee's store).

⁵⁴ Cost of litigation, and whether you can shift the cost to the opposing party, is generally a factor to consider at all stages of litigation. While franchise agreements may provide for recovery of attorneys' fees and costs, not all agreements permit such recovery. Franchise agreement that contain one-sided fee provisions that expressly permit recovery by only one party, generally the franchisor, are often interpreted to be reciprocal. Franchisees may be able to collect attorneys' fees under a state statute, where they are deemed a prevailing party. In consideration of such claims, franchisees must be cognizant that franchisors may also be able to recover attorneys' fees if they successfully defend claims. *HRCC, LTD., v. Hard Rock Café International (USA), Inc. et al*, 614CV2004ORL40KRS, 2018 WL 1863778, at *1 (M.D. Fla. Mar. 26, 2018) (awarding attorneys' fees and costs under Florida's Deceptive and Unfair Trade Practices Act).

⁵⁵ "Because Business and Professions Code section 17200 is written in the disjunctive, it establishes three varieties of unfair competition—acts or practices which are unlawful, or unfair, or fraudulent. 'In other words, a practice is prohibited as "unfair" or "deceptive" even if not "unlawful" and vice versa.'" *Podolsky v. First Healthcare Corp.* (1996) 50 Cal.App.4th 632, 647, 58 Cal.Rptr.2d 89, quoting *State Farm Fire & Casualty Co. v. Superior Court*, *supra*, (1996) 45 Cal.App.4th at 1093, 1102, 53 Cal.Rptr.2d 229.

The injunctive relief essentially precluded EPL from selling any additional franchise stores until it took certain remedial measures to provide adequate disclosure in its FDD and franchise agreements.

III. Conclusion

The outcome in *Bryman* demonstrates how a franchise disclosure deficiency, among other things, can be transformed and culminate in a landmark decision for franchisees. The plaintiffs in *Bryman* had the benefit of utilizing California's franchise protection. Although several other states also cater to protect franchisees, this is an important consideration when negotiating a franchise agreement and determining where best to operate a franchise location.